Can Canadian taxpayers defer a gain on a disposition of property by reinvesting the sale proceeds like US taxpayers can?

Kenneth Keung CA, CPA (CO, USA), CFP, LLB, MTAX, TEP
February 17, 2015

The recent case of *Livingston v The Queen* from the Tax Court of Canada has once again thrust the replacement property rules in section 44 of the Income Tax Act (the "Act") in the spotlight. Since numerous commentators have already discussed the case and debated whether the Tax Court was correct in its narrow interpretation of the legislation, we will take another approach and use this as an opportunity to highlight a common misconception about the Canadian replacement property rules that we frequently encounter in our practice.

Many Canadians are aware of the general concepts of section 44 of the Act: in certain circumstances, a gain on a sale may be deferred and rolled into a replacement property. The mistake made by many is to assume the application of this rule to be much broader than it really is. This misconception likely stems from confusion between the Canadian replacement property rules and the more widely known "like-kind exchange" rules in the US under § 1031 of the US Internal Revenue Code (the "IRC").

Enacted in 1921, § 1031 was the IRC's first non-recognition provision. If a taxpayer meets the requirements of § 1031, he or she will not recognize any gain or loss on the exchange of one property for another like-kind property. The policy behind IRC § 1031 is that when investors exchange property for like-kind property, they have not disposed of one investment for the other but are merely continuing their original investment.

Generally speaking, IRC § 1031 applies automatically if the following requirements are met:

- There is an exchange of property;
- "Solely" for like-kind property (where consideration includes "boot", i.e. something other than like-kind property such as cash, IRC 1031 may still apply but the exchange may be partially taxable);
- Both the property exchanged and the property received are held for productive use in a trade or business or for investment; and
- The taxpayer identifies the new property to be received within 45 days and the new property must be legally transferred within six months of the initial transfer of the former property.

Certain types of properties are precluded from § 1031, and these are:

- Inventory or other property held primarily held for sale;
- Stock, bonds, or notes;
- Interests in a partnership;
- Certificates of trust or beneficial interests; and
- Choses in action.

Outside of the above properties, one can see that § 1031 Exchanges are broadly available to US taxpayers disposing of business and investment properties. In fact, they are so frequently relied on and

publicized that Canadians are often under the impression that the Act operates in a similar fashion. This is a grave mistake that could lead to bad tax consequences.

In Canada, taxpayers may defer and roll capital gains into replacement properties under either section 44 or 44.1 of the Act. Section 44 applies to a property that:

(i) Has been stolen, destroyed, or expropriated (often referred to as an “involuntary disposition”),or

(ii) Was real estate used by the taxpayer (or a related person) primarily for earning income from a business, but rental property (and any land subjacent to the rental property or land that is contiguous to the rental property that is a driveway, yard, parking area, garden or that is otherwise necessary for the use of the rental property) is specifically excluded. This subset of property is specifically defined as a “former business property” under subsection 248(1) of the Act.

The seller must, within a specified timeframe, acquire a “replacement property”, which, generally speaking, is a property that replaces the former property and that is of same or similar use (see subsection 44(5) of the Act for further detail). If all conditions are met, the seller can elect to defer the gain realized on the former property by reducing the tax cost of the replacement property by such amount.

Section 44.1 works in a similar manner, but is limited only to certain Canadian private corporation shares where all or substantially all of the assets of the corporation are used principally in active business and where the total carrying value of the assets of the related group of corporations is less than $50,000,000. There are also subsections 13(4) and 14(6), which provide parallel deferral rules for recapture income in respect of depreciable property and eligible capital property.

Compared to IRC § 1031, the circumstances where the Canadian replacement property rules would provide for deferral are very narrow. A Canadian who sells rental property, wherever situated, will not be entitled to defer any gain merely because a replacement rental property is purchased with the sale proceeds, but the same transaction performed by a US taxpayer would qualify as a § 1031 Exchange. This would be the case even if the Canadian is in the business of renting property (see *Buonincontri v. Queen*, 85 D.T.C. 5277), or if the property is used for both business and rental but more than half of the space is devoted to the latter (see *Grove Acceptance Ltd. v R.*, 2002 D.T.C. 2172).

The *Livingston* case we referred to earlier is another example of the Court taking a narrow interpretation of section 44, finding that a replacement property must be a “direct substitution” of, and “the same species” as, the former property.

The incongruity between IRC § 1031 and the Canadian replacement property rules could lead to devastating tax results on Canada-US cross border transactions. A Canadian individual who owns rental property in the US is entitled to non-recognition treatment under § 1031 if another property is purchased within six months after the sale of the initial property and all other requirements under § 1031 are met. However, section 44 and subsection 13(4) of the Act will not apply because the property sold is a rental property. As such, the Canadian individual will recognize any capital gain and depreciation recapture in the year of the sale for Canadian tax purposes.

Normally, the foreign tax credit regime in section 126 of the Act protects Canadian taxpayers against double taxation by allowing Canadian income tax otherwise payable to be reduced by foreign income taxes paid on foreign income or gain. In the above example, however, because of the application of § 1031, no US income tax is payable in the year of sale and consequently, no foreign tax credit will be

available under section 126 of the Act. Therefore, the Canadian individual will be subject to the full amount of Canadian tax on the capital gain and depreciation recapture arising on the sale. However, the gain and depreciation recapture is merely deferred for US tax purposes, and these will eventually be realized on a future sale that is not accompanied by a § 1031 Exchange. At that moment, all gains and depreciation recapture will be subject to US taxation and because these were previously subject to Canadian tax, section 126 will not grant a foreign tax credit for the US tax paid, leading to double taxation.

The same mismatch occurs even if the Canadian individual owns the US rental property indirectly through a corporation. If the holding corporation is resident in Canada for tax purposes, an IRC § 1031 Exchange will cause the corporation to recognize a capital gain immediately for Canadian tax purposes. The corporation will not be entitled to any foreign tax credits to offset against the Canadian tax on the gain because no US tax will be payable in the year of the exchange.

On the other hand, if the holding corporation is resident in the US and it relies on IRC § 1031 to defer US tax on a sale, the Canadian individual will be deemed by virtue of the "foreign accrual property income" regime in subsection 91(1) of the Act to have received an imputed capital gain in the year of the exchange, as if the property were held personally. This leads to the same mismatch of foreign tax credit to the Canadian individual as described above.

This discrepancy between Canadian and US rules is a frequent trap for the unwary. However, with careful planning such traps can be avoided.