CHAPTER 7

INCOME FROM PROPERTY

Review Questions

1. Although the *Income Tax Act* specifically refers to property income as a separate type of income, it does not provide a specific definition of the term. Identify the source from which the definition of property income is derived, briefly explain the term's meaning, and provide examples of income from property.

2. Distinguish between income from property and the gains or losses that may occur from the sale of property.

3. Interest income earned on loans by a financial institution may, for tax purposes, be classified in a different way from interest income earned on loans by taxpayers who are investing their savings. Explain why.

4. Briefly explain how income from property is determined for tax purposes.

5. Compare and contrast the taxation year of an individual with that of a corporation with respect to the determination of business income and property income.

6. "An individual can deduct for tax purposes the interest expense incurred on the mortgage loan attached to their personal residence." Is this statement true? Explain.

7. A taxpayer has sold property (land) for $200,000 that was originally purchased for $70,000. The property was sold to an arm's-length party (not related). The terms of sale involve a cash payment of $100,000 on closing, with the balance to be paid at $20,000 per year for five years, with no interest charged on the unpaid balance. For tax purposes, what types of income may result for the vendor from this transaction?

8. An individual invests in a bank term deposit on July 1, 2022. When does the individual recognize the interest income for tax purposes if the investment has a term of three years, with interest compounded annually but paid only at the end of the three-year term? Would your answer be different if the taxpayer were a corporation? Explain.

9. Can a taxpayer deduct a reserve for unpaid interest on a loan if the interest appears not to be collectible? Explain. How does the treatment of unpaid interest compare with the treatment of the loan principal when its repayment is in doubt?

10. Briefly explain why an individual who receives dividends from a Canadian corporation must include 115% or 138% of the dividend received in income for tax purposes, while a corporation receiving the same dividend includes only the actual amount of the dividend.

11. "If a loss occurs from the renting of real estate (that is, if annual expenses exceed rental income), the loss is not recognized in determining a taxpayer's overall net income for tax purposes." Is this

statement true? Explain.

12. A building that costs $200,000 and is rental property will always create a terminal loss or a recapture of capital cost allowance when it is sold. The same result may not occur if the building is used directly in a business activity. Explain.

13. An investor in real estate may achieve a higher rate of return by acquiring a small portion (part ownership) of several properties, rather than a lesser number of whole properties. Explain.

14. Why is the purchase of rental real estate often referred to as a “tax-sheltered” investment?

15. Often, an enterprise conducting an active business will separate its business operations from its appreciating assets (such as real estate) by establishing a separate corporation for each. How may this type of structure impair future expansion activities?

Solutions to Review Questions

R7-1. The definition of property income is derived from common law precedents. From this source, income from property can be defined as the return on invested capital where little or no time, labour or attention is expended by the investor in producing the return. Property income includes the interest earned on bonds and loans, dividends earned on shares of corporations and rents earned from real estate [ITA 9(1)].

R7-2. Income from property refers to the regular returns derived from ownership of the property (such as dividends from shares). The gain or loss resulting from the actual sale of the property is classified as either a capital gain (loss) or business income (loss) depending on the purpose for acquiring the property [ITA 38, 39(1)].

R7-3. Interest income earned by a financial institution such as a bank or trust company is normally classified as business income because substantial cost and effort is expended to earn the interest -- the loaning of money is a part of the entity's business. A taxpayer who earns interest from investing their savings earns property income because little effort is required to generate and maintain the returns.

R7-4. Income from property is determined using the same rules as income from business. It is the profit determined in accordance with well-accepted business principles with the aid of normal accounting principles. Similar to business income, the determination of profit is modified by several general limitations and can apply the same exceptions to those limitations [ITA 9(1)].

R7-5. The taxation year of a corporation is the fiscal-period chosen to account for its affairs. Therefore, both business income and property income are determined annually for the corporation's fiscal year.

In contrast, property income earned by an individual cannot use a fiscal period and must be accounted for on a calendar year basis. For individuals carrying on business, a calendar year end is required, however, an election to use an alternative method is available [ITA 34.1].

