ARE YOU REALLY CUT OUT TO BE A LANDLORD?

Bounced cheques, leaky faucets and tricky tax laws can make you regret the day you became a landlord. We help you avoid the pitfalls and become a successful income property owner

By Julie Cazzin

When my mom and dad came to Canada from Italy in 1957, they had only one dream—to buy a home of their own. But after a few Sunday afternoons of real estate hunting in Toronto, they realized their meagre savings weren't going to go far. Then one weekend they stumbled upon a small, rickety duplex on bustling Claremont Street that was in much need of repair. It had a two-bedroom unit on the main floor and a one-bedroom unit on the second. It didn't take them long to figure out that, with rent payments coming in from one of the units, they could afford to buy and live in this modest property. So, with a small down payment—and a lot of elbow grease—they became landlords.

For the next 10 years, they dealt with a slew of tenants including a young nurse with a very active sex life, a carpenter with a roaring motorcycle and a university student with a pet iguana he carried around on his shoulder while doing the laundry. They eventually sold the duplex for a small profit and used the equity to buy a bungalow in the suburbs, and today they insist their days as landlords got them on the path to achieving their financial goals.

Most beginner landlords are inspired by my parents' story. And why not? Low interest rates and rising real estate prices are spurring Canadians to become landlords by renting out basement apartments, a second condo or small apartment building bought solely for investment purposes. But the sad truth is that just a few small mistakes can turn your landlord dreams into a nightmare. "When friends tell me they've bought themselves a rental property, I always say, 'Congratulations, you just bought yourself a business,' " says Deb Mattina, a former ➤

Illustrations by Tomer Hanuka

adjudicator with the Landlord and Tenant Board in Ontario. "Treat it like one."

While being a successful landlord means making sure the numbers work in your favour, it's also important to understand the other rules of the game, including landlord and tenant laws. "Good tenants are hard to come by," says Alan Silverstein, a real estate lawyer in Toronto who has witnessed his fair share of landlord dreams gone sour. "Laws require more and more of landlords all the time. You have to keep on top of it to come out ahead."

If you're considering becoming a landlord and want to know the secrets to making it a financial success, read on.

Pick a path to prosperity

There are several ways to become a landlord. You can rent out a part of your own home, such as a basement suite, or you can purchase a second place, in which case you'll need to decide if you want to deal with your tenants directly, or use a property management company. All the financial rewards are yours to keep if you deal with the tenants yourself, but you'll probably find yourself devoting a lot of time and energy to maintaining the property.

Just ask Milo Wu, a 31-year-old elementary school counselor in Vancouver. He and his wife Erica, 31, bought a bungalow in 2005. Wu had just read *The Automatic Millionaire* by David Bach and, as he tells it, was ready "to make real estate my piggy bank." But after just three years, the couple sold the bungalow because the endless stream of repairs was harming both their pocketbooks and their lifestyle. "It can be a ticking time bomb," says Wu. "If you're a hands-on landlord, any time the phone rings, it can be a tenant complaining about a leaky faucet or a plugged toilet. We wanted to be free of tenant complaints."

The lesson? "Landlording is not a passive investment," says Silverstein, the real estate lawyer. "You have to nurture it to make it worth your while. If you're not up to doing that, don't become a landlord."

Being a landlord can put a strain on your relationship, too. "You have to be a united front as a couple if you plan to become landlords," says Lenore Davis, a fee-only adviser with Dixon, Davis and Co. in Victoria. "It's not the financial stuff that ruins a couple, it's the emotional stuff." Her solution? "I have couples write down their long-term financial goals separately. Then we talk it through. Usually 20% of couples aren't on the same page with landlording and need to consider other investment options."

There are plenty of reasons for that disconnect. One partner may not be comfortable with carrying a lot of debt, or may not want their free time impinged upon by tenants. Whatever the reason, you and your spouse have to find a compromise before taking your first step.

Handing over the responsibility of maintaining your place to a property management company certainly helps reduce the amount of work. You don't have to deal with tenant issues and rent collection, but the downside is it will cost you up to 10% of the revenue—plus you're still on the hook for maintenance costs and missed rent.

Another option is to buy a condo for the sole purpose of renting it out. In that case, the maintenance fees will take care of some upkeep, so there's less responsibility on the owner. This has worked well for Wu, who currently owns a rental condo that he says requires no hands-on work.

