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Understanding The Taxation of Real Estate Transactions

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Audit . Tax . Consulting . Financial Advisory.

Agenda

- Ownership alternatives
- Taxation of rental income
- Taxation of dispositions of real property
- Planning alternatives
  - Disposition to arm's length party or family members
    - Capital gains reserves/Income reserves
  - Death of a taxpayer
    - Pre-mortem planning
      - Life insurance
      - Gift during lifetime
      - Estate freeze
      - Multiple testamentary trusts
    - Post-mortem planning
      - Double taxation
      - 164(6) loss carry back
      - 88(1)(d) bump
      - "Pipeline" planning

Ownership Alternatives

- Personal ownership
- Co-tenancy or joint venture
- Limited or general partnership
- Corporate ownership

Individual Ownership

- Simplest form of ownership
- Income taxed at individual's marginal tax rates
- Losses can be used to offset other sources of income
- Can be held jointly with other individual as tenants-in-common or joint tenants
- Unlimited liability

Co-tenancy/Joint Venture

- Not a separate legal entity
- Participants can be individuals, trusts, or corporations
- Discretionary deductions at participant's level – i.e. capital cost allowance ("CCA") taken by participants
- Gross revenues and expenses are allocated to participants based on co-tenancy/JV agreement and taxed in participants hands
- Unlimited liability – can be mitigated using corporate participants
- No annual information return required
- If applicable, GST/HST registration must be at participant's level – can designate one "operator"

Limited/General Partnership

- Partners can be individuals, trusts, or corporations
- Not a separate legal entity but income calculated at partnership level
- No discretionary deductions at partners' level – i.e. capital cost allowance ("CCA") taken at partnership level
- Income is allocated to partners based on partnership agreement and taxed in partners' hands
- Assets can be transferred to a partnership on tax deferred basis (including land inventory)
- Limited liability in the case of an LP
- Generally, partnership required to file an annual information return
- If applicable, GST/HST registration at partnership level

Corporate Ownership

- Separate legal entity
- Taxed as a separate individual – annual corporate tax filing required
- No flow through of losses – trapped in corporation and can only be used to offset income in the corporation
- Capital assets can be transferred to a corporation on a tax deferred basis – estate freeze
- Potential for income splitting with family members – i.e. "dividend sprinkling" may allow for absolute tax savings
- Beware of double taxation

Taxation of Real Estate Transactions

- Taxation of rental income
- Taxation on the disposition of property – deemed or otherwise

Taxation of Rental Income

Taxation of rental income will differ depending on ownership structure:

Rental Property owned personally (directly or indirectly through a partnership):

- Income taxed at individual's marginal tax rate
- Losses from rental activities can be used to shelter income from other sources

Rental Property owned through a corporation:

- Canadian Controlled Private Corporation resident in Ontario - Rental income will be taxed at 46.17% of which 26.67% is refundable upon payment of sufficient dividends to individual shareholders
- Losses can only be used to shelter rental income earned by the corporation and not income earned by other activities of the shareholder

Taxation of Rental Income (cont…)

- Capital Cost Allowance (CCA)
  - Taxpayers are permitted to claim a deduction against rental income for the depreciation of capital property acquired – Does not include the cost of land
  - There are multiple classes of CCA, depending on the type of property rented
  - Typically, residential and commercial buildings belong to CCA Class 1 – 4% (6% for non-residential, and 10% for M&P) declining balance deduction per annum
  - Optional deduction – taxpayer is not required to claim CCA if not beneficial
  - CCA cannot be used to create a loss from rental activities i.e. CCA deduction is limited to net rental income before taking CCA into account (unless real estate is owned by a corporation whose principal business was the leasing, rental, development or sale, or any combination thereof, of real property owned by it)

Dispositions of Real Property

- Land and building will be taxed as separate properties upon disposition

- In most circumstances, gain on sale of real property is on account of capital and therefore 50% taxable
  - Certain circumstances gain is on income account and thus 100% taxable – e.g. sale of land inventory

- If Capital Cost Allowance has been claimed, sale may create recapture of CCA which is 100% taxable

- Replacement property rules allow for a deferral of both capital gains and recapture

Dispositions of Real Property (cont…)

- Example
  - Property purchased for $100,000
  - $70,000 of purchase price allocated to building, $30,000 allocated to land
  - CCA of $30,000 claimed on building
  - Property sold for $200,000
  - $140,000 of sales proceeds allocated to building, $60,000 allocated to Land
  - Sale is on account of capital

Dispositions of Real Property (cont…)

- Tax on sale of land:

Proceeds of disposition	$60,000
Cost	($30,000)
Capital Gain	$30,000
½ Taxable	$15,000
Tax @47.97% [1]	**$7,196**

[1] Assumes individual lives in Ontario in 2012 and is in the highest income tax bracket

Dispositions of Real Property (cont...)