R7-6. Yes, the statement can be true. Interest expense on a loan is deductible in arriving at property income provided that the funds obtained from the loan are used to acquire an investment which in turn can generate taxable income [ITA 20(1)(c)]. Therefore, if an individual borrows money by mortgaging a home and uses the funds to acquire an income generating investment (and does not use the funds to buy the home), the interest is deductible.

R7-7. Because the property is sold to an arm's length buyer with substantial deferred payments without interest, it may be construed that the selling price of the property was increased in exchange for the elimination of interest. In such circumstance, a portion of the price may be considered to be property income (interest) and taxed accordingly.

The gain on the sale of the land (less the imputed interest) may be a capital gain if the land was acquired by the vendor to provide a long-term benefit and was not purchased for resale at a profit. As the capital gain is only 1/2 taxable, the reduced capital gain and enhanced interest income results in a greater taxable amount. On the other hand, the gain on sale of the land may be business income, in which case treating it as property income (interest) or business income would result in the same taxable amount.

R7-8. The individual must recognize the interest earned to each anniversary day (annual accrual method) from the issue date of the investment. Therefore, no income is recognized in 2022. Income from July 1, 2022 to June 30, 2023 would be included in the 2023 taxation year [ITA 12(4), (11)]. Income earned from July 1, 2023 to June 30, 2024 would be included in the 2024 taxation year. Income earned from July 1, 2024 to June 30, 2025 would be included in the 2025 taxation year.

If the taxpayer is a corporation, it must use the accrual method at all times. Income from July 1, 2022 to December 31, 2022 (assuming December 31 is the corporation’s year-end) is included in the 2022 taxation year [ITA 12(3)].

R7-9. Using the same rules for determining income from business, a deduction for a reserve for uncollectible interest on a loan can be claimed. Although the general limitations prohibit the deduction of reserves, a specific exception is made for uncollectible amounts, which have previously been included in income. Provided that the uncollected interest has been previously recognized as income, a reserve is permitted [ITA 20(1)(l) & (p)].

However, a reserve is not permitted for the uncollectible principal of the loan because it did not create income when it was established. If, however, it was part of the taxpayer's normal course of business to lend money, a reserve for the principal is permitted. [ITA 20(1)(l) & (p)].

R7-10. Dividends received from a corporation represent corporate earnings that have been taxed in the corporation. In order to diminish or eliminate the incidence of double taxation, a different mechanism exists for shareholders who are individuals and for shareholders who are corporations. Individuals are taxable on the receipt of dividends, but that tax is reduced by a dividend tax credit, which theoretically is equal to corporate taxes paid (27.5% or 13%). Therefore, an individual includes 138% of the eligible dividend received and 115% of the non-eligible dividend received in income, which is supposed to represent the pre-tax income of the corporation that has been distributed. For example, corporate income of $1,000 less corporate tax of 13% ($130) leaves $870 available for a dividend distribution. The individual, on receipt of a $870 non-eligible dividend includes $1,000 in income, calculates personal tax, and then reduces that tax by the dividend tax credit which is equal to $130 [ITA 82(1)(a), (b), 121].

If, however, the shareholder is a corporation, double tax is avoided by removing the dividend from taxable income altogether. As there is no dividend tax credit, there is no need for the gross-up. A corporation simply includes the actual dividend in net income and removes the full amount when calculating taxable income [ITA 112(1)].

R7-11. The statement is not true. A loss from real estate rentals can be used to offset other types of income. However, a rental loss cannot be created or increased by a capital cost allowance (CCA) deduction [Reg. 1100(11)]. Therefore, where expenses before CCA exceed the revenues, an actual loss is recognized but the loss cannot be increased further by CCA.

R7-12. Each building that is classified as a rental property to its owners and costs more than $50,000 must be included in a separate capital cost allowance class to which no additions can be made [Reg. 1101(1ac)]. Therefore, the sale of one building combined with the purchase of another is not pooled, and the sale will result in a recapture or terminal loss unless the selling price is equal to the property's undepreciated capital cost.

All buildings owned and used directly by the owner in a business are pooled together in a single class. Therefore, the sale of one building in a pool of several buildings, or the sale of a building combined with the replacement of another, may not result in a recapture or terminal loss. [Note that it is possible to place buildings meeting certain requirements into a separate Class 1.]