> "DON'T COUNT ON RISING PROPERTY VALUES TO MAKE MONEY. THAT'S JUST SPECULATION"

Once you find what works for you, the key is holding your property for the long haul—at least 10 years—to increase your chances of financial success. "Ultimately, money in real estate is made not by timing the market," says Tom Karadza, a real estate agent with Rock Star Real Estate in Toronto. "The money is made by time *in* the market." So plan to hold on to your rental property long enough for it to pay off.

Find the perfect property

Start your rental property search by looking at cities with good job and population growth so there's a large pool of tenants to pick from. Right now, good opportunities exist in Edmonton, Calgary, Halifax and Barrie, Ont. For instance, Barrie is considered a good market because its population is growing quickly and many new arrivals are still renting after three years, so there are lots of potential tenants.

Also build a team of professionals to help you, including a good real estate lawyer, tax accountant and mortgage broker. Read books on how to buy rental property and ask friends and family to share their own landlording experiences with you.

Ultimately, the best property for you might be your own home. "Learn the ropes with a basement apartment," says Silverstein. "Your losses are limited and you'll get a good idea about tenant demands."

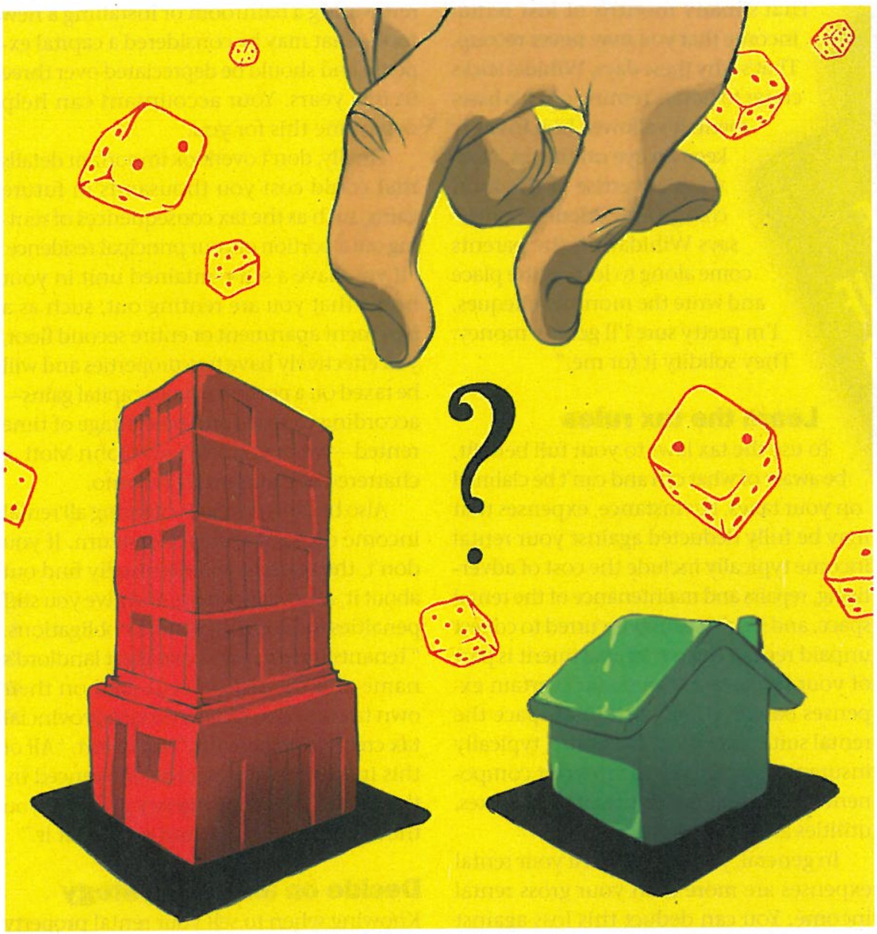
Figure out what you can afford

Based on the down payment you have available, what can you afford to buy? Keep in mind that in Canada small rental properties of one to four units require a minimum down payment of 20% to qualify for a Canada Mortgage and Housing Corp. (CMHC) insured loan. How would affordability change if you increased your down payment? Don't forget to factor in real estate closing costs and other financial commitments that you have in life—things like a new car, medical bills or daycare costs.

Of course, some investors are so keen to get in the game that they'll put just 5% down on a property, or they'll use credit card cash advances to scrape together a down payment. Don't do it. "Lenders want you to have some skin in the game," says Marc Lamontagne, a fee-only adviser with Ryan Lamontagne Inc. in Ottawa. "So down payments under 20% for investment properties are rare. Lenders don't want to be left on the hook if cash flow turns negative."