Tax on sale of building

Proceeds of disposition	$140,000
Cost	($70,000)
Capital Gain	$70,000
½ Taxable	$35,000
Tax @ 47.97%	**$16,790**
Recaptured CCA[1]	$30,000
Tax @ 47.97%	**$14,391**
Total Combined Tax (incl. land)	**$38,377**

[1] If a taxpayer sells a building for proceeds of disposition that exceed the original cost of the building and CCA has been claimed on the building, then the taxpayer will be taxable on recaptured CCA in an amount equal to the CCA previously claimed.

Terminal Losses

- If proceeds of disposition on sale of building are less than original cost of property less CCA claimed to date taxpayer will have a "terminal loss"
- Terminal loss is deductible against other sources of income
- Income Tax Act provides a mechanism that prevents taxpayers from shifting proceeds on the sale of a property from building to land in order to create a terminal loss on building and a capital gain on land

Planning Alternatives

- Disposition to arm's length party or family members
  - Capital gains reserves/Income reserves
- Death of a taxpayer
  - Pre-mortem planning
    - Life insurance
    - Gift during lifetime
    - Estate freeze
    - Multiple testamentary trusts
  - Post-mortem planning
    - Double taxation
    - 164(6) loss carry back
    - 88(1)(d) bump
    - "Pipeline" planning

Arm's Length or Non-Arm's Length Dispositions
Capital Gains Reserve

- When the proceeds of disposition on the sale of real property that is capital property are not received in full in the year of the sale, the taxation of the gain can be deferred
- Deferral mechanism is called a "reserve"
- Generally, the reserve mechanism limits the taxable portion of the gain on a pro-rata basis based on the proceeds of disposition received in that year
- Deferral is limited to a 5 year maximum
- By the fifth year the entire gain must have been recognized and included in income
- Income reserve similar but limited to 3 years – no minimum annual inclusion

Capital Gains Reserve (cont…)

- Allowable reserve is equal to the lesser of two amounts:

  1) A reasonable reserve - Ordinarily assumed to be:

$$\text{capital gain} \times \frac{\text{proceeds not yet received}}{\text{total proceeds}}$$

  2) (i) 4/5 of the gain in year of disposition
     (ii) 3/5 of the gain in year 2
     (iii) 2/5 of the gain in year 3
     (iv) 1/5 of the gain in year 4

- Prior year's reserve must be included in taxable income in following taxation year and new reserve, if available can be deducted

Capital Gains Reserve (cont…)

- Example
  - Taxpayer sells property for $500,000
  - Cost of property was $400,000
  - Taxpayer receives $250,000 on the date of sale and receives 1 year vendor take back mortgage under which remaining $250,000 of sale proceeds will be paid at the end of year two
  - Real property is capital property to the taxpayer

Capital Gains Reserve

Example (cont…)

Proceeds of Disposition	$500,000
Cost	$400,000
Capital gain	**$100,000**

Capital Gains Reserve (cont…)

Reserve – Year of disposition:

Lesser of:

1) $100,000 x $\frac{\$250,000}{\$500,000}$ = $50,000

2) 4/5 x $100,000 = $80,000

Therefore taxable gain in year of disposition:

Capital gain	$100,000
Less: allowable reserve	($50,000)
Revised capital gain	$50,000
Taxable income Inclusion	**$25,000**

Capital Gains Reserve (cont…)

Reserve – Year 2:
Lesser of:

1/ $\$100{,}000 \times \dfrac{\$0}{\$500{,}000} = \$0$

2/ 3/5 x $100,000 = $60,000

Therefore taxable income in year 2:

Inclusion of Year 1 reserve in income	$50,000
Less: Year 2 reserve	($0)
Capital gain Year 2	$50,000
Taxable portion	**$25,000**

