

TERRA FIRMA

ISSUE 03

The Tax Fortress

*How Canada's Tax Code Protects
the Disciplined Real Estate Investor*

A Publication for the Informed Investor

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The Tax Landscape

Before examining any individual tax strategy, you need to understand the landscape as it exists in 2026 – and that landscape has shifted significantly in the past two years.

Capital gains inclusion rate: unchanged at 50%. The federal government proposed increasing the inclusion rate from 50% to 66.67% for annual gains above \$250,000 (for individuals) and on all gains for corporations and trusts. This was originally proposed in the 2024 budget with a June 25, 2024 effective date, then deferred to January 1, 2026. On March 21, 2025, Prime Minister Mark Carney announced the proposed increase would be cancelled entirely. The inclusion rate remains at 50% for all taxpayers. This means that for every \$100,000 in capital gains on an investment property, \$50,000 is included in your taxable income.

The Lifetime Capital Gains Exemption (LCGE) was increased to \$1.25 million effective June 25, 2024, and is indexed to inflation starting in 2026 (approximately \$1.275 million for 2026). This applies to qualified small business corporation shares and qualified farm or fishing property – not to rental real estate directly, but relevant for investors who hold real estate through qualifying corporate structures.

Alternative Minimum Tax (AMT) changes. Effective January 2024, the AMT rules were expanded. Even with the inclusion rate remaining at 50%, taxpayers with large capital gains may face AMT exposure. This is particularly relevant for Ontario investors who realize significant gains in a single tax year – for example, upon the sale of a portfolio property.

The tax code does not reward the investor who earns the most. It rewards the investor who keeps the most. That distinction is the foundation of this issue.

The Principal Residence Exemption

The Principal Residence Exemption (PRE) is the single most valuable tax provision available to Canadian homeowners. When you sell a property that qualifies as your principal residence, the entire capital gain is exempt from tax – no matter the size. A \$200,000 gain or a \$2 million gain: both fully sheltered.

Qualification requirements. Under the Income Tax Act, the property must be "ordinarily inhabited" during the year by you, your spouse or common-law partner, or your children. The CRA does not specify an exact duration – the bar is relatively low. Only one property per family unit (you plus your spouse/common-law partner and minor children) can be designated as a principal residence per year. You must own the property (alone or jointly). Since 2016, the sale must be reported on Schedule 3 of your tax return to claim the exemption.

THE +1 RULE: HOW THE FORMULA WORKS

The PRE exemption formula is: $\text{Exempt Gain} = \text{Capital Gain} \times (1 + \text{Years Designated}) \div \text{Years Owned}$.

The critical element is the "+1" in the numerator. This extra year means that if you own two properties and designate one as your principal residence for all years of ownership, the +1 allows one overlap year where the other property is also fully sheltered. In practice, this means you can sell one home and buy another without any gap year creating a taxable event – provided you designate strategically.

Example: You own Property A for 10 years and Property B (a cottage) for 10 years. You designate Property A as your principal residence for 9 of those years. The exempt portion of Property A's gain = $(1 + 9) \div 10 = 100\%$. The exempt portion of Property B's gain = $(1 + 1) \div 10 = 20\%$. The remaining 80% of Property B's gain is taxable. The optimal designation depends on which property had the higher per-year gain – always consult a tax professional for multi-property scenarios.

The 2023 flipping rule. Since January 1, 2023, profits on residential property held for fewer than 365 days are treated as fully taxable business income – not capital gains. The PRE does not apply. Exceptions exist for certain life events: death, disability, the birth of a child, a new job requiring relocation, divorce or separation, and threats to personal safety. This rule fundamentally changes the calculus for any strategy involving short holding periods. The Canadian tax system now explicitly rewards holding, not trading.

THE CHANGE-OF-USE ELECTION: ITA SECTION 45(2)

When you convert your principal residence to a rental property, you trigger a "deemed disposition" at fair market value – potentially creating a taxable capital gain. However, by filing a Section 45(2) election, you can continue to designate the property as your principal residence for up to four additional years after the change of use, provided you do not claim CCA on the property and you remain a Canadian resident.

