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Reporting *Your* Rental Activities

More and more individuals are purchasing real estate as an investment and for rental purposes.

Others may rent out a portion of their home to supplement their income. In either case, the rental income and expenses must be reported for tax purposes, so it is important to know which expenses may be deducted, which should be capitalized, and which other considerations may be made.

Current or Capital Expenses?

It is important to determine whether an expenditure is of a current or capital nature, because that will determine the tax treatment of the expense.

Current expenses are generally those of a recurring nature or that may be incurred simply to keep the property in the

same condition as when you acquired it. Current expenses can generally be deducted from rental income in the year they are incurred. Examples of current items would include such expenses as advertising your property for rent; the current year's insurance costs; mortgage interest incurred to acquire or improve the property; maintenance and repairs; utilities; management or strata fees; property taxes; and many more.

Capital expenditures are those that improve the property beyond its original condition or that extend the useful life of the property. Generally, capital expenditures cannot be deducted in the year you incur them; their cost can be deducted over a period of years as capital cost allowance. Examples of capital costs would include the cost of acquiring the property; land transfer tax on acquisition; additions to the building; purchase of appliances and equipment; and many other expenditures having an enduring benefit. To help clarify the difference between current and capital expenditures, consider the following questions.

Question: Current or Capital?	Answer
We refinished the main floor of our rental property by replacing the carpet with hardwood. Can we write it off?	No. Replacing carpet with hardwood is clearly an improvement beyond the floor's original carpeted condition. Therefore, this is a capital expense.
What if we just replaced the old worn carpet with a similar-quality new carpet?	This would generally be considered repairs and maintenance, deductible in the year occurred.
We repainted the exterior of the rental property and it cost about \$5000. Can we write this off, too?	Yes. This type of expense, which simply restores the property to its original condition, is generally considered a deductible current expense.
We purchased a new stove for the rental property. It was the same quality as the old one.	The cost of replacing a separate asset within the property is a capital expense, i.e., the stove is not part of the building.

A few other expenses that you cannot deduct include the principal portion of your mortgage payments, any penalties assessed by Canada Revenue Agency (CRA), and the value of your own labour.

Renting a Part of Your Home

If you rent a part of your home, you must deduct only a reasonable amount of the related operating expenses, i.e., you may not deduct the portion of expenses that relate to the personal use of your home. This would include any expenses that relate specifically to the rental activity, plus a share of general operating expenses allocated on some reasonable basis. An allocation based on area, i.e., square footage, used for personal vs. rental use would generally be considered reasonable. Other reasonable methods may also be considered, however.

When renting part of your home, other important issues should also be addressed. For example, are you jeopardizing your claim for the principal residence exemption? Has your activity resulted in a “change in use” of your property (or part of your property) that potentially could be considered a taxable transaction? While this article is not intended to address these issues [see Kathryn’s article in *The Scrivener*, Vol. 13, No. 2, June 2004], they are simply raised here to remind you they must be considered.

Reporting Your Rental Activity

For individuals, your rental activity should be reported on your personal tax return using the schedule T776. This form is basically an income statement for your rental operation; it lists the revenue and expenses reported. A sample of this rental statement can be found on CRA’s Website at cra-arc.gc.ca.

You should also maintain well-documented records to support your claims for expenses and to confirm the amount of rental income received. Such records would include a copy of your lease agreement with your tenant or, if no formal lease is in place, clear evidence of the amount of revenue received, original receipts and evidence of payment for all expenses

incurred, and any other supporting documentation.

Although your rental activity may result in a net loss, as long as you incurred the expenses to earn rental income, this loss may provide you with a tax benefit. Rental losses may generally be deducted against any other income you report on your personal tax return.

The specific circumstances of your own rental activities should be considered before conclusions are drawn.

Be aware that in the event of review by CRA, rental expenses can be disallowed if sufficient documentation is not available to support your claims. In addition, if you have not reported the fair market value of your rental income, you may not claim the corresponding expenses. That situation may arise when a family member pays rent to you, but at a lower rate than the market would normally bear.

Further, if ongoing losses are realized by the rental activity over an extended period of time, the risk of CRA’s disallowing the losses may exist if there is deemed to be no reasonable expectation of profit.

Caution

This article is not intended to be a definitive guide to reporting your rental activities. The specific circumstances of your own rental activities should be considered before conclusions are drawn. In some circumstances, special rules may apply for tax purposes that could leave you with an unexpected tax result. We recommend that anyone commencing a rental activity or planning a change in that activity should first consult his or her tax advisor. ▲

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