Death of a taxpayer

- Deemed disposition on death of all capital property at its fair market value
- Beneficiaries receive property at fair market value of property immediately before death
- May result in capital or income gain and recapture of CCA realized by the taxpayer which will be reported on the final T1 Personal Income Tax Return of the deceased
- In the case of a surviving spouse there is an automatic "rollover" of assets at cost to the surviving spouse, unless an election is made to elect out of the automatic rollover

Death of a Taxpayer
Pre-mortem planning

Life Insurance

- Cash flow often a problem as deemed disposition results in tax liability that cannot be funded without selling property to an arm's length party or leveraging property
- Illiquid assets – could be difficult to equalize estate
- Life insurance provides liquidity and maintains value of the estate

Death of a Taxpayer
Pre-mortem planning (cont…)

Gift of love and affection during lifetime

- Deemed disposition on gift at fair market value
- Determine taxation of estate currently
- If "nil" consideration – no Ontario land transfer tax
- Equalize estate with other assets

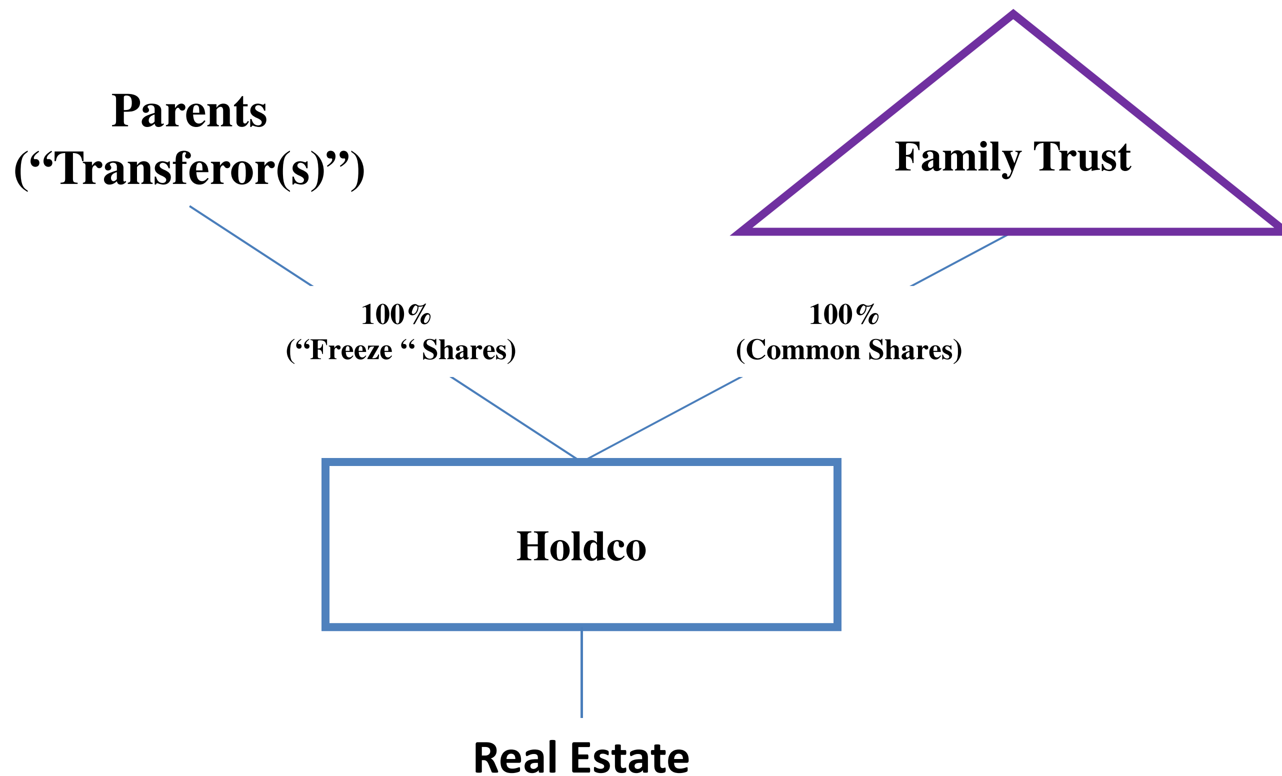
Death of a Taxpayer
Pre-mortem planning (cont...)

