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Replacement Properties

In certain instances, the Act provides for the deferral of realized capital gains upon replacement of business property. Recaptured capital cost allowance can also be deferred in these instances. The effect of the elections is to permit a "rollover" of the cost of the property. The election may be made either:

1. where proceeds arise as the result of certain involuntary dispositions (e.g., theft, destruction, expropriation), or
2. in respect of the disposition of a "former business property".

In the first case, the election applies to any capital property (except shares, as discussed below) giving rise to proceeds for involuntary dispositions, which are defined in the Act to include compensation for stolen property, compensation for property destroyed including insurance proceeds and compensation for property taken under statutory authority (typically by expropriation, but bankruptcy, or corporate squeeze-out under the authority of the Corporations Act, are also possibilities), or the sale price of property sold to a person who has given notice of an intention to take under statutory authority.

However, the election in respect of property subject to involuntary disposition does not apply to shares disposed of after April 16, 1999, other than shares disposed of after that date in consequence of a public takeover bid or offer filed with a public authority before that date. In exchange for withdrawing this election in respect of shares, certain rollover rules which allow shareholders to exchange shares on a tax-free basis were extended retroactively to permit those elections in respect of shares held in foreign corporations.

A former business property is defined as real property (not including rental property) that is capital property and used primarily to earn business income.

To qualify for the election, a replacement property in respect of one of the involuntary dispositions (which has a specific definition in the Act) must be acquired before the later of:

- the end of the second taxation year following the taxation year in which the original property is deemed to be disposed of, and
- within 24 months after the end of the taxation year in which the disposition occurred.

For other dispositions of a former business property, the time limit is the later of the end of the first taxation year after the year of the disposition and 12 months after the year of the disposition.

To qualify for this deferral of capital gain on property disposed of, voluntarily or involuntarily, there must (eventually) be a replacement property. A replacement property must meet several specific tests; essentially these are:

1. it is reasonable to conclude that the property was acquired by the taxpayer to replace the former property;
2. it must be property acquired by the taxpayer and used by the taxpayer or a person related to the taxpayer for a use that is the same as or similar to the use to which the taxpayer or a person related to the taxpayer put the former property (but note that an election to change the wording of this condition is possible in circumstances outlined below);
3. where the former property was used in a business (rather than merely as an income producing—i.e., rental—property) by the taxpayer or by a related person, the replacement property must be acquired for use in the same or a similar business or by a person related to the taxpayer for such a purpose; and
4. where the former property was taxable Canadian property (or would have been taxable Canadian property if the taxpayer had been a non-resident throughout the year in which the former property was disposed of and the former property were used in a business carried on by the taxpayer), the replacement property must also be taxable Canadian property (or would have been if the taxpayer had been a non-resident throughout the year of acquisition and the replacement property were used in a business carried on by the taxpayer).

The point of the rule in (4) appears to be to prevent the capital gain deferral from operating where a property used or situated in Canada is replaced with a property used or situated outside Canada. However, it appears that a Canadian resident can use the replacement rules to replace a former foreign property with a new similar property.

Note that the tests in (3) and (4) are conditional; that is, if the conditions do not apply the tests need not be met.

The CRA discusses the criteria for replacement property in Interpretation Bulletin IT-259R4; its interpretations of the same or similar use and the same or similar business are reasonably generous.

Generally, the date when the proceeds of an involuntary disposition are considered to be receivable is the earliest of:

1. the date the corporation agrees to settlement;
2. the date the compensation is determined by a court or tribunal;
3. two years after the expropriation, loss or destruction if no claim, suit or appeal is launched by that date;
4. the date on which the taxpayer ceases to be resident in Canada and is deemed to have disposed of its property (or, for an individual, the date of deemed disposition on death); and
5. the date on which a corporation is wound up (other than a subsidiary corporation under an 88(1) wind-up rollover).

Where the election is made, the corporation realizes a capital gain only to the extent that the cost of the replacement property is less than the proceeds of disposition of the former property. Where there are surplus proceeds to be recognized, the replacement property rules contain their own reserve provision allowing a capital gain reserve on the surplus subject to conditions virtually identical to the general reserve rules discussed under the previous subheading above.

Where the property disposed of is a former business property consisting of a building and land necessary for the use of the building, the Income Tax Act permits the taxpayer to change the allocation of the proceeds between land and building. This may enable the taxpayer to obtain a more favourable deferral of any capital gain or recapture arising on disposition.

The cost of the replacement property (or capital cost in the case of depreciable property) is reduced by the difference between the capital gain that would have been realized had no election been made and any capital gain that was in fact realized after making the election when replacement property was acquired. The effect of the election is to defer the capital gain which otherwise would be recognized currently to the point in time when the replacement property is ultimately disposed of. Similarly, the capital cost of the replacement property which is depreciable property is reduced by the amount of deferred capital gain (and where the election to defer recapture has been made the capital cost is reduced by this amount also) so as to prevent a double deduction for capital cost allowance purposes. It is not possible to use the rollover to shift deferred recapture to deferred capital gain.

Where the disposition and replacement occur in the same year, a correct accounting of the results of the rollover will be considered a proper election, although an attachment detailing the calculation cannot hurt. Where a replacement property is acquired in a taxation year following the disposition, the CRA's position is that you must report the undeferred gain in the year of disposition and must elect with the return for the year of acquisition of the replacement property to apply the replacement property rules by requesting a revision of the earlier year return. The CRA states (or at least implies) in Interpretation Bulletin IT-259R4, that this reporting and amended return procedure must be followed even where the replacement property has been acquired after the year of disposition but prior to the actual filing of the year of disposition return, so that the tax consequences of the rollover are known. It does go on to say that it is prepared to alleviate the prior year problem by accepting security in lieu of tax "until the time for the final determination of taxes is made or the time period for acquiring the replacement property has expired. Where this practice is followed, the full cost of providing such security is borne by the taxpayer and the interest on the unpaid taxes will continue to accrue at the appropriate prescribed rates subject to being reduced by interest credited on any subsequent reassessment giving effect to the deferral.". Some taxpayers have apparently found that, at least where the replacement property is acquired before the prior year return is filed, the CRA does not insist on its stated position. However, failure to follow the CRA procedures runs some risk of assessment and interest charges, or at least prolonged argument.