Renting Out Your U.S. Property

Authors: Jeff Pniowsky

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Reduce the Risk of an Adverse Audit

If you are buying a property in the U.S. with the intention of renting it out, you should be aware of the potential pitfalls in deducting expenses and using rental losses to offset other income.

If this is your first foray into a foreign jurisdiction, you should know that as long as you remain a Canadian resident, you must report your worldwide income in Canada (you will also have to report in the U.S., but you will be entitled to tax credits for taxes paid in the U.S. so that you are not double taxed). As such, Canadian tax laws apply to your foreign held property.

Canadian taxpayers generally know that we cannot deduct personal expenses from our income. The policy underlying expense deductibility in the Income Tax Act is to only allow deductions for businesses or income producing property (with some limited exceptions for employment income). Those who own businesses or income producing property are able to deduct reasonable expenses from income if they can show that they were:

1. actually incurred, and
2. incurred for the purpose of earning income from that business or property.

Proving the former is usually a simple process of keeping one’s receipts, log books or other source documents showing the amounts that were expended. As for showing an income earning purpose, in most instances this will be self-evident. A construction company buying lumber, an advertising company paying its office staff or a law firm buying legal texts are all obviously valid business expenses.

However, in situations where personal and business interests are intermingled, the issue is less clear. Where there is a material personal element to an enterprise, the burden on the taxpayer to prove an income producing purpose becomes weightier. This is particularly so where the enterprise generates losses which the taxpayer seeks to offset against other sources such as employment income. Not only will particular expenditures be more closely scrutinized, the entire enterprise will be examined to determine whether it is actually a business for income tax purposes. If a business (or income property) is found not to exist, the entire loss will be denied.

In the seminal Supreme Court of Canada decision of *Stewart v. R. 2002 S.C.C. 46*, the court distinguished businesses which had the ordinary trappings of a commercial enterprise from those having a personal or hobby type aspect to them. The Court held that it was generally not appropriate for the CRA to question the existence of a business simply because it was not generating profits. However, where there is a personal element, the court will enquire as to whether it is being operated in a sufficiently commercial manner. Part of that enquiry will include the profit and loss history including a determination as to whether there is a reasonable expectation of profit.

Does your property have a material personal element? Property located in vacation destinations where there appears to be an intention to use it personally by you or family members are typical ventures called into question by the CRA. For example, in*Quinn v. R. 2003 T.C.C. 423*, the taxpayers bought a portion of property at Hilton Head, South Carolina and claimed losses from the property for a number of years. The CRA denied the losses on the grounds that the property was personal and not a business. The court sided with the CRA and denied the taxpayers losses, finding that they did not prove that they made a serious attempt to profit from the property. In this case, the taxpayers never showed a profit in ten years, used the property almost 40% of the time, relied on “word of mouth” to rent it out, failed to have a formal business plan and scheduled the rentals around their personal time.

The lesson to be drawn from the case above is that if you plan to treat the enterprise as an income producing asset and wish to deduct a significant portion of the expenses such that losses may accrue, you should act as if the property is a business and not a personal vacation home. The following are some of the indicia courts have looked to when examining this issue:

- existence of business or marketing plan, with projections or pro-formas;
- concrete steps taken to carryout the business plan;
- trappings of a business - business name/number, business cards, formal advertisement;
- history of income/losses - does property have a reasonable expectation of profit, is there a history of losses; and
- is the above appropriately documented.

The greater the personal element the more scrutiny will be placed on the above factors. If the property has been used personally only a fraction of the time with the remainder leased to tenants, then the risk is less. Conversely, those who seek to have it both ways - using it themselves for significant periods, while also claiming it is a business - run the risk of the CRA declaring the property personal in nature.

There are no hard and fast rules, no black and white determinations - only various shades of grey. Being aware of the risks and taking appropriate steps ahead of time allows you to be much better prepared to withstand the scrutiny of the CRA if your property is one day subjected to an audit

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