Estate Freeze

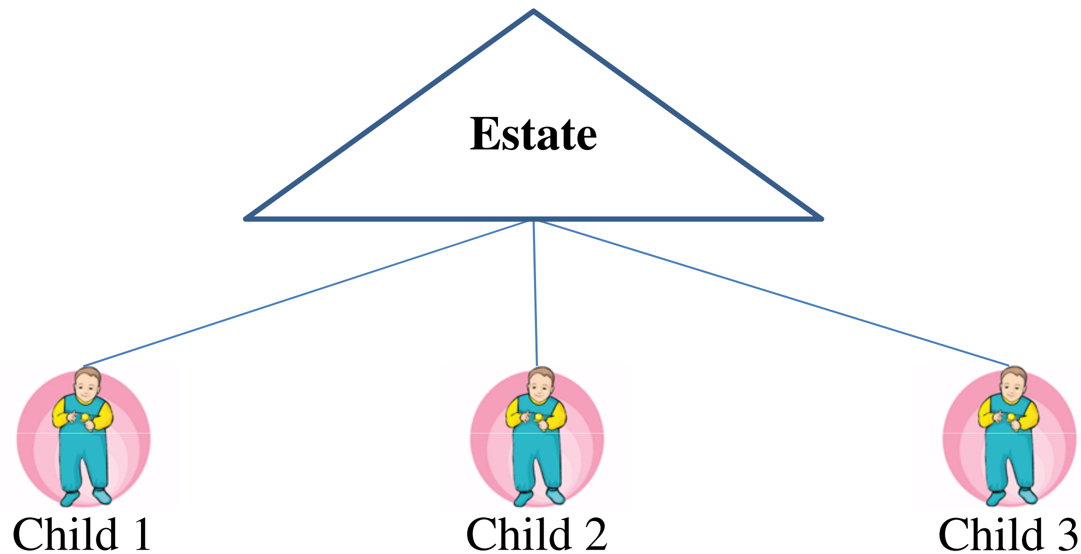
- Can be used to limit the tax liability that will occur upon death to an amount based on the fair market value of the property at the time of the freeze transaction
- Involves the transfer of the property to a corporation
- Transfer done on a tax deferred basis – Ontario land transfer tax exigible
- If structured correctly, tax on accrued gain on real property can become payable in small amounts over time as opposed to a lump sum payable at the time of death – "Wasting Freeze"

Death of a Taxpayer
Pre-mortem planning (cont…)

Estate Freeze – Illustration



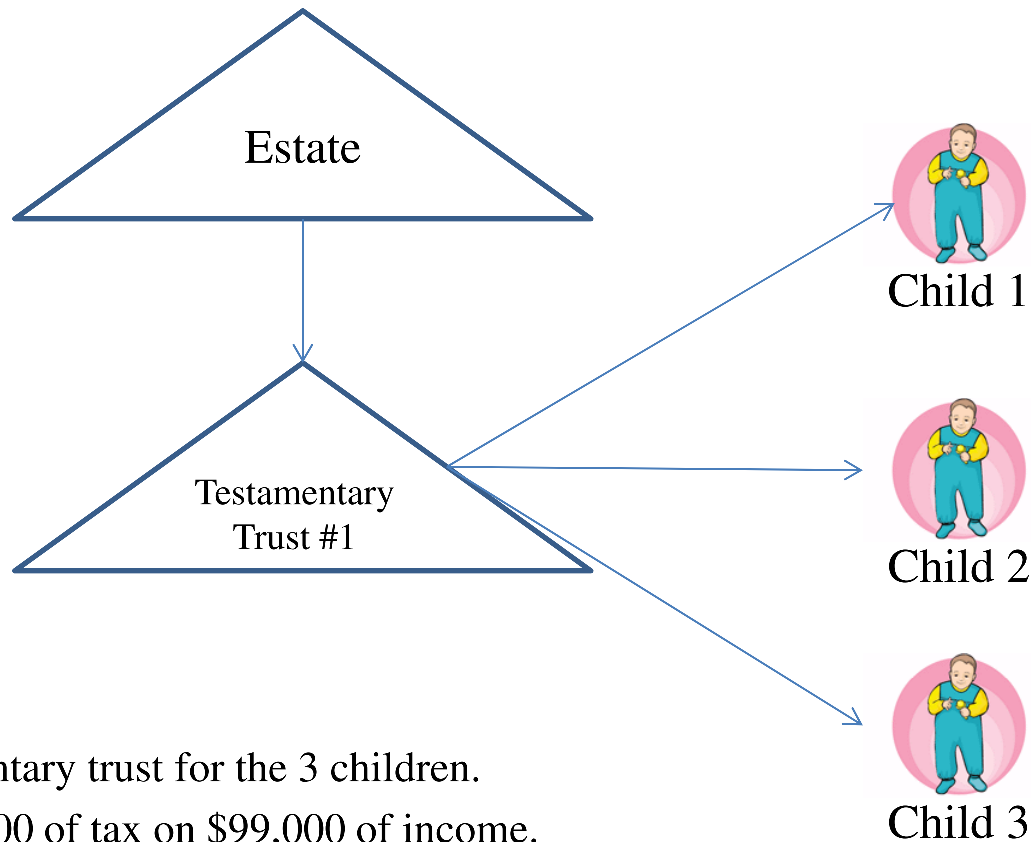
Death of a Taxpayer
Pre-mortem planning (cont…)
Multiple Testamentary Trusts



