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RELATED-PARTY TRANSFERS AND THE FLIPPED-PROPERTY RULES

The new "flipped property" rules in subsections 12(12) to (14), introduced by Bill C-32 on December 15, 2022 for dispositions occurring after 2022, have been the subject of great scrutiny, including in this newsletter (see David M. Sherman and Balaji (Bal) Katlai, "What Do the 'Residential Property Flipping' Rules Accomplish?" (2023) 23:1 *Tax for the Owner-Manager* 1-3). This article will explore situations (in particular, situations involving related-party transfers) where these rules may apply even though the circumstances appear unrelated to the provisions' stated purpose.

These rules, according to Finance, have been implemented because

> [t]he Government is concerned that certain individuals engaged in flipping residential real estate are not properly reporting their profits as business income. Instead, these individuals may be improperly reporting their profits as capital gains and, in some cases, claiming the Principal Residence Exemption. (2022 Federal Budget Supplementary Information)

The government views property flipping as "purchasing real estate with the intention of reselling the property in a short period of time to realize a profit."

To address this practice, new subsection 12(12) implements a bright-line test that deems gains from dispositions of flipped property to be business income. Subsection 12(13) defines "flipped property" as a housing unit of a taxpayer located in Canada that was owned by the taxpayer for less than 365 consecutive days prior to the disposition of the property. However, properties that are disposed of owing to, or in anticipation of, one or more of certain kinds of "life events" (for example, death, marital breakdown, and insolvency) are not considered flipped property.

The carve-outs to the "flipped property" definition are quite broad and provide relief in many circumstances. However, little or no thought seems to have been given to the many typical transactions that may result in a taxpayer owning property for less than 365 consecutive days but that fall, in principle, outside the activities that the government intended to target. The problematic aspect of these situations arises from a lack of any ownership-continuity provision in the flipped-property rules.

For example, a taxpayer may transfer a housing unit, held for more than 365 days as a capital property, to a related (or even wholly owned) corporation on a tax-deferred basis pursuant to subsection 85(1). On the basis of the current legislation (and on the assumption that the property continues to constitute a capital property of the transferee entity under general principles—however, see Justin Park and Lorne Shillinger, "Current Issues on the Sale and Acquisition of Real Estate in a Hot Market," in *2021 Ontario Tax Conference* (Toronto: Canadian Tax Foundation, 2021), 3:1-169), if the transferee corporation disposes of the property within 365 days, the entire historical accrued gain will be deemed to be business income, even though the same economic group held the property as capital property for longer than 365 consecutive days. This could also be the case for transfers to a partnership. (Because section 12 affects the determination of income, a partnership should be considered a taxpayer for the purposes of the flipped-property rules.)

Another problematic scenario arises when a trust distributes a housing unit to a beneficiary at cost pursuant to subsection 107(2). Subsection 40(7) deems the beneficiary to have owned the property for the same period of time that the trust owned it, but the subsection 40(7) deeming rule applies only for the purpose of paragraph 40(2)(b) and the definition of "principal residence" in section 54. Subsection 40(7) does not apply for the purposes of new subsections 12(12) to (14). Furthermore, subsection 12(12) specifically overrides paragraph 40(2)(b). Therefore, unless it can be argued that the beneficiary "owns" the housing unit as a result of being a beneficiary of the trust, the flipped-property rule should apply, and the entire historical gain is business income to the beneficiary. This appears to be in direct opposition to the intent of subsection 40(7).

Other common transactions that may be captured by the flipped-property rules are amalgamations and windups. An amalgamated corporation is deemed to be a new corporation (see paragraph 87(2)(a)), which restarts the 365-day clock. Similarly, a windup (see subsection 88(1) or (2)) would result in a property being held by a different taxpayer and therefore being caught in the "flipped property" definition.

Consider a scenario where a rental property that was a long-term capital property was transferred to a spouse, who then disposed of the property within 365 days. Assuming that there is no election out of the spousal rollover under subsection 73(1), is the transferee spouse's gain attributed back to the transferor spouse? If subsection 12(12) applies before the attribution rule in section 74.2, the gain would be recharacterized as business income of the transferee spouse, and section 74.2 would not apply. However, given the preamble of subsection 12(12) ("if, absent this subsection and paragraph 40(2)(b), [the] taxpayer would have had a gain"), other sections of the Act, such as section 74.2, likely take precedence over subsection 12(12). Therefore, the gain of the transferee spouse should be attributed back to the transferor spouse—but in that case, would the attributed gain be from the disposition of "flipped property" because the transferee spouse held the property for less than 365 days? The attributed gain is merely "deemed to be a taxable capital gain of [the transferor spouse] for the year from the disposition of property," so it is not clear what property the transferor spouse would be deemed to have disposed of. One hopes that the CRA would interpret this as the transferor spouse having a gain on the rental property, in which case that spouse could escape the "flipped property" definition, provided that the property was held for 365 or more consecutive days before its transfer to the transferee spouse. (This is because the definition of "flipped property" does not require that the property have been held for 365 or more consecutive days *immediately* before the disposition.) However, if the spousal rollover is elected to not apply and FMV consideration was paid by the recipient spouse (subsection 74.5(1)), a sale shortly thereafter would apparently be caught by the flipped-property rules, assuming that none of the "life-event" exceptions are met.

And what if Spouse loaned Borrower Spouse funds to acquire a housing unit, and Borrower Spouse sold it after holding it for 365 or more consecutive days? When the gain is attributed back to Spouse, is that a gain on a flipped property because Spouse has never owned the housing unit? The legislation appears unclear in this regard.

In our final example, we will consider issues that may arise because of an individual's death and that are supposedly addressed in the exception to the "flipped property" definition under paragraph 12(13)(a). Suppose an individual who has long owned a home passes away. The home passes to the individual's estate. Within 365 days of the individual's passing, the estate sells the home. The paragraph 12(13)(a) exception applies only to the taxpayer or to a person related to the taxpayer. Whether an estate or trust is related to a taxpayer is a much-debated question (see, for example, paragraph 1.49 of *Income Tax Folio* S1-F5-C1, although the position set out there appears to contradict *Wright Estate*, 96 DTC 1509 (TCC)). However, assuming that the relationship rules in the Act apply to the trustee or executor, the estate in the example at hand will be considered to be related to the deceased only if the executor was related to the deceased (see paragraphs 251(1)(a) and 251(6)(a)) (as recently discussed by John Oakey). For the purposes of the related-persons provision in paragraph 251(2)(a), it appears that children remain related to their deceased parent, but a spousal relationship ends upon death (*Kiperchuk v. The Queen*, 2013 TCC 60, and *Dreger v. The Queen*, 2020 TCC 25). In cases where the executor of an estate is unrelated to the deceased (as in the common situation where a spouse is named the executor), the exception in paragraph 12(13)(a) would not apply, and any increase in value between the time of death and the disposition would be deemed to be business income.

The examples above cover only a few of the situations that, given the government's stated purpose for the flipped-property rules, should not fall within the rules' ambit but are nonetheless caught by this legislation as it reads today. We suggest that Finance add a continuity-of-ownership rule. If the legislation aggregates the ownership period of related/affiliated taxpayers (with special provisions for estates), these common, inoffensive transactions would be carved out.

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