Rental Property and the Capital Gains Tax

By David Gargaro

Capital gains tax (CGT) is a tax on capital gains, which is the profit that occurs from the sale of capital property. The inclusion rate (currently 50%) is the amount of capital gain that is subject to the CGT. For example, if you purchased a property for $100,000 and sell it for $300,000, then the capital gain is $200,000 (the original price minus the selling price). Fifty percent of that amount, or $100,000, is taxable at your specific tax rate.

To calculate the capital gains on the sale of your rental property, you must know three amounts: the proceeds of disposition, adjusted cost base (ACB), and outlays and expenses incurred to sell the property. The basic formula is capital gains = proceeds of disposition – (ACB + outlays and expenses).

Proceeds of disposition is the sale price of the property. ACB is the actual cost of the capital property, which includes capital expenditures (i.e., additions and improvements to the property) but does not include current expenses (i.e., maintenance and repair costs). Outlays and expenses include amounts incurred to sell the capital property, such as commissions, surveyors' fees, legal fees, transfer taxes, and advertising costs related to the sale process.

"When calculating your capital gains, it is very important to have maintained receipts for capital additions or improvements made to the building and property," said Dennis Anderson, Partner, Tax Services, Ernst & Young LLP. "Differentiate these expenditures from operating expenses that have been deducted from rental income annually and are not added to the adjusted cost base."

Capital cost allowance

When selling a rental property, you must properly allocate the proceeds between the land and building. While you own the rental property, you can deduct the cost of the building (land is not depreciable) and any depreciable equipment (e.g., laundry machines) over a period of several years at specified rates. This deduction is known as capital cost allowance (CCA); the amount you can claim will depend on the type of property.

When you sell the rental property, you might be required to increase your income by the recaptured capital cost allowance. This can occur when the proceeds from the sale of the building (and other depreciable property) are more than the sum of the property's various undepreciated capital costs (UCC) (e.g., $80,000 for the building, $5,000 for paving, $5,000 for equipment). The UCC is the total capital cost of the building and additions, less the CCA claimed over the years.

Explained Dennis, "Suppose that you purchased a property for $200,000 and the land was valued at $100,000 while the building portion was valued at $100,000, and the building portion was depreciated (CCA claimed) by $50,000 over ten years. You then sell the property for $400,000. The capital gain is $200,000, and the taxable capital gain is $100,000. Assuming the portion of the proceeds allocated to the building exceed the original cost, the previously claimed CCA of $50,000 must also be included in taxable income."

Deferring taxes

When selling rental property, you can defer a portion of capital gains through a vendor-take-back (VTB) mortgage. The vendor takes back debt when the buyer takes on a mortgage or financing from the vendor to purchase the property. The vendor can elect to spread the capital gains over a period of up to five years through claiming a reserve for proceeds not yet received. The maximum reserve that can be claimed for a year is determined by formula, where the minimum amount of the gain that must be reported each year is 20%. Unless there is a lot of VTB debt, the amount to be reported in the first year would be much higher.

When the seller claims a reserve amount against the capital gain in the first year, that amount is brought into income in the following year. The seller claims a new reserve amount the next year, and the process repeats until the amount is fully paid or the five-year period expires.

In a simple example, a rental property sells for $1 million, and the capital gain is $500,000. The deal is financed by a VTB mortgage repaid evenly over five years at $200,000 per year. The reportable capital gain will be $100,000 per year by claiming the available reserve for proceeds not yet received.

"A vendor-take-back mortgage allows you to defer payment of the capital gains tax instead of taking full payment for the property's purchase and paying all the tax at once. You can also earn interest on the VTB mortgage," said Dennis. "However, there is the risk that the buyer will default on the mortgage."

Capital gains exemption

Unlike rental property owners, business owners can defer the capital gains and taxes on the sale of business properties for up to one year, depending on the timing of the sale compared to the business's taxation year. Under replacement property rules, the individual can defer some or all of the capital gain by acquiring a similar business property. The amount of gain deferred depends on the sale price and price paid for the new building. For example, a person who owns a building with a restaurant can sell the property to move her restaurant to a larger space in a new location, and defer the taxes on the sale. However, owners of rental properties do not qualify for this type of deferral.

Owners of corporations that own rental properties might be able to qualify for the $750,000 lifetime capital gains exemption (LCGE), which works out to a $375,000 lifetime capital gains deduction. They must own shares in a qualified small business corporation, which the *Income Tax Act* defines as a Canadian controlled private corporation that uses at least 90% of its assets to carry on an active business in Canada. The individual or a relative must have owned these shares for at least 24 months prior to the sale, and at least 50% of the corporation's assets must have been used in the active business for two years prior to the sale. Rental businesses with five or fewer full-time employees are not considered to be active businesses under the *Income Tax Act*.

If the corporation passes the test of running an active business, the shareholders could claim the lifetime capital gains deduction against taxable capital gains by selling the shares of the company, rather than having the company sell the rental properties.

"The LCGE is available to a qualifying corporation that is owned by several family members," said Dennis. "When they sell the corporation, they can potentially each claim the LCGE of up to $750,000 depending on their ownership." RHB

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