MoneySense

How to lower capital gains tax owed

Profit from the sale of a secondary property triggers tax, but you may be able to avoid or reduce this tax debt

by Romana King
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Q: Is it possible to sell my cottage lot, which is located in Ontario, and buy a residence outside of Canada and not pay capital gains tax? My home is located in Toronto, but I'd like to purchase a vacation property in Mexico.
— *Kevin H., Toronto*

Answer from Romana King, senior editor at MoneySense: The short answer is that you can't avoid paying capital gains tax, but you can minimize how much tax you have to pay.

To appreciate this, let's first take a step back to understand what this tax is and why you owe it to the Canada Revenue Agency.

What is capital gains tax?

Under the CRA there are different types of taxes charged on different types of profit. Your work earnings are charged income tax, while certain investment earnings are charged interest and, as a result, subject to income tax rates.

When property that is not used to generate a business income appreciates in value, that appreciation in price is considered a capital gain. You owe tax—known as capital gains tax—on this appreciation if and when you sell the property (less any legitimate expenses associated with its sale). Keep in mind that any property that is not your primary residence will be subject to capital gains tax. For more on what qualifies as a primary residence, please see my previous column on the matter.

Why does it matter what type of tax I pay?

Whenever you earn an income, you are charged income tax based on your marginal tax rate. Your marginal tax rate is based on your income bracket. For instance, the current federal middle-income tax bracket is 20.5%. So for every dollar you earn between roughly $45,000 and $90,000, you'll owe the federal government 20.5% of those earnings. In addition to federal tax, you also need to pay provincial income tax.

While a capital gain will be subject to your marginal tax rate, the capital gains tax allows you to shelter 50% of the profit from being taxed. For instance, if you sold your cottage and realized a $50,000 profit (from purchase price to sale price), you'd only pay tax on 50% of that gain, or on $25,000. If you were in the 35% tax bracket (where your federal and provincial marginal tax rates added up to 35%), you'd end up owing $8,750 of tax on that $50,000 profit.

The CRA has step-by-step instructions on how to calculate capital gains.

International property

What most people don't understand is that you will owe capital gains tax on any secondary property that you own and sell—even it the property is not located in Canada.

Say, for instance, you already bought your condo in Mexico. Once you sold that Mexican condo, you would have to report the profit of the sale to the CRA (and to the tax authority for whatever country the property is located in). You will then owe tax on that sale, even though the property is not located in Canada. The calculation on sold foreign property can get complex as there may be withholding tax in the host country, you may not get credit for this tax you pay, and you will also need to take into consideration the differences in the exchange rate. (For more on buying and selling U.S. property go here or read the estate planning tips for U.S. vacation homes.)

How to keep more away from the taxman

But just because you owe tax, doesn't mean there aren't legitimate ways to reduce that tax burden and keep more of the profit for yourself. There are several ways to legally reduce or avoid paying capital gains tax on secondary property.

For instance, you can reduce how much tax you owe by reducing the amount of taxable capital gains. You do this by selling off other investments that have experienced capital losses. Just keep in mind, that if the capital loss is greater than the taxable gain on your sold property, you can't claim to reduce your income tax. The capital loss can only be applied against a capital gain. (There is an exception for some small business corporations, but seek a tax specialist for advice.)

Another way to reduce your tax is to donate a portion of your gain to a registered charity the calendar year you received the sale money. This triggers a donation tax credit that can be help reduce the overall tax you owe.

If you opt to sell the cottage, but don't expect to receive the money straight away, you could apply to the CRA to defer the capital gain until a later date. Speak to a CRA representative or a tax specialist for specific advice.

Finally, you could shelter some or all of the profit by declaring the cottage as your principal residence. The principal residence exemption—known as the PRE—can help save you tons of money. That's because the CRA allows you to claim any property you own in Canada as a principal residence, as long as you ordinarily inhabit that property. That means a house, condo, cottage, even a trailer can be sheltered from tax using the PRE. Just keep in mind there are a few rules when it comes to using the PRE. First, a family unit—and this includes spouses and any children under age 18—can only designate one property as a principal residence in each calendar year. Second, the PRE only applies to the dwelling an half a hectare of adjoining land. That means that even a cottage you use in the summer can qualify as a primary residence.

Keep in mind that if you’re a farmer or recent immigrant to Canada, the CRA has special capital gains rules just for you. Go here for more information.