Should you Incorporate your Real Estate Holdings?

From a tax and a non-tax perspective there are pros and cons to incorporating real estate holdings and it may even be more beneficial to consider alternative ownership structures, like a partnership. This article is directed mainly to persons who hold real estate but who are not in the business of purchasing and selling real estate and who do not carry on a real estate management business.

Generally speaking, the advantages of incorporating a business include:

- **Lower tax rates**: If a corporation qualifies for the "small business deduction", the first $200,000 of its income is taxed at roughly 19%. This is advantageous because income reported personally is taxed as high as 46% combined federal and provincial, depending on a person's income level. There is a significant tax-deferral advantage to earning active business income in a corporation so long as the income is retained in the corporation.
- **Limited liability protection**: Given that for legal purposes a corporation is considered a legal entity distinct from its owners, the owners of the company are generally not responsible for the liabilities of the company. This is known at the "corporate shield".
- **Capital gains exemption**: An individual who sells "qualified small business corporation" shares can benefit from the access to the capital gains exemption available on the disposition of these shares. This exemption provides that capital gain made on the sale of shares of up to $750,000, in your lifetime, will not be taxed.

The above listed advantages may not be beneficial to a person who simply holds real estate on which they are earning rental income. On the other hand, these would be beneficial to a person who is in the business of purchasing and selling real estate or who runs a management company. The following will outline why the above items may not be relevant if you simply hold real estate:

- **Lower tax rates**: Income from real estate is generally income from property and not income from business and therefore is not eligible for the "small business deduction". The advantage of incorporating to use the "small business deduction" will only be applicable if the operation is earning income from business. For example, if a person buys, renovates and sells real property, the person will likely be considered to be earning income from business and therefore eligible for the small business deduction. On the other hand, if the person earns income from simply holding the real estate, like rental income, the person would not be eligible for the small business deduction and would not benefit from lower tax rates.[1]

- **Limited liability protection**: If a person owns the real estate along with several other people, he or she may want to consider incorporating to benefit from the "corporate shield". Otherwise, given the complexity and costs of incorporating, obtaining proper insurance may be sufficient to provide protection from potential liabilities.
- **Capital gains exemption**: Again here, to be eligible for the capital gains exemption, the corporation must be an active business which means earning business income and not rental income.

Before thinking of incorporating ones real estate holdings, a person should also consider the use of losses. Tax deferral and tax savings are of a benefit only if a corporation is profitable. If real estate investments held through a corporation are not profitable and generate tax losses, such losses accumulate in the corporation and are not available to an individual shareholder to deduct against his or her other sources of income. Therefore if a person is considering incorporating, he or she may want to postpone the incorporation until the activity becomes profitable. This way the losses can be used against other sources of income. Furthermore, while thinking of incorporating, consideration must be given to the land transfer tax liability that will arise as a consequence of the transfer of the assets to a corporation. This tax could be substantial.

Instead of incorporating, especially if the above listed advantages would not be of any beneficial, an alternative structure would be creating a partnership. Some of the advantages of establishing a partnership include:

1- creating a limited partnership can provide limited liability protection;
2- losses in a partnership, while calculated at the partnership level, are flowed through to the partners of the partnership; and,
3- assets can be transferred in and out of a partnership (if transferred to a corporation) on a tax deferred basis.

In summary, for owning real estate, it may be more beneficial to own it personally, through a corporation or through a partnership and sometimes the best solution may be to use multiple structures. It is advisable to consult a professional to discuss your goals and options in order to come up with the best possible structure for you.

[1] Exceptions may apply, however, if in holding the real estate you employ more than five (5) full-time employees.