The trade-off: while the 45(2) election is in effect, you cannot designate any other property as your principal residence. For investors converting a home into a rental before purchasing a new residence, this creates a strategic decision that requires careful analysis of which property will generate the greater gain over time.

Capital Cost Allowance

Capital Cost Allowance (CCA) is Canada's tax depreciation system. It allows rental property owners to deduct a portion of the building's cost each year against rental income. It is optional, it is powerful, and it is widely misunderstood.

How it works. Most residential rental buildings acquired after 1987 fall into CCA Class 1, which carries a 4% declining-balance rate. Only the building portion qualifies — land is not depreciable. In the year of acquisition, the half-year rule limits your claim to 50% of the net addition (effectively 2% in year one). CCA is claimed on Form T776 (Statement of Real Estate Rentals).

The critical constraint: CCA cannot be used to create or increase a rental loss. If your total rental income from all properties is negative before CCA, you cannot claim any CCA for the year. If your net rental income is \$5,000 before CCA, you can claim up to \$5,000 in CCA — reducing your rental income to zero, but no further. Unclaimed CCA carries forward indefinitely.

CCA is not a deduction. It is a deferral. Every dollar you claim today will be recaptured tomorrow — at full income tax rates.

RECAPTURE: THE TAX THAT WAITS

When you sell a rental property, if the sale price allocated to the building exceeds the undepreciated capital cost (UCC), the difference is "recaptured" and included in your income as ordinary income — taxed at 100% inclusion, at your marginal rate. This is not a capital gain. It is full income.

Example: You purchased a rental building for \$400,000 (building portion) and claimed \$60,000 in CCA over the years. UCC is now \$340,000. You sell the building portion for \$450,000. Recapture: \$400,000 - \$340,000 = \$60,000 (taxed as income). Capital gain: \$450,000 - \$400,000 = \$50,000 (50% inclusion = \$25,000 taxable). Total taxable amount: \$85,000.

The strategic question: CCA saves you tax at your current marginal rate and triggers recapture at your future marginal rate. If you expect to be in a lower tax bracket when you sell (e.g., retirement), CCA is beneficial. If your rate will be the same or higher, you are merely deferring — not saving. Many advisors recommend not claiming CCA on residential rental properties unless there is a clear tax-bracket differential or the time value of the deferral is meaningful.

New: Accelerated CCA for purpose-built rental. Under Bill C-15, new purpose-built residential rental buildings that begin construction after April 15, 2024 and before 2031 (available for use before 2036) qualify for an accelerated CCA rate of 10% instead of the standard 4%. This is a significant incentive for developers and investors building new rental supply in Ontario, though the recapture implications on an eventual sale must still be modelled carefully.

The Smith Manoeuvre

In the United States, mortgage interest on a primary residence is tax-deductible. In Canada, it is not. But the Income Tax Act, under Section 20(1)(c), does allow Canadians to deduct interest on money borrowed to earn income from investments — including dividends, interest, and rental income.

The Smith Manoeuvre, developed by financial planner Fraser Smith, exploits this distinction. It is a debt-conversion strategy that gradually transforms your non-deductible mortgage interest into tax-deductible investment debt — without increasing your total debt.

HOW IT WORKS: STEP BY STEP

1. Readvanceable mortgage. You need a mortgage product that combines a traditional mortgage with a home equity line of credit (HELOC). As you pay down mortgage principal, the HELOC limit increases automatically by the same amount. Products from major Canadian banks and credit unions offer this structure.
2. Borrow and invest. Each time a mortgage payment reduces your principal, borrow the newly available HELOC room and invest it in income-producing assets: Canadian dividend stocks, dividend ETFs, bonds, or rental real estate. The borrowed funds must be traceable to income-generating investments — the CRA requires a direct and clear link.
3. Deduct the interest. Because the HELOC funds are now invested to earn income, the HELOC interest becomes tax-deductible under ITA s.20(1)(c). You can also capitalize the interest (borrow from the HELOC to pay its own interest), which is itself deductible.
4. Reinvest tax refunds. The deduction generates a tax refund. Use it to make an extra mortgage payment — which creates more HELOC room — which you borrow and invest. This accelerating cycle pays off the mortgage faster while building an investment portfolio.
5. End state. Over time, the non-deductible mortgage is fully repaid and replaced by a tax-deductible HELOC of equivalent size. Your total debt is unchanged, but the after-tax cost is dramatically lower.

