



Capital gains reserve



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UPREIT 101

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What is an UPREIT?

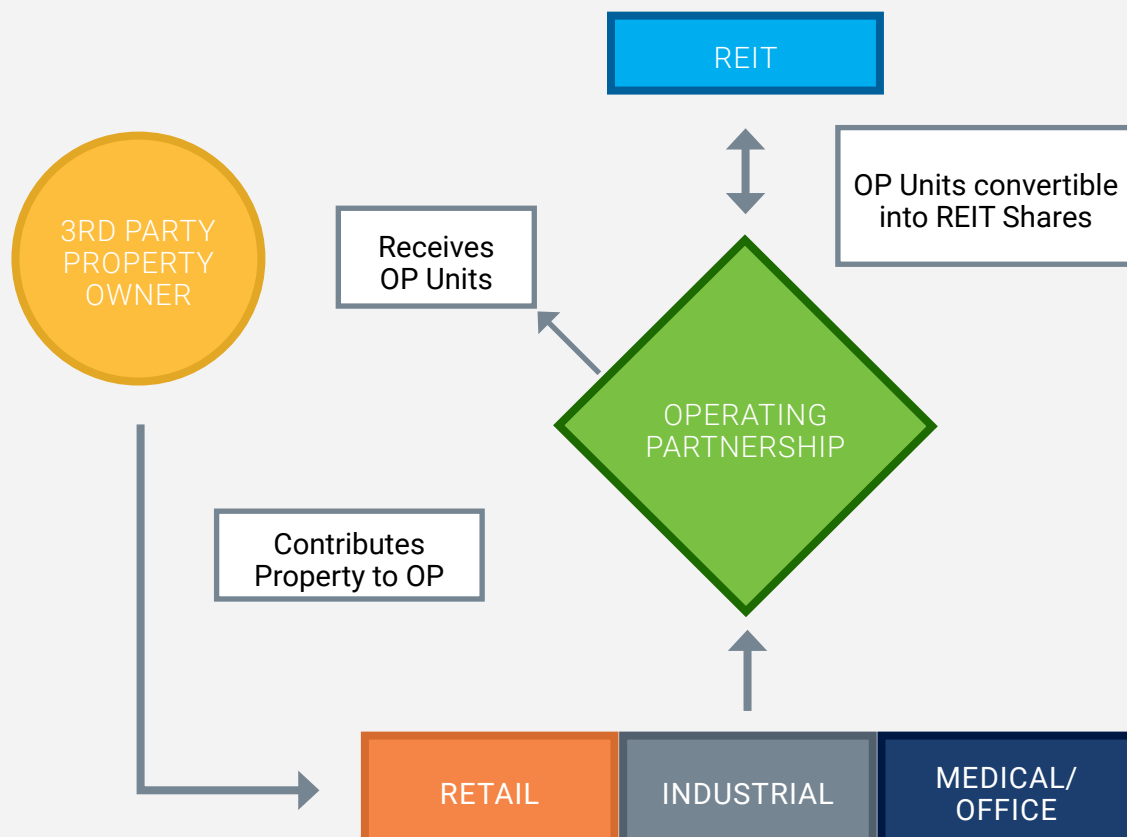
I.K.O REAL ESTATE LIMITED PARTNERSHIP and I.K.O Xchange. AS An UPREIT (Umbrella Partnership Real Estate Investment Trust) is a corporate structure that allows real estate owners to exchange their property holdings for operating partnership (OP) units in a Real Estate Investment Trust (REIT) in a tax deferred transaction similar to a 1031/Capital gains reserve.

How it Works

In a simple UPREIT structure, a REIT typically acquires all of its properties through its Operating Partnership (the UPREIT entity).

Individuals contribute their real estate directly to the Operating Partnership in exchange for OP units. Since the OP entity is not considered an "investment company" for tax purposes, the contribution may not be treated as a sale and capital gains taxes may be deferred. The property contributor's new OP units are then convertible into REIT common shares at the contributor's discretion.

The Mechanics Of An UPREIT Transaction



UPREIT Benefits

In addition to tax deferral, UPREIT transactions benefit from a variety of attractive features. Some of the most notable attributes include:



Diversification

OP unitholders own an interest in a portfolio rather than a single asset



Passive Management

OP unitholders benefit from professional REIT management and are freed from daily operating concerns



Recurring Cash Flow

OP units generally mirror performance of REIT common shares including monthly or quarterly dividend payments



Estate Simplification

OP units can be distributed among heirs and receive a stepped up tax basis equal to the value at death

Who Can Benefit From UPREITs?

UPREIT transactions are limited to “accredited investors” as defined by Ontario Securities and Exchange Commission (OSEC). In order to qualify, investors must meet certain income or net worth requirements.

Assuming the investor is accredited, the best candidates for UPREITs are generally real estate owners with low tax bases, family-owned properties (multiple heirs), and owners having too much of their net worth tied up in a single asset (diversification issues).

Final Thoughts

UPREITs are often the most attractive option for real estate owners looking to dispose of real estate while simultaneously deferring capital gains. Though less common than 1031 exchanges, UPREITs carry a variety of added benefits and should be included in any list of real estate sale options.

