

REAL ESTATE LAW

TAX ASPECTS OF REAL ESTATE TRANSACTIONS

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Chapter 8

Income Tax Act Aspects of Real Estate Transactions¹

[§8.01] Introduction

General practitioners should be aware of potential income tax consequences of the acquisition, holding, use and disposition of real estate. This chapter highlights the more important tax issues that the general practitioner can expect to encounter in practice. The objective is to briefly describe taxation principles as they apply to real estate transactions, while alerting lawyers to tax planning opportunities and pitfalls. All statute references are to the *Income Tax Act* (Canada). This chapter does not discuss the GST as it applies to real estate.

[§8.02] Principal Residence

1. Principal Residence Exemption

As a general rule, when an individual taxpayer sells his or her principal residence, he or she is not taxed on any appreciation in value during the period of ownership (s. 40(2)(b)). One reason for this favourable treatment is clear: taxpayers would regard the tax system as quite unfair if they were not able to move because of the tax cost of doing so.

In order for the gain on the sale of property to be fully exempt, the property must have been the taxpayer's principal residence throughout the time he or she owned it, and the taxpayer must have been a resident of Canada throughout the ownership period.

To qualify as a principal residence, a property must satisfy the definition set out in s. 54. The test is an annual one, so a property may be a principal residence for some years and not for others. The main requirement is that the taxpayer, the taxpayer's spouse or former spouse, or a child of the taxpayer, must ordinarily inhabit the housing unit in the year. It has been accepted that even a short seasonal occupancy satisfies the ordinarily inhabited requirement if the taxpayer's principal reason for acquiring the property was not to derive income from it.

Certain types of trusts also qualify for the principal residence exemption. In order to qualify, the trust must designate the property as its principal residence for the year, the trust must specify the "designated beneficiaries" of the trust, no corporation may have an interest in the trust, and only one property may be designated for each family unit (see the definition of "principal residence" in s. 54). A "specified beneficiary" is an individual who has a beneficial interest in the trust and who ordinarily inhabited the residence during the year, or who has a spouse, former spouse or child who ordinarily inhabited the residence during the year.

Up to one-half hectare of the land surrounding a housing unit is regarded as part of the principal residence if it contributes to the taxpayer's use and enjoyment of the unit as a residence. Any land in excess of one-half hectare is included only if the land is necessary to the use and enjoyment of the housing unit. It has been held that land in excess of one-half hectare meets this test if the taxpayer is prohibited from subdividing the land, and thus could not legally reside on a smaller property.

The types of property that can qualify as a principal residence are "a housing unit, a leasehold interest in a housing unit, or a share of the capital stock of a cooperative housing corporation". The term "housing unit" is not defined in the Act; in accordance with the Canada Revenue Agency's administrative policy, the term includes a house, an apartment, a condominium, a cottage, a mobile home, a trailer and a houseboat. A principal residence may be owned by the taxpayer alone, or jointly (either as joint tenants or tenants in common) with one or more other persons.

A "family unit" is limited to only one principal residence in a year. For this purpose, a family unit consists of a taxpayer, his or her spouse (other than a separated spouse), and unmarried children under the age of 18.

Section 54 requires a taxpayer to designate a property as a principal residence for each year that he or she wishes it to be regarded as such. The designation is made for all years when the taxpayer files a tax return for the year of disposition of the property. As an administrative concession, the Canada Revenue Agency ("CRA") does not require the designation form to be filed if the gain is fully exempt by virtue of the principal residence exemption (except for trusts).

¹ Prepared by David R. Davies, Thorsteinssons, Vancouver. Reviewed in July 2008, July 2006 and July 2005 by Joel Camley of Gowling Lafleur Henderson LLP.