The Ontario advantage. With Ontario property values supporting large HELOC limits, and combined marginal tax rates reaching 53.53% at the highest bracket, the Smith Manoeuvre's benefit is substantial. At a 50% marginal rate, a 6% HELOC rate effectively becomes 3% after the tax deduction. That spread — versus a non-deductible mortgage at the same rate — compounds significantly over a 20-year amortization.

Risks and requirements. Investments can lose value while the HELOC debt remains. The CRA requires meticulous traceability — mixing personal and investment use of the HELOC will

disqualify the deduction. This is not a passive strategy; it requires discipline, proper record-keeping, and professional advice from both a mortgage broker and a tax professional.

FHSA + HBP: The Entry Strategy

For first-time buyers entering the Ontario market, Canada now offers the most generous set of tax-advantaged home purchase programs in the country's history. The combination of the First Home Savings Account (FHSA) and the Home Buyers' Plan (HBP) creates a pathway that, used strategically, can assemble a substantial tax-sheltered down payment.

\$40K

FHSA Lifetime Contribution Limit

\$60K

HBP Maximum RRSP Withdrawal

\$100K

Combined Per-Person
Tax-Advantaged Entry

THE FIRST HOME SAVINGS ACCOUNT (FHSA)

Introduced in 2023, the FHSA is uniquely powerful because it combines the best features of both the RRSP and the TFSA:

Contributions are tax-deductible — like an RRSP. An \$8,000 contribution at Ontario's ~43% combined marginal rate (for income around \$110,000) saves approximately \$3,472 in income tax.

Qualifying withdrawals are tax-free — like a TFSA. When you withdraw funds to purchase a qualifying home, you pay no tax on the withdrawal, including any investment growth within the account.

Annual limit: \$8,000 per year. Lifetime limit: \$40,000. Unused room carries forward up to \$8,000 per year (room only begins accumulating once you open the account). The account can remain open for 15 years or until you turn 71.

Key distinction from RRSP: FHSA contributions in the first 60 days of a year cannot be deducted on the prior year's return (unlike RRSP contributions). Plan accordingly.

FHSA withdrawals never need to be repaid. This is the fundamental advantage over the HBP.

THE HOME BUYERS' PLAN (HBP)

The HBP allows first-time buyers to withdraw up to \$60,000 from their RRSPs tax-free to purchase a qualifying home (increased from \$35,000 in April 2024). A couple can each withdraw \$60,000, for a combined \$120,000.

Repayment: HBP withdrawals must be repaid to your RRSP over 15 years, starting in the second year after withdrawal (or the fifth year for withdrawals made between January 1, 2022 and December 31, 2025, under temporary relief measures). Minimum annual repayment is 1/15th of the total withdrawal. Amounts not repaid on schedule are included in taxable income for that year.

Stacking FHSA + HBP: You can use both programs for the same home purchase. A single buyer: up to \$40,000 (FHSA) + \$60,000 (HBP) = \$100,000. A couple: up to \$200,000 combined. The FHSA withdrawal has no repayment obligation; the HBP does. Prioritize maximizing FHSA contributions first, then supplement with HBP as needed.

Incorporation

One of the most common questions from Ontario real estate investors scaling their portfolios is whether to hold rental properties personally or through a corporation. The answer, like most tax questions, is: it depends.

The corporate tax rate advantage. A Canadian-controlled private corporation (CCPC) pays a combined federal-Ontario tax rate of approximately 12.2% on the first \$500,000 of active business income (the small business rate). However, rental income is generally classified as passive investment income, which is taxed at a combined rate of approximately 50.17% at the corporate level. This largely eliminates the tax-deferral advantage that incorporation offers for active business income.