Scenario #1

- 3 properties (each earning $33K/year) left to 3 children – all in top tax rate.
- Each child will pay $15,300 or $45,900 tax in aggregate each year. (46% x $33,000 x 3)

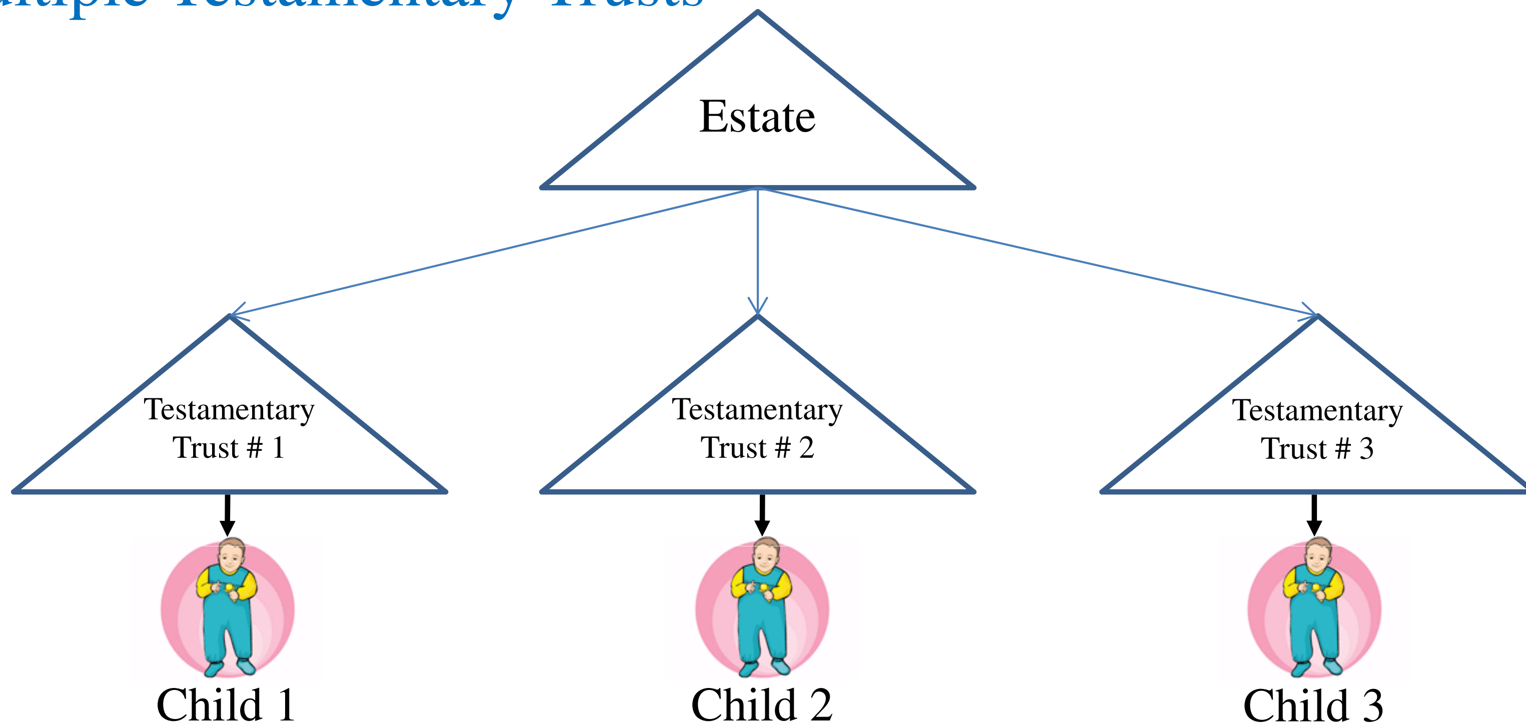
Death of a Taxpayer
Pre-mortem planning (cont...)
Multiple Testamentary Trusts