2. Partial Exemptions

If a property was a principal residence for some years and not for others, or if the taxpayer resided outside Canada in any of the years that he or she owned the property, then the total gain is divided into a portion that is exempt and a portion that is taxable (s. 40(2)(b)). Only those years in which the property was the taxpayer's principal residence and during which the taxpayer was resident in Canada are included in calculating the exempt portion of the gain. More specifically, the exempt portion of the gain is equal to the total gain, multiplied by $(1 + \text{the number of years after 1981 ending after the acquisition date that the property was a principal residence and during which the taxpayer was resident in Canada})$, divided by $(\text{the number of years after 1981 that the taxpayer owned the property})$.

A property may be a principal residence for some years and not for others for any one of at least three reasons.

- The taxpayer may own more than one property that is ordinarily inhabited by family members and may designate one property as his or her principal residence for some years and another property as his or her principal residence for other years.
- Before 1982, the Act permitted each taxpayer, as opposed to a family unit, to have a principal residence. When the Act was amended to impose a limit of one principal residence per family unit, this may have prevented the taxpayer from continuing to treat the property as a principal residence. A common example of this would be a regular residence owned by a taxpayer and a recreational property owned by the taxpayer's spouse, with both properties having been acquired before 1982. Both properties might have qualified as principal residences for 1981 and earlier years, but only one could qualify after 1981.
- A property may fail to be a principal residence for some years because the taxpayer used the property in those years to earn income. For example, a taxpayer may have lived in a house for several years, and then rented it to third party tenants.

3. Change in Use of Property

Generally, a change in the use of a property (for example, a principal residence becoming a rental property or property used in a business, or *vice versa*) triggers a deemed disposition of the property at its fair market value (s. 45(1)). Elections are available to defer, or in some cases avoid, these deemed

dispositions (s. 45(2) and (3)).

With respect to property which is initially a residence and which becomes an income-producing property, the election to override the deemed disposition must be made in the taxpayer's tax return for the year in which the change in use occurred (s. 45(2)). However, the CRA's administrative policy is ordinarily to accept a late-filed election if the taxpayer intended to elect under subsection 45(2), provided no capital cost allowance has been claimed with respect to the property subsequent to the change in use. During the time that the election is in effect, capital cost allowance cannot be claimed in respect of the property.

As a consequence of the election, the property can continue to be designated as a principal residence for an additional four years, whether or not the taxpayer ever returns to live in it (s. 54 "principal residence"). Thus, a taxpayer who moves out of his or her residence but continues to own it and rents it to someone else is entitled to the principal residence exemption in respect of any continuing appreciation for up to four years. Of course, designating the property as a principal residence precludes the use of the principal residence exemption in respect of any other property for the years in question.

The four year period is extended indefinitely if the taxpayer has moved from the residence as a consequence of the relocation of his or her place of employment or the relocation of the place of employment of the taxpayer's spouse or common-law partner (s. 54.1). However, this extension is available only if the taxpayer returns to the property during the term of or following the termination of that employment or if the taxpayer dies during the term of the employment. As a consequence of this provision, a taxpayer who moves to take a new job and who expects to return to his or her residence in the future can benefit from the principal residence exemption even while he or she does not inhabit the residence.

4. Transfers Between Spouses or Common-law Partners

If property is transferred between spouses or common-law partners or by one spouse or common-law partner to a spousal trust or a common-law partner trust for the other on a rollover basis (including a transfer as a consequence of death), the transferee is deemed, for the purpose of the principal residence rules, to have owned the property throughout the period during which the transferor owned it (s. 40(4)(a)). Moreover, if the transferor had designated the property to be his or her principal residence for a particular year (or in the case of a transfer on death was eligible to designate the property as a principal residence) the transferee is

entitled to treat the property as a principal residence for that year (s. 40(4)(b)).

Whenever property is transferred between spouses or common-law partners, you must consider the possible application of the attribution rules. Those rules are described in the *PLTC Practice Material: Company*.