When incorporation may make sense:

If your rental operation is sufficiently large and active that it qualifies as a business rather than passive investment (multiple properties, employees, active management), the income may be treated as active business income eligible for the small business rate. The CRA applies a facts-and-circumstances test. Having a dedicated office, employees, regular advertising, and a significant number of properties supports this characterization — but there is no bright-line rule, and CRA has challenged many taxpayers on this point.

THE PASSIVE INCOME PENALTY

Since 2019, a corporation's access to the small business deduction is clawed back when its passive investment income exceeds \$50,000 in the prior year. For every \$1 of passive income above \$50,000, \$5 of the business limit is reduced. At \$150,000 in passive income, the small business deduction is fully eliminated.

For real estate investors who also operate an active business through a corporation, this creates a direct tension: rental income in the same corporate structure can erode the tax benefits of the operating business. Many advisors recommend separating active business and investment activities into distinct corporate entities — but the added complexity and cost must be justified by the tax savings.

Other considerations. Incorporation provides asset protection (the corporation, not you personally, is the property owner), estate planning flexibility, and the ability to income-split through dividends (subject to the Tax on Split Income rules). However, a corporation cannot claim the PRE. Properties held in a corporation will always trigger capital gains and recapture

on disposition. Land transfer tax applies on transfer of property into a corporation. And the added cost of corporate tax filings, legal fees, and accounting can easily run \$3,000-\$5,000 per year.

The decision to incorporate should be driven by portfolio scale, liability concerns, and long-term tax planning – not by the assumption that "corporate" automatically means "lower taxes." For most Ontario investors with fewer than five rental units, personal ownership remains simpler and often more tax-efficient.

The Integrated Strategy

No single tax strategy operates in isolation. The Ontario investor who builds lasting, tax-efficient wealth is the one who integrates these tools into a coherent plan.

Phase 1: Entry (first property). Maximize FHSA contributions (\$8,000/year, opened as early as possible to accumulate room). Supplement with HBP if needed. Purchase an owner-occupied property – ideally a duplex or property with a legal secondary suite – to begin building equity while generating rental income. Claim the PRE. If renting a portion, maintain clear records separating personal and rental use for CCA and expense allocation purposes.

Phase 2: Accumulation (properties 2-4). Use equity from the first property (via HELOC or refinancing) to fund additional acquisitions. Consider the Smith Manoeuvre on your principal residence to convert non-deductible debt into deductible investment debt. Hold rental properties personally. Defer CCA claims unless you have a clear tax-bracket advantage. Ensure your rental income reporting is meticulous – the CRA's rental income audit program is active in Ontario.

Phase 3: Scaling (properties 5+). Transition to commercial lending (DSCR-based, as covered in Issue 02). Evaluate incorporation – particularly if your rental activity approaches "business" characterization or if liability concerns warrant corporate protection. Consider CMHC MLI Select for 5+ unit acquisitions. Model CCA recapture scenarios before claiming. Work with a CPA who specializes in real estate to structure the portfolio for tax efficiency across federal and Ontario provincial brackets.

Phase 4: Preservation. Strategic property dispositions – selling in years of lower income, staggering sales across tax years to manage the \$250,000 AMT threshold, and using the PRE designation formula to shelter the highest-gain property. Estate planning through a spousal rollover (on death, a principal residence can transfer to a surviving spouse without triggering tax). For portfolio properties, consider transferring to the next generation through a family trust – though the 21-year deemed disposition rule for trusts requires careful planning.

The tax code is not your enemy. It is architecture – and like all architecture, it rewards those who study the blueprints.

NEXT ISSUE

Issue 04: The Location Equation

A data-driven analysis of Ontario's regional markets — GTA, Ottawa, Hamilton, Kitchener-Waterloo, London, and Northern Ontario — examining cap rates, rental yields, vacancy trends, and the micro-market dynamics that separate wealth-building locations from capital traps.

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