Run the numbers

Before buying anything, ask yourself whether you can still make money, given that prices in many parts of Canada are at seven-year highs. "There's more than one way to assess a property, but ensuring that it's cash-flow positive from



day one is the ideal," says Lamontagne. "Don't count on appreciation in price for your investment return. That's just speculation."

Once you know your down payment, it's time to look at what rents and expenses will be like for the properties you are considering. That means looking at total annual rental income less all expenses (typically mortgage interest, property taxes, insurance and utilities). Put all of this information into a cash flow statement, and the number you get when you subtract expenses from income will show either a positive cash flow (meaning you're making money) or negative cash flow (you're losing money).

Some investors will argue that it's fine to lose a bit of money each month because the tenants are paying your mortgage. But this line of thinking is a slippery slope to losses, because there will be items you can't control—like rising mortgage rates, major repairs and unpaid rents—that can cost you thousands. "You have to think of it as you would any small business," says Silverstein. "If a small business is in the red, that's not a good thing, and neither is it for a rental property—whether tenants are paying your mortgage or not."

The one thing that often trips up landlords is unforeseen expenses. To minimize that risk, budget 2% of the purchase price of your property for maintenance and repair costs. So if the property you bought costs $300,000, you should add $6,000 a year for repairs to your annual expense budget to get a more accurate cash flow projection. Otherwise, losses can mount quickly.

Also make sure you beef up your rainy-day fund. "The biggest mistake I see people make is failing to recognize that you need reserves," says Ross McCallister, a property manager in Arizona. "They stretch their finances too far and then, when a tenant doesn't pay for a month or two or three, it becomes emotional and pinches the family's lifestyle."

Alen Majer, a sales trainer in Toronto, learned that the hard way. Majer first became a landlord in 2006 when he bought a 600-sq-ft one-bedroom condo in Mississauga, Ont., for $165,000 for the sole purpose of renting it out. "I liked the idea of buying a property while someone else paid the mortgage," says Majer. But even though the property started out with positive cash flow, it soon turned negative when the condo management unexpectedly raised monthly maintenance fees by 15% to $428 a month. "That's when our cash flow started to suffer," says Majer, who found he had no emergency cash for a much-needed stove.

So, after owning the property for five years, Majer sold it, pocketing about $48,000 after taxes and expenses. "Based on an initial investment of $25,000, our investment did well over those five years," says Majer. "But we knew that being short $50 a month can quickly turn into a $100-a-month loss, which can become $150. As a landlord you need to be vigilant about maintaining that positive cash flow."

Majer says he learned his lesson and is more prepared with his second foray into landlording—a condo in Toronto. "I built a financial safety cushion of a few thousand dollars right into my cash flow calculations," says Majer. "If mortgage rates go up, as they're bound to do in the near future, I'll be covered."

Know the law

Learn about landlord and tenant laws in your province to ensure you're prepared in case things go wrong—and they will. The three most common types of disputes from a landlord's perspective are non-payment of rent, persistent late payments, and unruly behaviour or damages. Each has a separate form that has to be filed to the Landlord and Tenant Board to get your case heard. "I tell all landlords to be consistent and not to get emotionally involved," says Toronto paralegal Cathy Corsetti. "Those are the messiest cases. When they go sour, they really go sour."

By far the biggest reason landlords go to Landlord and Tenant Court is for arrears of rent. "Tenants can be pretty savvy when it comes to excuses for why they haven't paid the rent," says Corsetti. "They've had their wallet stolen, a cheque is late." Corsetti advises landlords to stick to the rules and not be swayed by emotional pleas for exceptions.

You can minimize problems by doing a check on all potential tenants. That means calling their employer as well as two of their previous landlords. Be careful though, because some tenants will put down the names of friends and family as references, hoping you won't dig deeper. Others may even give photocopies of fraudulent credit scores and bank statements in the hope of hiding their bad tenancy record. "There are professional renters out there," says Mattina. "Once they're in, they don't pay the rent. Then it's up to you to evict them and get the rent money. That can be a challenge because these ➤

IT'S EASY FOR THE TAXMAN TO FIND OUT IF YOU HAVE UNDECLARED RENTAL INCOME

renters know the law and will do everything they can to stay without paying."

As soon as one of your tenants doesn't pay the rent, serve them notice in writing. If rent is to be paid on the first of the month, in most provinces you can legally file notice on the second. (Although many landlord and tenant laws are the same across Canada, check with your own province's Tenancies Act or Landlord and Tenant Board for the specifics.) Usually the tenant then gets 14 days to pay the full amount owing. If they don't pay, the landlord can file an application for a hearing three weeks later. "Always, always serve notice on the first day you can," says Mattina. "Once you apply, the clock starts ticking. You can change your mind if they come through with the rent, but serve the notice. The longer you take to file it, the longer it will take to get your money."

