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DOES A SECTION 45 DEEMED DISPOSITION TRIGGER THE FLIPPED-PROPERTY RULE?

Under section 45, there is a deemed disposition when a residential property shifts from a non-income-earning purpose to an income-earning purpose, or vice versa. If this occurs before the owner has owned the property for a full year, could there be an interaction with the flipped-property rule, which received royal assent on December 15, 2022? Specifically, could subsection 12(12) deem the gain from the disposition to be on account of income—that is, fully includible in income with no entitlement to the principal residence exemption? Fortunately, this does not appear to be the case.

Consider an individual who purchases a housing unit as capital property for $500,000 with the intent of earning rental income from it. The individual decides to move in 11 months later, when the property is worth $550,000. Assume that the move is sufficient to trigger a change in use and is not due to any "life event" exceptions described in subsection 12(13).

The effect is that, absent a subsection 45(2) election, subparagraphs 45(1)(a)(ii) and (iii) should apply to cause a deemed disposition of the property, resulting in a capital gain of $50,000. If the deemed disposition were considered a disposition of a flipped property under subsection 12(12), the $50,000 capital gain would be converted into an income gain. But for several reasons this is unlikely.

For the flipped-property rule in subsection 12(12) to apply, there must be a "disposition." Also, a housing unit does not become a flipped property unless it is the subject of a "disposition," since the definition of flipped property in subsection 12(13) contains the condition that the housing unit must be held for less than 365 consecutive days prior to its disposition. But, according to the preamble of subsection 45(1), the deemed disposition that arises under that subsection is only "for the purposes of this Subdivision." The subdivision referred to is subdivision C, Taxable Capital Gains and Allowable Capital Losses, which does not include subsections 12(12) and (13). Therefore, a disposition that is deemed to arise under subsection 45(1) should not be considered a disposition for the purposes of the flipped-property rule.

Furthermore, applying the flipped-property rule would be logically inconsistent. If the housing unit was considered a flipped property and subsection 12(12) applied, that subsection would deem the housing unit to have always been

inventory of the taxpayer and not capital property "throughout the period that the taxpayer owned the flipped property." If the property was always inventory, then section 45, which does not apply to property that is inventory, could not apply to cause the deemed disposition in the first place.

This result—that a deemed disposition event under section 45 should not result in the application of the flipped-property rule—also accords with the spirit and purpose of the new legislation. According to the fall 2022 economic statement, the flipped-property rule was enacted to "ensure profits from flipping residential real estate are always subject to full taxation." A deemed disposition where the beneficial owner of the residence has not changed and has not profited from "flipping" should not fall under the mischief that the government was targeting.

Note that if the housing unit was instead acquired initially as inventory and the taxpayer later changed its use to a long-term rental property, this would presumably cause the property to change from inventory to capital property. The CRA's view is that the conversion of real property from inventory to capital property does not cause a deemed disposition under section 45 (see CRA document nos. 9335765, February 21, 1994 and 2015-0596921E5, September 25, 2015), so the issue addressed in this article does not arise.

Kenneth Keung and Jason Lau
Moodys Private Client Law LLP, Calgary
kkeung@moodystax.com
jlau@moodystax.com

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