[§8.03] Non-Resident Seller

The Act contains safeguards to ensure that tax is collected when non-resident persons sell certain types of property, including real property situated in Canada (s. 116). These provisions are necessary because of the practical difficulty of collecting taxes from non-residents. Provision is made for advance payment by the seller on account of tax, or alternatively, for the furnishing of security to the Minister, and for the issuance by the Minister of a certificate in respect of the proposed disposition. If the seller fails to obtain a certificate, or if the sale price exceeds the amount fixed in the certificate, the buyer may be liable to pay tax on behalf of the non-resident seller, up to 25% of the price of the property (50% in the case of depreciable property). The buyer will want to take all possible steps to avoid this liability.

The buyer is not liable if after reasonable inquiry he or she had no reason to believe that the seller was a non-resident of Canada. Accordingly, a buyer should seek a statutory declaration or similar document from the seller stating that the seller is a Canadian resident. Any information which comes to the buyer's attention which indicates that the seller may be a non-resident should be followed up.

If the seller is, or appears to be, a non-resident, the buyer should require a certificate as a condition of closing, and the amount fixed in the certificate should be no less than the purchase price. As noted above, the seller obtains the certificate by providing details of the proposed transaction to the Minister and by either making an advance payment in respect of any tax which the seller may ultimately owe, or alternatively, by posting acceptable security. Usually, a bank letter or guarantee is acceptable security. You should allow at least 30 days for obtaining a certificate.

Other points which should be noted are as follows:

- (a) a certificate can be obtained after the completion of a transaction, and will have a similar effect to the pre-completion certificate in protecting the buyer from liability;
- (b) if a certificate will not be available on closing, the buyer should protect himself or herself by requiring a holdback, with the holdback to be released on the production of a certificate before the date that the buyer is required to pay any tax in respect of the transaction;

- (c) the buyer has 30 days after the end of the month in which property was acquired to pay any tax for which he or she is liable. Any holdback should be used for the purpose of satisfying this obligation;
- (d) in the case of non-depreciable property, the seller must notify the Minister within ten days of a sale if advance notification was not provided; and
- (e) the rules which apply when a seller is a non-resident also apply to inter vivos gifts and non-arm's length dispositions made by non-resident persons, and in these cases the property is treated as if it were disposed of for its fair market value.

[§8.04] Disposition of Real Estate

1. Capital Gain or Income

The nature of a profit or loss which arises on the disposition of property must be determined for tax purposes. If the profit or loss is of an income nature, then the full amount must be included in income (if a profit) or can be deducted from other income (if a loss). If the profit or loss is of a capital nature, then it is subject to the capital gains rules. Taxpayers will normally prefer to have their profits characterized as capital gains and their losses characterized as being on income account.

The capital gains versus income issue is not unique to real estate investments. Nonetheless, the great majority of cases involve real estate since such transactions are common and it is often unclear on which side of the line a particular gain or loss falls.

A gain or loss is of an income nature if, at the time of acquisition of the property, the taxpayer was motivated partly or wholly by an intention to sell the property at a profit. Under existing jurisprudence, even if the taxpayer intended to sell at a profit only if his or her other plans for the property were unsuccessful, the property is on income account if this secondary intention was a motivating factor when acquiring the property. On the other hand, if the taxpayer acquired the property as an investment, i.e., in order to realize income from the property, then the gain or loss is of a capital nature. "Personal use property" is also subject to capital gains treatment, except that any loss on the disposition of such property is deemed to be nil. A "personal use property" includes property that is used primarily for the personal use or enjoyment of the taxpayer or a person related to the taxpayer.

Factors that a court may consider in determining whether property was held on income or capital account include the following:

- (a) the period of ownership—the longer the period, the more likely the property will be considered as an investment;
- (b) the frequency of similar transactions—is the transferor a trader of real estate?
- (c) the extent of the effort made to put the property into a more marketable condition;
- (d) the reason for the sale—was the sale actively promoted or was it the result of an unanticipated event?
- (e) the nature of the taxpayer's regular business—is the taxpayer a builder or a real estate agent?
- (f) the extent to which income was derived from the property during its ownership by the seller—profits derived from the sale of raw land are generally taxed on income account; and
- (g) The extent to which borrowed money was used to finance the property—transactions not involving borrowed money are more likely to be of a capital nature.

