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Tax and Real Estate Investment: Types of Income

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As Toronto real estate prices continue to soar and many still consider buying or selling real estate as an investment, we will cover some of the more common questions or misconceptions that our clients deal with when it comes to taxes and real estate investment.

Our first in our series of real estate tax articles looks at one of the most commonly misunderstood concepts: the nature of income earned on the sale of a real estate property.

Depending on the buyer's intentions, a real estate property could be treated as a capital property or an inventory.

The major difference between a capital property and an inventory is that the gain resulting from the sale of a capital property is only taxed at 50% (taxable capital gain), whereas the gain on the sale of an inventory is fully taxable (business or property income).

The Income Tax Act does not describes the circumstances in which gains from the sale of real estate are to be determined as being either income or capital. However, as a result of many court decisions, there are general factors that the CRA will look at to make such determination:

a) intention with respect to the real estate at the time of its purchase;

b) feasibility of the intention;

c) geographical location and zoned use of the real estate acquired;

d) extent to which intention carried out;

e) evidence that the intention changed after purchase of the real estate;

f) the nature of the business, profession, calling or trade of the individual and associates;

g) the extent to which borrowed money was used to finance the real estate acquisition and the terms of the financing, if any, arranged;

h) the length of time throughout which the real estate was held by the taxpayer;

i) the existence of persons other than the taxpayer who share interests in the real estate;

j) the nature of the occupation of the other persons referred to in (i) above as well as their stated intentions and courses of conduct;

k) factors which motivated the sale of the real estate;

l) evidence that the taxpayer and/or associates had dealt extensively in real estate.

If it can be proven that at the time of acquiring the property there was a secondary intention of reselling it at a profit when the main or primary intention does not pan out, when the secondary intention is carried out, any gain realized on the sale of the property is usually fully taxable as business income.

This determination is often a question of facts, but the Federal Court of Appeal in its decision in the Canada Safeway Ltd. v. Canada case noted that for there to be a secondary intention, it "must have been an operating motivation in the acquisition of the property".

Principal Residence Exemption

You can designate a property as your principal residence and this could fully or partially (depending on the number of years you designate the property as your primary residence) shelter the gain on the sale of the residence from taxes.

To designate a property as your principal residence for a particular year, the property does not have to be the place where you live all the time. The property will qualify as a principal residence if you or your spouse or common-law partner, or any of your children lived in it at some time during the year. However, if you are in the construction business or if you buy and sell homes often, the CRA may determine that your intention in buying and selling these properties is to generate income, and not for your use and personal enjoyment. In this case, the CRA may consider your home as inventory and you may be fully taxed on the gain as business profit.

In October 2016, the CRA changed its longstanding policy which did not require taxpayers to report the sale of their principal residence if the entire gain from the sale was sheltered from tax, due to a full claim of the principal residence exemption.

Prior to 2016, there was no need to report the sale on your tax return if the entire gain was sheltered by the principal residence exemption. Starting with the 2016 tax year, the sale of a principal residence must be reported on your tax return, since the CRA uses this information to track frequent purchases and sales of homes by taxpayers who are often considered to be "flipping" properties.

This article has been prepared for the general information of our clients. Specific professional advice should be obtained prior to the implementation of any suggestion contained in this article. Please note that this publication should not be considered a substitute for personalized tax advice related to your particular situation.

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Originally published March 5, 2018