# Can you avoid capital gains tax?

**Your home can be an effective tax shelter, but other forms of real estate can attract capital gains taxes. Here's what you need to know about some of the more nuanced real estate scenarios.**

By Romana-King-Blog | Online only, 1/05/13
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When you buy real estate you expect that, over time, it will appreciate in value. If you sell that property for more than you paid, you will have an appreciable gain in value and this triggers a taxable capital gain for the Canada Revenue Agency (CRA).

According to my accountant, this isn't necessarily a problem. His

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rationale: If you owe tax it means you've made money. And capital gains are taxed at only half your marginal tax rate—one of the more favourable tax treatments offered by the CRA.

The real quandary, for most readers, is how to calculate this capital gains tax when the sale of the property is a tad more complicated than selling your principal home.

For that reason, I address some of the more interesting questions readers have sent regarding the sale of property and how to calculate the taxes owed on their capital gains.

(For more on the basics of the principal residence exemption and how the sale of property doesn't always produce a capital gain see my Home Owner column in the June 2013 issue of *MoneySense* on newsstands May 13.)

**Claiming investment expenses**

Recently a reader, who had bought and rented out a condo as an investment, asked if he could claim the condo's special assessment bill as an expense against the potential capital gains tax he'd owe once he sold the condo.

"He's mixing apples with oranges," says Albert Luk, lawyer with Devry Frank LLP, a Toronto-based law firm. You can't claim business expenses against a capital gain—you can only claim deductions against business income (or annual expenses against annual rental income). If you want to reduce your capital gain you need a capital loss—such as selling stock that dropped in value.

Every investor has to make a decision, says Luk, either claim expenses and report the sale as income, or eat the expenses and sell the property as an investment, enabling it to qualify for the preferential capital gains tax treatment.



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**I won a home!**

For the fortunate few, lottery wins are not taxable. That's great news for one reader who wrote in asking how to calculate the capital gains tax on the sale of a home they won in a regional lottery.

"If you don't already own a principal residence, the home can be sheltered from taxable gains through the principal residence exemption," explains Scott Plaskett, president of IRONSHIELD Financial Planning, a fee-only firm in Toronto's west-end.

If you already own a home, and decide to sell your winnings, the CRA will calculate your capital gains based on the difference in current market value of when you won the home versus when you sold the home. The longer you wait, the greater chance you'll owe capital gains tax.

"I had a client who won a home in the Princess Margaret lottery," says Plaskett. The client already had a principal residence and, though appreciative, wanted to sell the winning home quickly. The client sold and paid no tax, as the capital gain was almost nil from when he won to when he sold. "He was just tired of cutting the lawn."

**Renting out your basement**

Many readers want to know if their home will continue to qualify for the principal residence exemption if they rent out a portion of their house. Their concern is prompted by stories of people who lost this exemption after years of renting out their basement.

While it's true—you can lose your principal residence exemption—it really only happens if you rent out more than 50% of your home, or when you decide to claim capital cost allowance on the portion



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of your home that is the rental.

The CRA recognizes that, over time, depreciable property will become obsolete. Believe it or not, this also applies to real estate. Because of this you are well within your right to offset this loss in value by deducting the depreciation over a period of several years. This deduction is the capital cost allowance (CCA). However, if you claim CCA on your home, you are effectively telling the taxman that this property is used to produce income, and you use lose the opportunity to claim a capital gain, which is taxed much more favourably than income.

But what if you buy a duplex or fourplex and live in one unit while renting out the others? Can you deduct costs, including CCA, to offset the rental income you collect each year and still claim a principal residence exemption? Yes: but you'll need to clearly document what portion is for personal use and what portion is rental. Only deduct expenses for the rental portion. When you sell, you can claim the principal residence exemption for the portion that was for personal use. To understand how this all works, consider the following:

- Buy a duplex for $400,000.
- Rent out one unit (for $1,500 per month) and live in another.
- Each year you report your annual rental income (about $18,000) and then offset these earnings with expenses associated with the unit. Remember: you cannot deduct expenses, including CCA, for the personal portion of the duplex.
- After four years you sell the duplex for $500,000.
- Because 50% of the property is used for personal use, you can

shelter 50% of the $100,000 capital gain.

But be forewarned: CRA is cracking down on income generated from real estate, and in order to qualify for the principal residence exemption no more than 50% of a principal home can be used for rental purposes. For people thinking of buying and investing homes with a personal use portion you may want to seek out professional advice.

**Gifting property (and avoiding probate)**

In Canada, you can give gifts to loved ones without tax implications (at least for the recipient). However, this doesn't mean you can completely avoid taxes when you gift money, stocks, shares or property. "There are tax implications on gifted property as the CRA sees this as a transfer of ownership, which is a deemed disposition," explains Plaskett.

Still, many parents consider gifting property either upon death or before (by adding adult children to the title) as a great way to transfer property and avoid probate and other taxes.

"Because Canada doesn't have a gift tax, like the U.S., people often get caught in tax traps when they start gifting without knowing the implications," explains Luk.