2. Allocation of Proceeds of Disposition

(a) Interests of Seller and Buyer

When depreciable and non-depreciable capital properties are sold together, the seller and the buyer often have conflicting interests in the allocation of the purchase price amongst the properties.

To understand this conflict, it is necessary to have an understanding of the rules applicable to depreciable property. Depreciable property is property the cost of which may be deducted for tax purposes. Such property is grouped into classes, and a specified proportion of the cost of the property in each class may be deducted each year. These deductions are referred to as capital cost allowance. When a property is sold, the sale proceeds, up to the cost of the property, are subtracted from the un depreciated capital cost ("UCC") of the class (UCC is the cost of the property in the class remaining to be deducted). If the amount to be subtracted exceeds the UCC of the class, this excess, referred to as recapture, must be included in income. If the amount to be subtracted is less than the UCC and there are no properties remaining in the class, the excess UCC may be deducted. This deduction is referred to as a terminal loss. The portion of the sale proceeds exceeding the cost of the

depreciable property is subject to capital gains treatment.

For example, assume

- (i) a taxpayer has acquired an income-producing building at a cost of \$350,000;
- (ii) this is the only property in its class; and
- (iii) the taxpayer has claimed capital cost allowance of \$100,000 in respect of the building (so that its UCC is \$250,000).

If the taxpayer sold the building for \$375,000, there would be recapture of \$100,000 and a capital gain of \$25,000. On the other hand, if the building were sold for \$200,000, there would be a deductible terminal loss of \$50,000.

A common situation in which a seller favours one allocation of the purchase price while the buyer prefers another is the sale of a building in respect of which the seller has claimed capital cost allowance, together with the sale of the associated land. The seller will usually prefer that the sale proceeds be allocated to the land to the greatest extent possible. Any profit on the sale of the land will be a capital gain, 1/2 of which is taxable (subject to the capital gains exemption), whereas, to the extent that sale proceeds are allocated to the building, recapture may arise or a terminal loss may be reduced. The buyer, on the other hand, generally prefers to allocate as much as possible to the depreciable property, since he or she is able to deduct this amount over time through the capital cost allowance mechanism. The cost of land is not deductible.

In some circumstances, one party or the other may not care how the purchase price is allocated. For example, a seller with large loss carryforwards may be willing to accept recapture, since this will not result in the payment of any additional tax. As another example, a seller that is a non-taxable entity clearly does not care how the proceeds are allocated, since it faces no tax consequences. A third example is a buyer who intends to use the property personally, and thus will not be claiming capital cost allowance.

The important point to draw from the above is that the seller and buyer should always turn their minds to the allocation of the purchase price, and the allocation should be documented in the purchase and sale agreement.

(b) Statutory Provisions Affecting Allocation

When the seller and buyer deal at arm's length, and both parties have a financial interest in the allocation of the purchase price, the CRA will usually accept the allocation arrived at by the parties. However, as noted above, there are situations in which one party does not have a financial stake in the allocation, and so is willing to accept whatever allocation is proposed by the other party. If the allocation made by the parties is unreasonable, the CRA is authorized by s. 68 to reallocate the proceeds on a reasonable basis.

Many disputes with the CRA have arisen from dispositions of real estate where the proceeds were allocated in such a way as to produce a terminal loss on the sale of a building (which was fully deductible) and a capital gain on the underlying land (only part of which was required to be brought into income). In other instances, most notably *R. v. Malloney's Studio Limited*, [1979] 79 D.T.C. 5124 (S.C.C.), land was sold clear of all buildings (which were demolished before completion) so that the full purchase price was in respect of the land. In order to put an end to these and similar practices, s. 13(21.1) was added to the Act. This section makes arbitrary adjustments to the proceeds of disposition of a building and related land.

Loosely speaking, s. 13(21.1) applies whenever a building is disposed of for less than its undepreciated capital cost (original cost less capital cost allowance which was claimed). A disposition includes a demolition, as well as a sale. If land associated with the building is sold in the same year, the section requires a reallocation of the proceeds so that a portion or all of any capital gain on the land is treated as part of the proceeds of disposition of the building. As a consequence, the terminal loss which would otherwise be claimed is partially or fully denied, and recapture may even result, even though the building may have a fair market value less than its undepreciated capital cost.