Whitney Wihidal, a chiropractor and landlord in Orillia, Ont., is pragmatic about rent arrears and evictions. He owned a 14-unit apartment building with his brother-in-law for several years before selling it in 2009 for about the same price he'd paid for it. "There were always a couple of tenants I had to chase down for the rent, and one or two in the process of being evicted every month," says Wihidal. "Cut your losses by knowing the law."

But even if everything goes in your favour, it can still take anywhere from three months to a year to get a tenant evicted. That's many months of lost rental income that you may never recoup. That's why these days, Wihidal sticks closer to home, renting out his basement. It's allowed him to easily keep an eye on things. "I always advertise at the local college for student tenants," says Wihidal. "If the parents come along to look at the place and write the monthly cheques, I'm pretty sure I'll get my money. They solidify it for me."

Learn the tax rules

To use the tax laws to your full benefit, be aware of what can and can't be claimed on your taxes. For instance, expenses that may be fully deducted against your rental income typically include the cost of advertising, repairs and maintenance of the rental space, and legal expenses incurred to collect unpaid rent. If the rental apartment is part of your home, you can deduct certain expenses based on the portion of space the rental suite takes up in the house, typically insurance premiums, the interest component of mortgage payments, property taxes, utilities and landscaping.

In general, you have a loss if your rental expenses are more than your gross rental income. You can deduct this loss against your other sources of income. So, for instance, if you made $10,000 in rent, and expenses were $4,000, then $6,000 will be added to your taxable income for the year. At the 40% tax bracket, you would pay $2,400 in taxes on that rental income. If, instead, your expenses exceeded your rental income by $6,000, this amount is subtracted from your other sources of taxable income, like your salary. So if you paid taxes on all your other income throughout the year, you would get a refund of $2,400.

Some expenses may not be fully deductible in the year they're incurred: they may have to be amortized over several years at prescribed rates. These are called capital expenses, and the method of deducting them over time is referred to as depreciation, or capital cost allowance (CCA). The distinguishing feature of a capital expense is that it has an enduring value that benefits the current as well as future years, such as renovations and major appliances.

If you incur expenses to bring a property back to its original condition—for example, painting and grouting—the expenses should be fully deductible in the year incurred. If, on the other hand, you enhance the original condition of the property—say, by renovating a bathroom or installing a new roof—that may be considered a capital expense and should be depreciated over three to five years. Your accountant can help determine this for you.

Finally, don't overlook important details that could cost you thousands in future gains, such as the tax consequences of renting out a portion of your principal residence. "If you have a self-contained unit in your home that you are renting out, such as a basement apartment or entire second floor, you effectively have two properties and will be taxed on a portion of your capital gains—according to space and percentage of time rented—when you sell," says John Mott, a chartered accountant in Toronto.

Also be diligent about claiming all rental income on your annual tax return. If you don't, the taxman will eventually find out about it, ask for back taxes and give you stiff penalties for dodging your tax obligations. "Tenants have to put down their landlord's name and the annual rent paid on their own tax forms to receive certain provincial tax credits and benefits," says Mott. "All of this info can easily be cross-referenced by the Canada Revenue Agency and cost you thousands when they find out about it."

Decide on an exit strategy

Knowing when to sell your rental property is easy if you have a long-term financial goal. Do you want to hold on to your property for a source of income in retirement? If not, then one exit strategy may involve selling sometime in your 60s. "If you're close to retirement, take advantage of good market conditions," says Thomas Venner, a financial planner in Hamilton, Ont. "Take your profit and stuff it in annuities for your later years."

Or you may have a more immediate goal for your rental gains. Gord Radman and his wife Rossana certainly do. Eight years ago, the Burlington, Ont., couple purchased a 1,300-sq-ft townhouse that they've rented out. The property has been cash flow positive since day one. With three kids aged 15, 13 and 11, the Radmans plan to sell and tap into what will be close to $200,000 of equity in the townhouse in five years. The goal? To pay for their children's post-secondary education.

"The kids' RESPs will fund some of their education, but we've always known it would never be enough," says Gord. "The equity from the townhouse will fully fund the rest. Instead of getting a Ferrari or buying a bigger house, the money will go to the kids' schooling. That's always been the plan and we aim to stick to it." M