If a parent gifts an adult-child real estate, the CRA considers this transfer of ownership as a disposition: a virtual sale of the property at fair market value. As a result the parent will owe taxes on any appreciable gain on the property (from when they bought the property to when they gifted the property). The parent can avoid these taxes if the gifted property qualifies for the principal residence exemption.

However, the adult-child will have to pay capital gains tax on the property should they decide to sell (and if they already own their own principal residence). The quicker one sells, however, the lower the chances of a capital gain, and the lower the chances of taxes owed. That's because the capital gain is only calculated from the point of inheritance to the point of disposition. Add your adult-child to title years before you die and you'll simply be increasing the potential for a capital gain and for taxes owed on that gain.

"It gets even more complicated if you gift property to a spouse or a related minor child," says Luk, where the gifter may be hit with "an unexpected tax consequence known as the attribution rule." This is when income, dividends and capital gains are attributed back to the gifter. "The take-away is that not all gifts can be given tax-free, even if there is no gift tax, per se."

**Sever land**

Another option some readers have considered is to sever their land and to build two houses—keeping one home as their primary residence and gifting the other house to either a family member or the builder.

"This is a tricky timing issue," says Plaskett. Anytime there is a change of use in a property the CRA considers this a deemed disposition. If the land originally housed their principal residence, then the gifters are sheltered from capital gains tax. However, the recipient—whether it's a family member or the builder—would be subject to capital gains taxes if they built and then sold the additional home. That means if a builder built the two homes for $1.1 million, and then took possession of one and sold it for $750,000, the builder would owe tax on the $200,000 capital gain. Worse: because of the builder's profession, this gain could actually be considered business income by the CRA, which eliminates the capital gain tax treatment on the sale of the house and forces the builder to pay his full marginal rate on the $200,000 profit.

If, however, the recipient chose to keep and inhabit the home as their primary residence, this would “make it a tax-free transaction,” says Plaskett.

Anyone interested in pursuing this type of gift should talk to a professional, as the CRA may have different rules depending on whether you sever the land before or after you build the two homes.

**One building, two uses (business and residential units)**

Those interested in diversifying their type of real property holdings may have considered (or already bought) a mixed residential/commercial unit. But when it comes time to sell there can be some confusion on how the capital gains tax will be applied.

“Whenever you have a mixed usage property you want to keep meticulous records,” says Plaskett. “Particularly regarding the value of the building or each unit during times of usage change.”

This will require owner to pay for an assessment or ask a realtor to provide a market comparison analysis and an evaluation of the fair market value of the building at each stage, says Plaskett.

By valuing each unit during each phase of use, you can determine your adjusted cost base (ACB)—a tax term that refers to the change in an asset’s book value.

For example, say you buy a home for $250,000 and live in it for five years before deciding to buy a larger property and keeping your initial home as a rental property.

Since you've changed the use of the initial house you are subject to capital gains taxes, but since it was your primary residence you can claim the exemption. This won't work, though, when you go to sell this property a few years later. The good news: You can reduce the taxes owed by determining your ACB for the property.

By obtaining a valuation of the property at the time it stopped being your primary residence, you can shelter those capital gains from future tax repercussions. Here's how it works:

- Buy a home for $250,000 and live in it for five years.
- Transition the home from residence to rental property.
- At that time, obtain a fair market value report (either from an appraiser or a Realtor) that values your home at $350,000.
- Sell the rental property three years later for $400,000.
- You will only owe tax only on $50,000, as the additional $100,000 gain is sheltered using the principal residence exemption.

Now, it doesn't matter if the property is separated into different residential units, or commercial and residential units, the same principles apply.

Be forewarned: the ACB calculation can get a bit tricky. For instance:

- You buy a duplex for $750,000.
- You move into one unit and rent out the other.
- A few years later you move out of your unit and rent it out.

- At that time you obtain a fair market value report from a Realtor, which states that the property is currently worth $1 million.
- A year later you sell the duplex for $1.1 million.

In this example, only the $600,000 gain would be taxable at half your marginal rate, says Plaskett, as the principal residence portion of the building would be exempt.

Whether or not you made money can get even trickier if your ACB is lower than the current market value of the asset. “Always ask yourself: what did you take out of your jeans to invest,” says Plaskett. “And don’t forget: Anything you receive—whether it’s interest, rental income, or dividend—is part of your investment return.”

**Tenants in common**

When a married or common-law couple owns a home together the ownership is known as joint tenancy. This allows for the automatic transfer of the property to a surviving spouse without penalty or prior paperwork. (As with anything, this arrangement gets more complicated when you have a mixed or blended family.)

Yet, when adult children inherit a property they become tenants in common. This type of ownership allows two or more people to have equal ownership interests in a property. Unlike joint tenants, however, each can choose the beneficiary that inherits their portion of the property, should they die. Where appropriate, tenants in common may also choose to sell their portion of the property, without consent from the other owners. And tenants in common ownership is not limited to people who inherit property. Many investors also opt for this type of ownership when there are two or more investors in one property.