If the associated land is not disposed of in the same year as the building, then the proceeds of disposition of the building are deemed to be increased by one-half of the amount by which the undepreciated capital cost of the building (or its fair market value, if greater) exceeds those proceeds. At best, this results in a denial of part of the terminal loss that would otherwise be claimed.

It is important to keep s. 13(21.1) in mind whenever a building is sold, or is demolished before the sale of land. This section must always be examined to ascertain whether it overrides the allocation of proceeds the parties would otherwise wish to agree to. The section can be avoided by ensuring that the proceeds allocated to the building are at least equal to its undepreciated capital cost.

3. Deferred Payment

When a portion or all of the sale proceeds are not receivable until after the taxation year in which property is sold, the seller may be entitled to claim a reserve under s. 20(1)(n) if the property was on income account, or under s. 40(1)(a)(iii) if the property was on capital account. The effect of these reserves is to defer the tax on a portion of the profit until a subsequent year. Note that in the case of land, the s. 20(1)(n) reserve is available whenever proceeds are not due until after the end of the taxation year. In the case of any other type of property, the reserve is available only for the portion of the proceeds due more than two years after the date of sale. The maximum reserve claimable under s. 40(1)(a)(iii) is 4/5 of the gain in the first year, 3/5 of the gain in the second year, 2/5 of the gain in the third year and 1/5 of the gain in the fourth year.

Section 16(1) should also be borne in mind whenever the sale price is paid over time. To the extent that a portion of any payment can reasonably be regarded as interest, it must be included in computing the recipient's income as interest rather than as part of the sale proceeds.

4. Rollovers

The Act contains a number of provisions which permit property to be transferred from one taxpayer to another without any immediate tax consequences, or which permit the taxpayer to replace his or her property while deferring the tax consequences which would normally arise.

A commonly used rollover is in s. 85, which enables property to be transferred to a corporation for deemed proceeds of disposition equal to an amount agreed upon by the transferor and transferee, subject to certain limits. Section 85 is described in detail in the *Practice Material: Company*. A point worth noting is that the s. 85 election is not available in the case of real property which constitutes inventory or in the case of real property, an interest in the real property or an option in respect of the real property, owned by a non-resident person, unless it was used by the non-resident in the year in a business carried on in Canada.

A spousal or common-law partner rollover enables capital property to be transferred by one spouse to another or from one common-law partner to another or to a spousal trust or common-law partner trust for the benefit of the other spouse or common-law partner on a rollover basis (s. 73(1)). This rollover is described in the *Practice Material: Company*. The rollover applies automatically, unless the parties elect not to have it apply. When the transferee subsequently disposes of the property, the attribution rules may apply to deem the capital gain or capital loss to have been received by the transferor.

A replacement property rollover is available whenever property has been destroyed or expropriated and is replaced within two taxation years by property intended for a similar use (ss. 13(4) and (4.1)). The rollover is also available when a "former business property" (generally real property used for the purpose of earning income from a business, other than property used for the purpose of earning rent) is sold and is replaced within one taxation year by property intended for a similar use. In order to take advantage of the rollover, an election must be made in the tax return filed for the year that the replacement property is acquired. The amount of recapture or capital gain that is deferred by this rollover depends upon the cost of the replacement property.

5. Capital Gains Exemption

Until February 22, 1994, individuals were able to shelter up to \$100,000 of capital gains on investment real estate by using their capital gains exemption. The Federal Budget of February 22, 1994 eliminated the \$100,000 capital gains exemption, subject to transitional rules. However, individuals can still shelter up to \$750,000 of capital gains arising from the disposition of qualified farm property or qualified small business corporation shares.