The Navigator

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Capital gains reserve

When you sell capital property, you may realize a capital gain or loss equal to the difference between the sale proceeds and the adjusted cost base (ACB) of the property. You will generally need to pay tax on the capital gain realized on the sale in the year of sale even if you are not fully paid in the year of sale. However, you may be able to defer a portion of the capital gain and the associated taxes by claiming a reserve when you receive the proceeds over a number of years. In this article, we will discuss the capital gains reserve rules.

Who can claim a reserve?

Generally, you can claim the reserve when you dispose of capital property unless you:

- were not a resident of Canada at the end of the tax year of the sale or at any time in the following year;
- were exempt from paying tax at the end of the tax year or at any time in the following year; or
- sold the capital property to a corporation that you control in any way.

How do you calculate the capital gains reserve?

The capital gain reserve reduces the amount of the capital gain you report as income in a particular year. As such, you first calculate your capital gain, then you reduce the capital gain with the reserve you would like to claim in the year. In the year after you claimed a reserve, you must include the reserve as income. You may then claim a recalculate reserve amount.

Generally, you may calculate the capital gain reserve as follows:

The lesser of:

- a) $\frac{\text{Capital gain}}{\text{Proceeds of disposition}} \times \text{Proceeds still payable after the end of the year}$
- b) $1/5^{\text{th}}$ of the total capital gain $\times (4 - \text{number of preceding tax years ending after disposition})$

Under this formula, you cannot take more than four-fifths of the gain as a reserve in the year you sell the capital property. Each year you repeat the calculation to determine the amount of the reserve. As a result, you can spread the capital gain over a maximum of five years. If purchaser pays you the purchase price over a period longer than five years, for example, an eight-year period, you must still recognize the capital gain in full over a period of five years.

Please contact us for more information about the topics discussed in this article.

When deciding if you should claim the reserve, you will want to consider your current and future marginal tax rate. The deferral of the capital gains can be especially advantageous if you expect to be in the same tax bracket or a lower tax bracket over the next four years.

You must recognize the capital gain in full by the year in which you receive the final payment. So, if the purchaser pays you 50% of the purchase price in the year of sale and the remaining 50% in the following year, you will recognize 50% of the original capital gain in the year of sale and the remaining 50% in the following year.

Numerical example

For example, let's assume that you sell your cottage to your children at fair market value for \$400,000. The ACB of the cottage is \$100,000. You would normally declare a capital gain of \$300,000. However, your children can only afford to pay you \$100,000 in the year of the sale so you agree to take back a note for the remaining \$300,000. In this case, you can claim a "reserve" for tax purposes for a portion of the \$300,000 capital gain. You can recognize a portion of the \$300,000 capital gain in the year of the sale and defer a portion of this gain to a future tax year since you have not received all the proceeds in the year of the sale. The calculation of the capital gain reserve you can claim would be:

The lesser of:

$$a) = (\$300,000) / (\$400,000) \times \$300,000 = \$225,000$$

$$b) = (1/5 \times \$300,000) \times (4-0) = 60,000 \times 4 = \$240,000$$

Therefore, you only have to recognize a capital gain of \$75,000 (\$300,000 - \$225,000), in the year of the sale. You can defer the remaining \$225,000 capital gain to future tax years. In the following year, you would include the \$225,000 as a capital gain in your income and you would repeat the capital gains reserve calculation.

Ten-year reserve period for certain types of capital property

You may be able to spread the capital gain you realize over a maximum period of ten years if you are

transferring certain types of capital property to a child, grandchild, or great-grandchild who is a resident of Canada at the time of transfer.

The property that qualifies must be:

- Family farm property or family fishing property (which includes shares of a family farm or fishing corporation, an interest in a family farm or fishing partnership, as well as land or depreciable property in Canada that you, your spouse or common-law partner, your parent or any of your children used in a farming or fishing business); or
- Shares of a qualified small business corporation (QSBC).

Lifetime capital gains exemption (LCGE)

A capital gain that you bring into income in the year following the year you claim a reserve may still qualify for the LCGE. In order to qualify, the original capital gain must qualify for the LCGE. Generally, you qualify for the LCGE if you dispose of shares of a QSBC, qualified farm property or qualified fishing property.

Other considerations

When deciding if you should claim the reserve, you will want to consider your current and future marginal tax rate. The deferral of the capital gains can be especially advantageous if you expect to be in the same tax bracket or a lower tax bracket over the next four years.

Another benefit of claiming the capital gains reserve is the ability to match the cash flow from the proceeds of sale to the income tax payment.

If you receive certain income-tested benefits, bear in mind that deferring recognition of capital gains can be a potential disadvantage. This is because when you include portions of the capital gain in your income



If you are selling your property with accrued gains and will not be receiving all of the proceeds upfront, the capital gains reserve may help you defer taxes. Speak to a qualified tax advisor for more information.

in future years, the amount of certain benefits to which you may be entitled (e.g. Old Age Security) may be reduced.

In addition, in the year of death, you cannot claim a reserve. Any remaining deferred capital gain must be included in your final return and your estate is responsible for the related tax liability.

Conclusion

If you are selling your property with accrued gains and will not be receiving all of the proceeds upfront, the capital gains reserve may help you defer taxes. Speak to a qualified tax advisor for more information.

This article may contain several strategies, not all of which will apply to your particular financial circumstances. The information in this article is not intended to provide legal, tax, or insurance advice. To ensure that your own circumstances have been properly considered and that action is taken based on the latest information available, you should obtain professional advice from a qualified tax, legal, and/or insurance advisor before acting on any of the information in this article.

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