R7-13. If an investor purchases a fewer number of larger real estate properties (each costing over $50,000), the opportunity to dispose of a lower quality property in order to acquire a better quality property is diminished, because the cash available on the sale of the first property may be reduced by tax on the recapture of capital cost allowance. However, if a larger number of lower cost properties (each costing less than $50,000) are acquired, the sale of one to acquire a better quality property may defer the tax on recapture due to the fact that, the properties are pooled in a single capital cost allowance class. Therefore, more cash is available for replacement.

Of course, one must also consider the marketability of properties that are partly owned, compared to properties that are wholly owned.

R7-14. Real estate is often referred to as a tax-sheltered investment because it permits the deduction of capital cost allowance even when it is not an actual expense and bears no relationship to economic reality. Capital cost allowance is an arbitrary allocation of a building cost, which does not take into account the estimated salvage value of the property. In many cases, the sale of a building, results in substantial recapture of capital cost allowance indicating that the previous deductions of capital cost allowance were too high. Therefore, annual rental income is subject to annual reduced tax in exchange for the payment of tax, at a later time (recapture). In effect, a portion of the annual rental income is sheltered from tax until the property is sold and this enhances annual cash flows.

R7-15. By separating the appreciating property from the corporation in which the business is carried on, the property becomes classified as rental property. Therefore, the normal transaction of selling a smaller building to replace it with a larger building as part of an expansion program will result in diminished cash flows from recapture of capital cost allowance, impairing the expansion capability (each rental property over $50,000 falls into a separate class).

On the other hand, this diminished cash flow can be avoided if the building were held directly in the business corporation as a business asset because the sale and replacement activities are pooled in the same class.

The replacement property rules allow a taxpayer, who incurs capital gain and/or recapture on the disposition of a former business property to elect to defer the capital gain and/or recapture to the extent that the taxpayer reinvests the proceeds in a replacement property within one year or 12 months after the end of the taxation year in which the disposal takes place [ITA 13(4); 44(1)]. The taxpayer can take advantage of these rules even if the property is held, separate from the business as long as the person who owns the property is related to the entity, which uses the property to carry on business. *Former business property* is defined in ITA 248(1) as a capital property used by the taxpayer or a related person for the purposes of earning income from a business. These rules are discussed in Chapters 6 and 8.

Key Concept Questions

QUESTION ONE

Determine the amount of interest to be included in income in Years 1, 2, and 3 for each of the following situations.

- Percel Ltd. has a December 31 year-end. In Year 1, Percel purchased a $10,000 bond on its issue date of November 1. The bond pays interest at 6% compounded annually. Percel will receive interest when the bond matures on October 31, Year 3.

- Debra Singh purchased a $10,000 bond on its issue date, November 1, Year 1. The bond pays interest at 6%, compounded annually. Debra will receive the interest when the bond matures on October 31, Year 3.

CPA Competency 6.2.2 & 6.3.2 Interest income. Income tax reference: ITA 12(1)(c), 12(3), (4), (11).

QUESTION TWO

Anne Williams received the following dividend income during the current year:

- $1,000 of eligible dividends from taxable Canadian corporations

- $1,000 of non-eligible dividends from taxable Canadian corporations

- $1,000 of foreign dividends; the foreign country withheld $150 in foreign tax and Anne received the net amount of $850.

Determine the amount of dividend income to be included in Anne's property income for the current year.

CPA Competency 6.2.2 & 6.3.2 Dividend income. Income tax reference: ITA 12(1)(j), (k), 82(1).

QUESTION THREE

A Ltd. received the following dividend income during the current year:

- $1,000 of eligible dividends from a taxable Canadian corporation

- $1,000 of non-eligible dividends from a taxable Canadian corporation

Determine the amount of dividend income to be included in A's property income for the current year.

CPA Competency 6.2.2 & 6.3.2 Dividend income. Income tax reference: ITA 112(1).