[§8.05] Holding Real Estate

1. Bare Trust Corporation

Corporations are often used as bare trustees or nominees to hold real estate on behalf of the shareholders. The advantages include:

- (a) simplicity of title registration in the company's name rather than the names of a large number of individuals;
- (b) simplicity of transferring title to shares rather than title to real property; and
- (c) avoidance of British Columbia Property Transfer Tax by transferring the shares of the corporation rather than the land itself.

Whenever property is to be held in trust, the income tax consequences of the trust must be examined. The CRA views a bare trust to exist where the trustee has no significant powers or responsibilities, and can take no action without instructions from the settlor; the trustee's only function is to hold legal title to the property, and the settler/transferor is the sole beneficiary and can cause the property to revert to him or her at any time. When a bare trust corporation is to be used, the appropriate agreement or declaration of trust should be drawn up on a timely basis.

2. Carrying Costs

The deduction of carrying charges (interest and property taxes other than land transfer taxes) relating to vacant land is restricted (s. 18(2)). In general, carrying charges are not deductible except to the extent that the revenue from the land exceeds other expenses. The restriction does not apply in any year in which the land is used in a business (other than an adventure in the nature of trade) carried on in the year by the taxpayer (unless the land is held primarily for the purpose of resale or development) or in which the land is held primarily for the purpose of earning income from the land.

Section 18(9.1) allows the deduction of bonuses and penalties on the payout of a mortgage if the property was used by the taxpayer in the course of carrying on a business or to earn income. The deduction is not available on a "refinancing" transaction where one mortgage is bought out and replaced with another debt obligation; it is only applicable where a mortgage is bought out and not replaced.

Corporations whose principal business is the leasing, rental or sale, or the development for lease, rental or sale of real property are entitled to a larger deduction for carrying charges (s. 18(2)(f)). Carrying charges are deductible by such corporations to the extent of the revenue for the land (net of other deductions) and the base level deduction of the corporation. The base level deduction is the interest for a year, computed at a prescribed rate, on \$1,000,000. In effect, such corporations are permitted an additional deduction in respect of carrying charges of up to approximately \$60,000 (based on the current prescribed rate). The additional deduction must be shared by associated corporations.

When land is held as capital property, non-deductible carrying charges are added to the adjusted cost base of the land (s. 53(1)(h)). In the case of land that is held as an adventure or concern in the nature of trade, the carrying charges are added to the cost of the land under ss. 10(1.01) and 10(1.1). Presumably this policy will continue. Thus, in all cases the carrying charges are taken into account by a

reduction in the profit (or an increase in the loss) on the disposition of the land.

The limitation on the deductibility of carrying charges also applies to interest incurred on borrowed money used by the borrower to assist, directly or indirectly, certain persons to acquire land (s. 18(3.1)(b)). As an example, money borrowed to acquire shares of a corporation of which the taxpayer owns 10% of the shares would be caught if the corporation used the funds obtained through the issuance of shares to acquire vacant land.

[\$8.06] Foreclosure and Forced Sale

1. Foreclosure

When a mortgagee realizes on the security of a mortgaged property, there are income tax implications to both the lender and the borrower.

Section 79 of the Act applies to determine the tax consequences to the borrower where the lender acquires beneficial ownership of a property as a consequence of the borrower's failure to pay an amount owing. In these circumstances, there is a disposition of the property by the borrower. The proceeds of disposition to the borrower will equal the principal amount and unpaid interest on the mortgagee's claim, plus the principal amount and unpaid interest on any other debt owing by the borrower to the extent that the other debt is extinguished by reason of the foreclosure. If the borrower is forced to pay any taxes as a result of the foreclosure, the borrower may face a hardship because no cash may have been received from which the tax can be paid. A payment made by a borrower to a mortgagee after the foreclosure is deemed to be a capital loss if it relates to non-depreciable capital property and an income loss if it relates to depreciable property.

