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CESTNICK

TAX MATTERS

Changes could mean a high tax rate on short-term rental income

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We've been planning a trip to attend my niece's wedding this summer. My wife, Carolyn, was speaking with a guy who owns several short-term rental homes. "Do you want a home with a shower or a bath?" the man asked. Since Carolyn is always looking to save money, she asked, "What's the difference?" There was a pause, then the man replied, "Well, you need to stand up in the shower."

This guy's full-time vocation is renting out his homes. Late last year, draft legislation was introduced that changes the tax rules for people who own short-term rental housing. The new rules could create steep tax rates. Let me explain.

The rules

The government is concerned about the number of residential properties that are used for short-term rentals because these places restrict the supply of housing available for purchase or long-term rental, contributing to higher prices overall.

So the 2023 Fall Economic Statement proposed new rules – detailed in draft legislation released Dec. 20, 2023 – to deny tax deductions for short-term rentals where a taxpayer who owns a property is not complying with municipal or provincial rules.

Who is affected by these changes? You could be if you (1) own a residential property (2) offered as a short-term rental (3) that is non-compliant. A residential property is considered to be all or any part of a house, apartment, condominium, cottage, mobile home, trailer, houseboat or other property located in Canada. That's a pretty broad definition.

A short-term rental is one of the properties mentioned above that is offered for rent for less than 90 consecutive days. As for being non-compliant, this will include any property that is rented in a province or municipality that does not allow short-term rentals or where the jurisdiction requires a registration, licence or permit to operate a short-term rental and you don't comply.

So if you're caught renting out a non-compliant short-term rental property, what happens from a tax point of view?

You'll be denied a tax deduction for all or part of your expenses related to the property. The actual amount denied is equal to your total expenses for the property multiplied by a fraction, which is the number of days in the year that your property was non-compliant, divided by the total number of days the property was a short-term rental. Follow me?

Now, these rules came into effect Jan. 1, so if you're filing your 2023 tax return this month you don't have to worry about having expenses denied for 2023. But I wanted to write about this today because, if you're non-compliant, some or all of the expenses you've already incurred in 2024 could be denied when you file your tax return next year. If the clock is ticking on your non-compliance, you might want to get things in order now to avoid what could be a very high tax rate on your short-term rental earnings for 2024 and later years. Consider an example.

The example

Suppose you have a short-term rental property and halfway through 2024 your municipality bans short-term rentals. This means you'd be non-compliant for half the year. Let's also assume that you earn $80,000 in rent during 2024 and incur $50,000 of expenses, leaving you with $30,000 of profit. If you're in the highest tax bracket in Ontario in 2024, you'd pay $16,060 in taxes on that profit.

Under the new rules, however, part of your $50,000 in expenses will be denied since you were non-compliant for part of the year. The denied expenses will equal $50,000 multiplied by the fraction 183/366 (183 out of 366 days of non-compliance in 2024, a leap year, in our example). That is, one half, or $25,000 of expenses, will be denied. The result? Your taxable income from the rental is no longer $30,000, but $55,000 ($30,000 plus the $25,000 of denied expenses). The tax owing on $55,000 would be $29,442.

Did you catch that? Since your actual accounting profit was $30,000, and you're paying $29,442 in taxes, your effective tax rate is 98.1 per cent. It could easily exceed 100 per cent in many cases. Ouch.

The nuances

The good news? There's a transitional rule for 2024 that will deem you to be in compliance with local and provincial rules if you're required to have a registration, licence or permit and you're in compliance with this on Dec. 31, 2024.

Be aware, too, that you could face GST/HST in situations where you convert a property from a taxable short-term rental into an exempt residential property. Speak to a tax pro about this.

Finally, the rules allow the Canada Revenue Agency to reassess you without being limited to the normal reassessment period to deny your deductions. Sorry about that.

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