QUESTION FOUR

At the end of 2022, Fred Hicks owned two residential rental properties. Rental property 1 cost $125,000 (land - $50,000; building - $75,000) and at the close of 2021 had a UCC of $64,000. Rental property 2 was acquired in 2022 for $210,000 (land - $80,000; building - $130,000). Revenue and expenses for the rental properties during the year were as follows:

	Property 1	Property 2	Total
Revenue	$13,200	$4,500	$17,700
Expenses:			
Mortgage interest	(0)	(3,000)	(3,000)
Repairs & maintenance	(5,000)	(0)	(5,000)
Property tax	(3,100)	(1,000)	(4,100)
Insurance	(500)	(200)	(700)
	(8,600)	(4,200)	(12,800)
Income	$ 4,600	$ 300	$ 4,900

Determine the maximum CCA deduction for the rental properties for 2022.

CPA Competency 6.2.2 & 6.3.2 Rental income. Income tax reference: Reg. 1100(11), 1101(1ac).

Solutions to Key Concept Questions

KC 7-1

[ITA: 12(1)(c), 12(3), (4), (11) - Interest income]

In both cases $1,236 of interest will be earned and received on the maturity of the bond on October 31, Year 3.

Nov 1, Year 1 to Oct 31, Year 2 -	$10,000 x 6% =	$ 600
Nov 1, Year 2 to Oct 31, Year 3 -	$10,600 x 6% =	636
		$1,236

Timing of income recognition for tax purposes:

Percel Ltd.

Corporations must include interest income as it is earned on a daily basis [ITA 12(3)].

Year 1:	Nov 1 to Dec 31 - $10,000 x 6% x 61/365 =		$ 100
Year 2:	Jan 1 to Oct 31 - $10,000 x 6% x 304/365 =	$500	
	Nov 1 to Dec 31 - $10,600 x 6% x 61/365 =	106	606
Year 3:	Jan 1 to Oct 31 - $10,600 x 6% x 304/365 =		530
			$1,236

Debra

Individuals must include interest income on an annual accrual basis referred to as an *anniversary day* accrual [ITA 12(4)]. Interest earned to the anniversary day must be included. The first anniversary day in this case is October 31, Year 2 [ITA 12(11)]. The second anniversary day is October 31, Year 3, the maturity date in this case.

Year 1:	No interest income is included as there is no anniversary day	$ 0
Year 2:	Interest earned Nov 1, Year 1 to Oct 31, Year 2 is included	600
Year 3:	Interest earned Nov 1, Year 2 to Oct 31, Year 3 is included	636
		$1,236

KC 7-2

[ITA: 12(1)(j), (k), 82(1) - Dividend income (Individual)]

Anne will include $3,530 of dividend income in her property income for the current year.

Eligible dividends from Canadian corporations – grossed up ($1,000 x 138%) =	$1,380
Other dividends from Canadian corporations – grossed up ($1,000 x 115%) =	1,150
Dividends from foreign corporation	1,000
	$3,530

KC 7-3

[ITA: 12(1)(j), 112(1) - Dividend income (Corporation)]

A Ltd. will include $2,000 of dividend income in property income for the current year. The corporation includes the amount received [ITA 12(1)(j)]. In computing its *taxable income*, the corporation will deduct the $2,000 of dividends received from taxable Canadian corporations [ITA 112(1)].

KC 7-4

[Reg. 1100(11), 1101(1ac) - Rental income]

Two special rules apply to rental properties with respect to CCA:

- Each rental building costing $50,000 or more must be held in a separate CCA class. They cannot be pooled [Reg. 1101(1ac)].
- CCA can be deducted only to the extent that it does not create or increase a net loss from all rental properties combined [Reg. 1100(11)].

	Class 1 #1	Class 1 #2	Total
UCC, beginning of year	$64,000	$ 0	
Purchases		130,000	
Maximum CCA available:			
$64,000 x 4%	$(2,560)		
$130,000 x 4% x 1.5		$ (7,800)	$10,360

Since these are residential buildings, the CCA rate is 4%. Although a maximum of $10,360 CCA is available, the maximum CCA that can be claimed is limited to $4,900, being the net rental income before CCA for the two properties, combined. The $4,900 of CCA can be claimed partly from property #1 and partly from property #2, in any proportion up to the maximum available for each class.

Net rental income before CCA	$4,900
CCA	(4,900)
Net rental income for tax purposes	$ 0