Section 79.1 also contains rules that apply to the mortgagee when the mortgagee acquires property by way of foreclosure. The cost of the property to the mortgagee is deemed to equal the cost to the mortgagee of the amount owing at the time of foreclosure. Thus, if the mortgagee disposes of the property in the future for proceeds that are less than its cost, the mortgagee will realize a loss at the time of sale. Where the mortgagee previously owned the property and claimed a reserve in respect of any sale proceeds still owing, the amount of the reserve is deducted from the deemed cost of the property to the mortgagee.

2. Forgiveness of Debt

When a debtor's obligation to pay an amount is settled or extinguished for less than the full amount owing, s. 80 results in tax implications to the debtor. Section 80 requires the forgiven amount to be applied to first reduce the amount of the various types of losses that the debtor carries forward from prior years. If the forgiven amount exceeds the loss carried forward, the balance must be used to reduce the cost of the debtor of depreciable property and non-depreciable capital property. If there is still a remaining forgiven amount, two-thirds of the balance is included in the debtor's income.

[\$8.07] Leasing

1. Introduction

Under a leasing arrangement, rent will be paid by the tenant to the landlord. In addition, there may be various other types of payments or transfers of property from one party to the other, or to a third party. Examples include inducements, premiums to obtain leases, tenant improvements and cancellation payments. The tax implications of these payments or transfers of property should always be considered. In addition to the general tax principles that will apply, there are special provisions in the Act applicable to leases. Some of these are described below.

2. Capital Cost Allowance Restrictions

As a general rule, when a building is used to produce rental income, the amount of capital cost allowance claimed by the landlord each year cannot exceed the net rental income from the building (Regulations 1100(11) to (14.2)). This restriction is referred to as the rental property rule. The rule does not apply to life insurance corporations, to corporations whose principal business is the leasing, rental, development or sale of real property, or to partnerships of such corporations. As a consequence of the rental property rule, a taxpayer (other than the exempted corporations and partnerships) is not able to shelter other income with losses created by claiming capital cost allowance in respect of rental properties.

Similar rules, known as the leasing property rules, apply to other types of depreciable property (Regulations 1100(15) to (20)). These rules are relevant when the owner of a building also owns furniture, fixtures, appliances and other depreciable property which is leased together with the building.

3. Tenant Inducements

A common aspect of real property lease negotiations is the offer by the landlord of assistance to the tenant as an inducement to enter into the lease. Tenant inducements can take a variety of forms, such as:

- (a) a cash payment, which may be related to the cost of tenant improvements or to other costs to be incurred by the tenant, or may be independent of any tenant costs;
- (b) improvements made at the landlord's cost;
- (c) a rent-free or low rent period;
- (d) rental rebates throughout the term of the lease; or
- (e) an assumption by the landlord either of the tenant's responsibilities under another lease or of the cost of terminating the lease (lease pick-ups).

Generally, a landlord will want to treat the cost of providing the inducement as a current expenditure for tax purposes while the tenant will want to avoid an income inclusion or reduced deductions on account of the inducement.

Section 12(1)(x) governs the tax treatment of inducement payments. Amounts received as inducements or as reimbursements, contributions, allowances or assistance in respect of the cost of property or in respect of expenses must be included in income in the year of receipt. However, if the amount is received in respect of the cost of depreciable property acquired in the year in which the amount is received, in the three preceding years or in the immediately following year, the taxpayer may elect that the cost of the property for tax purposes be reduced by the inducement payment (s. 13(7.4)). If an election is made, s. 12(1)(x) does not apply to the inducement payment. A similar election is available when the amount is received in respect of non-depreciable capital property acquired in the same three year time span (s. 53(2.1)). Since this exemption from s. 12(1)(x) does not depend on there being any connection between the property in respect of which the allowance or contribution is provided and the leased premises, the exemption can be obtained by structuring the inducement as assistance in respect of the cost of any capital property acquired for use in the tenant's business.

In some instances, a taxpayer may prefer to have s. 12(1)(x) apply to an inducement rather than have the cost of property reduced. This would be the case, for example, if the taxpayer had loss carryforwards which were about to expire and which would otherwise not be useable.