Scenario #2

- Deceased creates **one** testamentary trust for the 3 children.
- Trust will incur approx. $32,000 of tax on $99,000 of income.
- Beneficiaries will save approx. $14,000 of tax per year ($45,900 - $32,000)

Death of a Taxpayer
Pre-mortem planning (cont…)
Multiple Testamentary Trusts



Scenario #3

- Deceased creates **three** testamentary trusts (1 for each child) – designated in Will.
- Each trust receives 1 property (generating $33,000 each).
- Each trust will incur approx. $7,000 of tax ($21,000 total) on $33,000 of income.
- Beneficiaries will save approx. $25,000 of tax per year (in total) ($45,900 - $21,000).

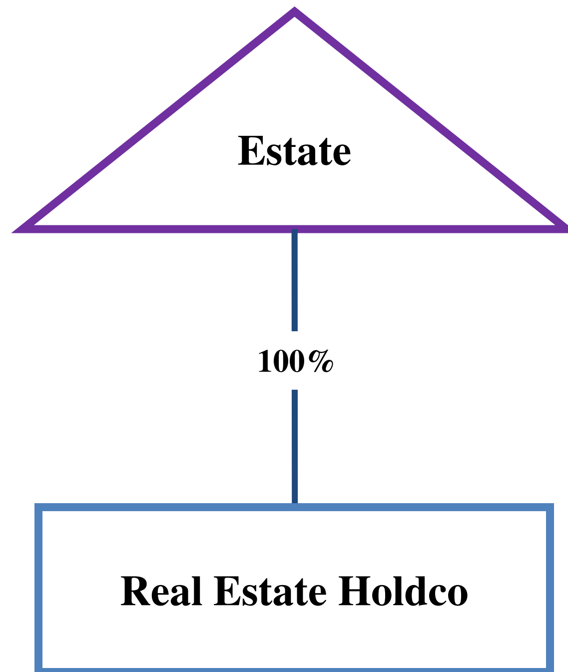
Death of a Taxpayer
Post-mortem planning

Double taxation on death

- Issue arises where
  - Taxpayer dies owning shares of a private corporation
  - Estate pays tax on deemed disposition of shares
  - Company owns assets with accrued but unrealized gains
- Avoided if there's a surviving spouse
- Mitigated if estate subsequently sells shares of corporation, or if assets are held in corporation for an extended period of time

Death of a Taxpayer
Post-mortem planning
Deemed disposition of private company shares

Double Taxation example:



FACTS:

1) Testator owns common shares;
2) FMV of shares is $101
3) ACB of shares is $1
4) Real Estate Holdco owns real estate;
5) FMV of real estate is $101
6) ACB of real estate is $1

A) Tax on terminal return:

FMV	$101
ACB	($1)
Capital Gain	$100
Tax @ 23.98%	**$24**

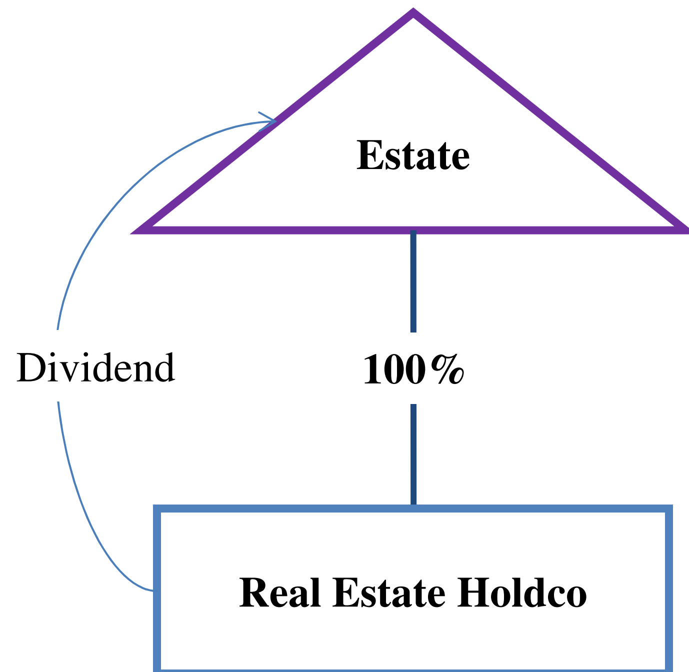
B) Tax on sale of assets by Real Estate Holdco:

FMV	$101
ACB	($1)
Capital Gain	$100
Taxable capital gain	$50 (50% inclusion)
Tax @ 46.17%	$23
RDTOH	($13) (26.67% of TCG)
Net corporate tax	**$10**

Remaining for distr. $91 ($101-$10)

Death of a Taxpayer
Post-mortem planning
Deemed disposition of private company shares

Double Taxation example cont'd:



C) Tax on distribution to shareholder:

Return of capital	$1	
Capital dividend	$50	
Taxable dividend	$40	($100 - $10 - $50)
Personal tax on dividend*	**$14**	

D) Total tax paid on $100 gain:

Tax on death	$24
Corporate tax	$10
Personal tax on redemption	$14
Total taxes paid	**$48**

* **Assumes top marginal rate in Ontario, on ineligible dividends – i.e. 34.52%**

Death of a Taxpayer
Post-mortem planning
Deemed disposition of private company shares

Planning alternatives

- As illustrated in our example, main tax exposure inherent at death is double taxation
- Planning available
  - Depends on the nature of company's assets; future intention of surviving shareholders
- Complicated process depending on tax attributes
  - RDTOH/CDA/GRIP/non-depreciable capital property
- Three alternatives can be considered (or combination of any of the alternatives):
  - Subsection 164(6) "Loss Carry-back"
  - Paragraph 88(1)(d) "Bump"
  - "Pipeline" planning

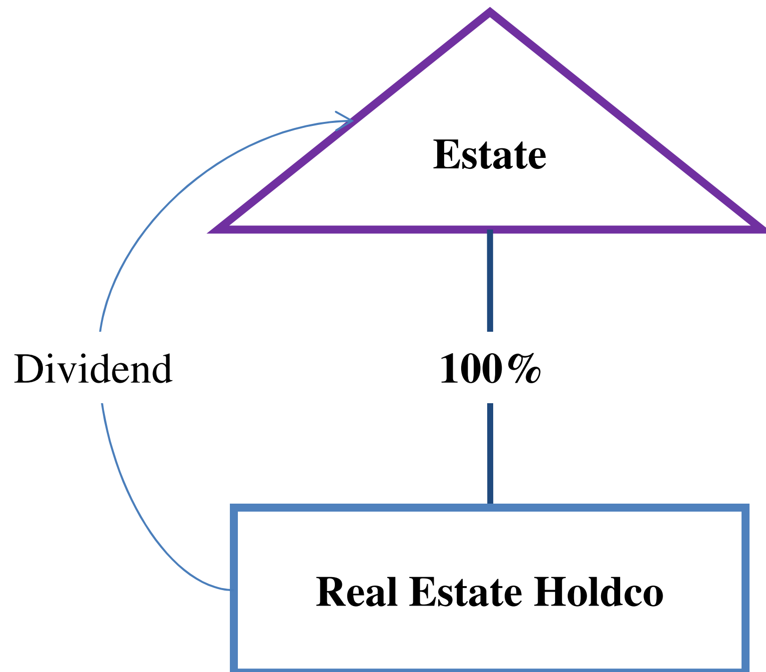
Death of a Taxpayer
Post-mortem planning
Deemed disposition of private company shares

Subsection 164(6) "Loss Carry-back"

- On death the assets of deceased are transferred to the executor at fair market value
- Assets received by executor may be sold during the administration of the estate potentially resulting in a gain or loss to the estate
- Subsection 164(6) is designed to allow the executor to elect to report any capital and/or terminal losses realized in the first year of an estate on the final return of the deceased
- Deems the loss to be a loss of the deceased taxpayer in the taxpayer's last taxation year

Post Mortem Planning cont'd

Subsection 164(6) "Loss Carry-back" example:



Shares redeemed in hands of Estate:

Potential recovery of tax if capital loss carried back:

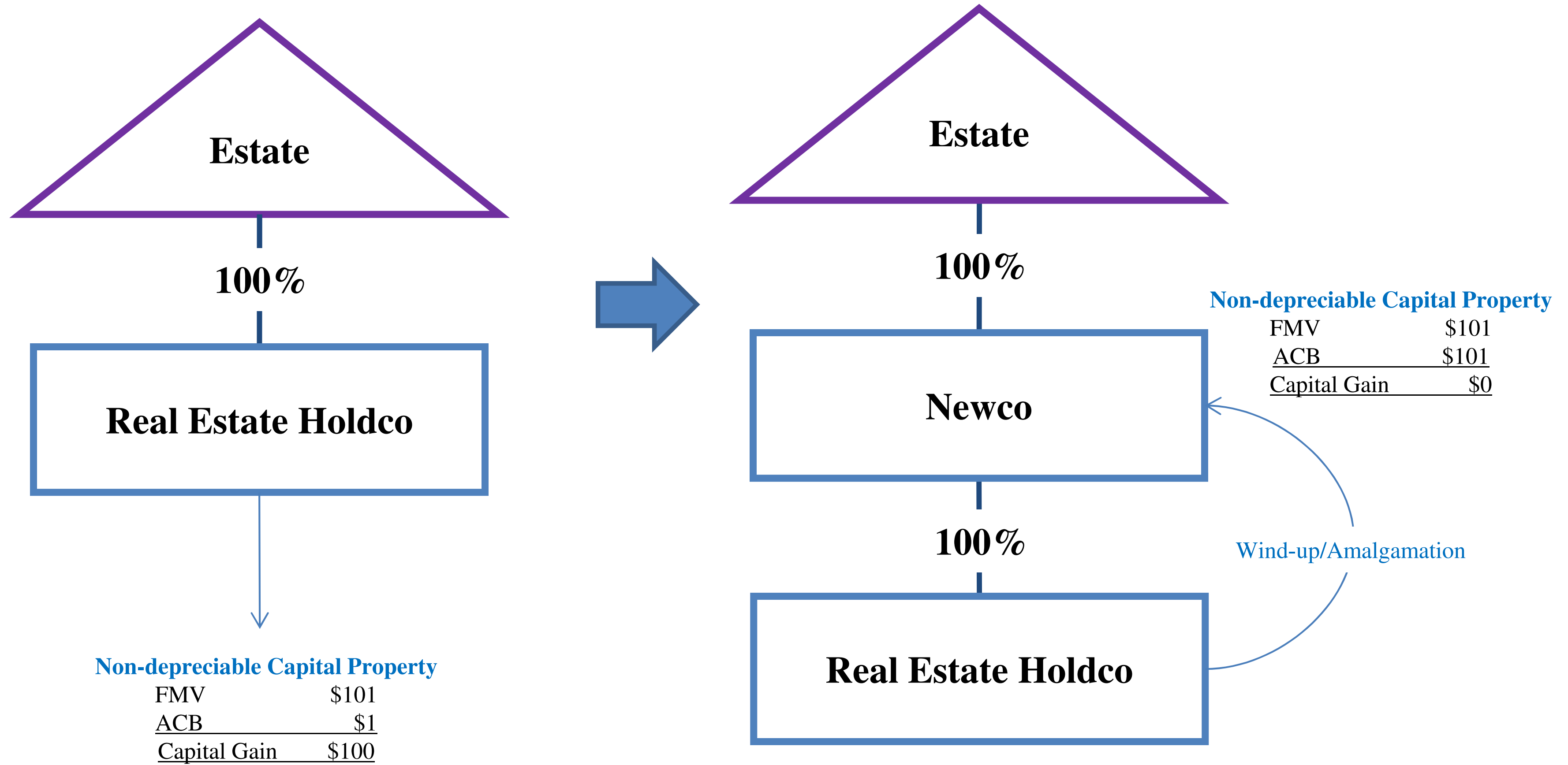
A) Capital gain is hands of deceased:	**$99**
B) Shares redeemed in hands of Estate:	
Proceeds:	$100
Paid up capital (PUC):	$1
Deemed Dividend (Taxed in Estate):	**$99**

Estate also calculates capital gain/loss on redemption:

Proceeds	$100
Less: Deemed dividend	($99)
Adjusted proceeds:	$1
Adjusted cost base	($100)
Capital loss (carried back to deceased):	**$99**

Death of a Taxpayer
Post-mortem planning
Deemed disposition of private company shares

Paragraph 88(1)(d) "Bump" Planning:



Questions?

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