TAX ALERT

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To deduct or not to deduct; that is the question

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Owning property for the purpose of earning rental income creates benefits and challenges. Property owners incur a variety of expenditures in order to earn rental income and maintain property value. Since not all expenditures are treated equally for tax purposes, it is important to be aware of the tax implications when incurring such expenditures in a rental property business.

An expenditure incurred for the purpose of earning income from business or property can be categorized as a current expense or a capital outlay. This categorization will impact the timing of the deductibility of the expenditure, since current expenses normally may be deducted the year in which they are incurred, whereas capital outlays normally are deducted as a capital cost allowance over a number of years.

So, when is an expenditure a capital outlay or a current expense? The answer is not as straightforward as one might think.

The Canada Revenue Agency has published guidance to assist taxpayers in determining if the expenditures they incur for repairs and maintenance are capital outlays or current expenses. Several key guidelines apply to the analysis.

Does the expenditure provide a lasting benefit?

Capital outlays generally provide long-term benefits to a property that will be used for a number of years. Conversely, expenditures that recur on a frequent or short-term basis are considered current expenses. For example, installing vinyl siding on the exterior walls of a wooden property provides a long-term benefit to the property and thus is a capital outlay. In contrast, paint on the exterior of a wooden house typically requires regular maintenance and re-painting on a short-term basis, therefore it represents a current expense.

Does the expenditure maintain or improve the property?

A capital outlay generally improves the property. Repairing or replacing a part of the property beyond its original condition generally is considered an improvement to the property and a capital outlay. Only restoring a part of the property to its original condition generally is considered a current expense. For example, repairing rotten or broken boards on a wooden fence restores the fence to its original condition, thus representing a current expense. Replacing the wooden fence with a vinyl fence is an improvement and a capital outlay.

Is the expenditure for a part of the property or for a separate asset?

Many properties are rented with household appliances included for the occupants to use. These appliances are considered separate assets from the property and, as such, their purchase (a new refrigerator, for example) is a capital outlay. Current expenses generally involve repairs to an integral part of the building that cannot be separated. Electrical wiring, for example, is an integral part of a building, so expenses for repairing or replacing wiring can be claimed as a current expense as long as the work does not improve the property beyond its original condition.

What is the relative value of the expenditure to the value of the whole property?

A capital outlay generally carries a high dollar value in relation to the value of the whole property and/or in relation to previous average maintenance and repair expenditures. In contrast, current expenses are those that carry lower dollar values in comparison to the total value of the building and/or are consistent with yearly repair and maintenance expenses.

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In addition to the above guidelines, there are special situations that can impact the analysis of whether an expenditure is a capital outlay or a current expense.

Buying used property

Expenditures incurred to repair or renovate a used property to make it suitable to rent represent a capital outlay. For example, when buying an older home for the purpose of earning rental income, repairs to the electrical wiring prior to renting the home to a tenant are a capital outlay.

Selling your property

Repair expenditures incurred prior to selling a property, or as a condition of sale are considered capital outlays. However, where the repairs would have been incurred in the normal course of owning and maintaining the property, regardless of the sale, they may not qualify as capital outlays.

When we analyze the various expenditures that are incurred during the course of owning property, for the purpose of earning rental or business income, the list can grow quickly. Though the guidelines above provide a basis to analyze expenditures, they are not all-inclusive. The facts and circumstances of each property and each expenditure can vary. Your Collins Barrow Advisor can help you determine whether your rental property expenses are current expenses or capital outlays.

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