An inducement payment made by a landlord may be a current expenditure (which is either immediately deductible or must be amortized over the course of a lease), an eligible capital expenditure (two-thirds of which can be written off at the rate of 7% per year on a declining balance basis), or a capital expenditure. The better view in law appears to be that inducements in the form of payments are current expenditures.

4. Lease Cancellation

An amount paid by a tenant to cancel a lease is a deductible expense of the tenant (assuming that the property is leased in connection with a business) and is generally income to the landlord. However, there may be situations where the amount received by the landlord is on a capital account.

The tax treatment of a payment by a landlord to procure the cancellation of a lease is governed by specific statutory provisions. Section 18(1)(q) prohibits any deduction, except to the extent permitted by s. 20(1)(z) or 20(1)(z.1). While the property continues to be owned by the landlord, s. 20(1)(z) provides for the deduction of the payment on an amortized basis over the remaining term of the lease (including all renewal periods) to a maximum of 40 years. On the disposition of the property, s. 20(1)(z.1) provides for the deduction of one-half of the balance that was not deductible under s. 20(1)(z) (or in the case of non-capital property, the full amount of the balance).

In general, a cancellation payment received by a tenant is a capital receipt for the relinquishment of rights in respect of a leasehold interest. Thus, the payment represents proceeds of disposition of the leasehold interest. However, if renting property forms part or all of a business being carried on by the tenant, then the payment is regarded as business income.

5. Sale-Leaseback

A sale-leaseback includes two transactions: the sale of property to the lessor and the grant of a lease to the original owner. The CRA is concerned that such arrangements may, in substance, provide the original owner with a way to borrow money and to deduct all repayments. If the CRA regards the arrangement as the borrowing of money on the security of property, they will seek to treat it as a loan. In this case, the lessee will be regarded as the owner of the property, and will be entitled to claim capital cost allowance and to deduct the portion of the rental payments that may be regarded as interest. See CRA Insurance Tax Technical News No. 21, June 14, 2001 for a review of CRA's current approach to this situation.

Section 16.1 sets out an elective scheme of rules which applies to treat a lease as a purchase and loan for purposes only of the lessee's taxation. The election must be made jointly by the lessor and lessee and is available for certain leased tangible property, other than prescribed property, that would otherwise have been depreciable property. The effect of the election is to treat the fair market value of the leased property as a loan. The lease payments are then treated as blended payments of principal and interest, and the lessee is entitled to claim capital cost allowance.

6. Lease-Option

A lease-option is a lease which includes an option permitting the lessee to acquire the property during or at the end of the term of the lease. If, in substance, the arrangement is an instalment sale of the property, the CRA is concerned that the lessee may be charging the purchase price against income as rent. Accordingly, such a transaction may be regarded as a sale rather than a lease. In such a case, the lessor is required to account for the transaction as a sale of the property and the establishment of a receivable. In some circumstances, the payments may be regarded as being in part interest and in part proceeds of disposition. The lessee is entitled to claim capital cost allowance, and will be able to deduct the portion of the payments characterized as interest.

CRA Income Tax Technical News No. 21, June 14, 2001 sets out the circumstances that will lead the CRA to characterize a lease-option as a sale. In general terms, this is likely to happen whenever the lessee has a right to acquire title to the property at some future time at a price that is substantially less than the probable fair market value.

In the case of lease-options which are truly that, and not contracts of sale, the Act contains provisions designed to prevent "tax leakage" when amounts paid as rent are in reality part of the purchase price. If a lessee exercises an option and acquires the property at a cost less than its fair market value, then the excess of the fair market value of the property over the option price (or alternatively the total rental payments, if lower) is treated as part of the cost of the property and as depreciation which has been allowed to the lessee (s. 13(5.2)). Thus, if the lessee ever sells the property for more than the option price, a portion or all of the rental payments will be recaptured (i.e., included in income). Apart from this provision, the full amount of the sale proceeds in excess of the option price would be a capital gain.

The effect of the above provision cannot be avoided by selling the option since a gain on the sale of the option will be included in income: s. 13(5.3).