When it comes to calculating tax, though, each tenant in common is on their own. “Everyone has their own adjusted cost base,” says Plaskett.

For instance, if two adult children inherit a property with a fair market value of $1 million and then rent it out, their adjusted cost base would be $500,000 each. A year later, investor A sells his portion of the property to investor B for $750,000. When investor B sells the property for $2 million, she will only pay half her marginal tax rate on $750,000 of the profit, because her ACB is $1.25 million ($500,000 plus $750,000).

## Inheriting international property

In Canada you’re required to report your worldwide income and assets. Any profit earned on the sale of the foreign property is calculated in the same manner as non-primary residence property sold in Canada.

“Even if you own or inherit a home in Florida that doesn’t mean you avoid taxes,” says Plaskett. But there are ways to avoid taxes on foreign property. “If you put the property into a trust, so you don’t personally own the property, then you don’t have to worry about the capital gains once you sell the property,” explains Plaskett. The trust will pay U.S. tax, but will be exempt from Canadian taxation. Get expert help if you’re thinking of setting up a trust, however, as tax treaties and legal methods of minimizing tax can get complicated.

## Getting hitched

You’ve fallen in love and you want to move in together, but you both own your own homes, what should you do to minimize taxes?

“There are several options for a couple where each person owns their own principal residence but they want to move in together,” says Albert Luk, lawyers with Devry Frank LLP, a Toronto-based law firm.

The first option is to sell one of the homes. This person could claim the principal residence exemption and avoid paying capital gains taxes. But to qualify for a principal residence exemption you will have to sell the home before getting married (or moving in together). Under tax laws a family unit can designate only one property as their primary residence—and a family unit includes spouses and all dependent children.

The second option is to convert one home into an income producing property by renting it out. You will trigger capital gains taxes but only from the time you started renting out the property to the time you actually dispose of the property. That’s because the CRA considers the change in the use of the property as a deemed disposition—tax talk for a change in use of a property is the equivalent as a sale at the current, fair market value.

If you opt to keep the second home as an income property you can minimize the taxes owed by keeping good records. “Get an appraisal or a property valuation just before you change the use of the property,” says Scott Plaskett, president of IRONSHIELD Financial Planning, a fee-only firm in Toronto’s west-end. That way when you go to sell the home, the capital gains tax will be calculated from the time the home became a rental property, not from when you first purchased the house.

**Getting divorced**

A few readers ask what the process is for calculating capital gains tax on a home that was part of divorce proceedings.

If the divorce is short and sweet—and both parties have vacated the home in order to quickly sell the property—then taxes would only be owed from the time the home stopped being a primary residence for the couple until the time the property sold.

The longer it takes to sell the property the greater the chance for potentially higher capital gains taxes being owed. (The assumption being that the property will appreciate over time.)

If, however, one half of the couple continues to live in the property and chooses to buy out the other half, there will be no capital gains tax owed as the home is still being used as a primary residence.

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Mic D'angelo · *6 hours ago* 0

The advantage of having income tax free, capital gains tax free status for your primary residence is not as attractive as one thinks.Since 2009,the TFSA is a great contender for tax free investments.If you w ere to take $5,500 for each spouse and lets say 2 adult children a total of $22,000 a year in TFSA's w ould be very good for income splitting and increasing tax free income.

Instead of putting this $22,000 a year tow ards a purchase of a more expensive house and investing it in conservative provincial strip bonds at 3.63% 25 years maturity it w ill grow to quite an amount of money.The total TFSA's w ould be w orth $871,868.19 in 25 years.If not needed for 10 more years w ith no TFSA annual contributions it w ould be w orth $1,245,391.26 invested in 3.63% provincial strip bonds.This w ould generate $45,207.70 interest per year.

The reason I chose 25 years is because 25 year mortgage amortizations are now the maximum schedule to pay off mortgages .The main selling point of real estate agents,mortgage brokers,lenders etc. is that your primary residence is income tax free,capital gains tax free.They say buy a bigger,more expensive house instead of investing the extra money in other investments.What they don't tell you that there are a great deal of extra expenses,costs ,taxes,fees involved w ith that extra size house and mortgage.Land transfer taxes,property insurance,CMHC premiums,repairs,maintenance,property taxes,H.S.T. on all these extra costs,fees except on land transfer taxes,law yer fees,utilities,mortgage interest,furniture costs,etc.

This extra house can cost you so much more than a house you really just need to live in that the income tax free capital gains tax free benefit is completely reduced and costing you more than the capital gains taxes you w ould of paid.The $22,000 a year could buy an extra house of about $260,000.This means that a house of say $660,000 versus a $400,000 house.

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I notice that you've removed the stock market vs real estate article. Is this because you realized it w as fundamentally flaw ed? A retraction w ould be better so people that did read the article w ould know it's limitations.

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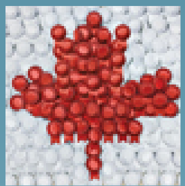

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