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TAX MATTERS

The residential property flipping rules that can catch you unawares

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Sometimes confusion can be your friend. I recall the story a few years ago of a robber who tried to steal money from a local pizzeria in the rural United States. The manager thought the robber's "I want it all" demand referred to a large pizza, so he began reading off the options and prices, confusing the thief, who then ran off with nothing.

In other cases, confusion can cost you money. I'm thinking of federal residential property flipping rules that came into effect on Jan. 1, 2023. Let me share the story of a friend and highlight some scenarios in which you might be caught by these confusing rules.

The rules

My friend, Jackson, bought two condos in late 2023 and found it tough to rent them at amounts he needed to break even. So, he sold one for a profit of $75,000 six months after acquiring the place, and the other he sold nine months after his purchase for a loss of $50,000 when the market for condos took a turn for the worse.

The problem? Jackson's transactions are caught under the residential property flipping rules. Those rules say that if you sell a residential property (or a right to acquire one) within 365 days of acquiring it, any profit will be taxed as business income. You'll have no ability to call the profit a capital gain, or to use the principal residence exemption to shelter the gain from tax.

There are a few exceptions in which the disposition takes place due to death, a marriage breakdown, additions to the family, disability, insolvency, certain job relocations, involuntary termination of employment, and threats to personal safety or expropriation.

For Jackson, the rules will cause him to face tax on the $75,000 profit on his first condo as business income. But what about his loss on the second condo? Under the rules, the loss on a flipped property is deemed to be zero. So, Jackson can't apply his $50,000 loss against his $75,000 profit. Ouch. (As an aside, he wants to argue that these properties fall outside the definition of a flipped property, saying that they were inventory of a business he was carrying on. I know it sounds confusing – it is.)

Jackson's story got me thinking about situations in which the property flipping rules could apply to an unsuspecting owner. Let me share a few of these.

The scenarios

Transfers to a spouse: If you transfer a residential property to your spouse and elect for that transfer to take place at fair market value (which allows you to avoid the attribution of income from the property back to you later), your spouse is considered to have acquired the property on the date of the transfer – not on the original date you bought the property. So, if your spouse sells the property for a profit within 365 days of receiving it, your spouse will pay tax on the profit as business income – even if you owned the property for longer than 365 days prior to the transfer to your spouse.

Transfers to a corporation: Many people will transfer ownership of real estate from their hands personally to a corporation, or from one corporation to another, as part of their estate or asset protection planning. If you make this transfer, and the recipient corporation sells the property within 365 days, the sale will be caught under the flipped property rules. This is true even if the property was owned within the same related group for more than 365 days. The rules will also apply when two corporations are amalgamated, or one corporation is wound up into another, and the property owned by the predecessor corporation is sold within 365 days of the amalgamation or windup.

Trust distributions: A trust that owns a residential property can distribute that property to a capital beneficiary on a tax-deferred basis. Yet the rules don't deem the beneficiary to have owned the property for any period before the distribution. So, if the beneficiary then sells the property within 365 days of receiving it, the flipped property rules will apply to tax any profit as business income. That profit reflects any increase in value of the property while it was in the trust. The flipped property rules will still apply.

Dispositions after death: A deceased taxpayer is not always "related" to their estate, which can result in the flipped property rules applying when the estate sells a residential property within 365 days of acquiring the property from the deceased.

Dispositions by an alter ego trust: If you transfer a residential property to an alter ego trust (a popular alternative to a will) and the trust sells the property within 365 days, the flipped property rules could apply.

As an aside, if you live in British Columbia, there are also provincial property flipping rules which could treat some scenarios differently.

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