Income Tax Info Sheet

Sale of a Residence by an Owner Builder

January 2005

This Info Sheet:

- Answers some common questions for an owner builder who has sold, or plans to sell a house that he/she constructed and lived in.
- Explains how the gain from the sale should be treated for income tax purposes.

Gain on the sale

Income gain vs. capital gain

When an individual builds (or hires someone to build) a house on land owned by the individual and then lives in it before selling it, any gain from the sale will be considered either *income* from business or a *capital gain*.

If you are self-employed and build houses to sell at a profit, or you construct houses (or have houses constructed for you) as an adventure or concern in the nature of trade, then any gain from the sale of those houses will be considered business income.

> In general terms, the phrase *"adventure or concern in the nature of trade"* refers to a business venture intended to earn a profit, including one done infrequently or even in isolation.

An individual does not have to be involved in the housing construction industry to have business income from the sale of houses, and the sale of one house can result in business income.

On the other hand, when you build a house with the intention of living in it for the long term, and with **no intention to sell it at a profit at the earliest opportunity**, then you will be considered to own the house on account of capital. Any gain on its sale will result in a capital gain.

Taxation of the gain

While one hundred percent of business income is taxable, only one-half of capital gains, referred to as taxable capital gains, are included in income for income tax purposes.

However, where the gain from the sale of your personal residence results in a capital gain (as opposed to business income), all or a portion of the gain may be exempt from income tax as a result of the principal residence exemption (see below).

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La version française de ce document est intitulée *Vente d'une habitation par un particulier qui en est le constructeur.*

Canada

Factors to be considered

The *Income Tax Act* does not contain provisions that describe the circumstances in which gains from the sale of your house are determined as being on income or capital account. However, the courts and the Canada Revenue Agency have considered the following factors in making this determination:

Owner's intentions:

- The intention of the owner at the time the land was purchased and the house was built, and the feasibility of that intention.
- The extent to which the intention was carried out (i.e., the actual course of conduct).
- Evidence that the individual's intention changed after the purchase of the property.

Owner's business practices:

- Nature of the business, profession, or trade of the owner. The closer an individual's business or occupation is related to real estate transactions, the more likely the gain from the sale will be business income.
- The extent to which financing was used towards the purchase of the land, the construction of the house, and the financing terms. Did you arrange financing that is consistent with a person in the business of buying and selling houses, such as short-term financing or financing without balance repayment penalties?
- Length of ownership period. The shorter the period of ownership, the more likely the sale will be on income account.
- Frequency of similar transactions, and the extent of past real estate dealings. A history of buying land, building houses, and selling them may be taken as evidence that any gain is on income account.
- Circumstances surrounding sale of the property, including the motivation for the sale. Did you put the house up for sale or take other actions to attract buyers prior to moving into it or shortly after you moved into it?
- The existence of others who share an interest in the house. Do you co-own the house with others who do not intend to live in the house?

Although no single factor is conclusive, and the relevance of any factor will vary with the facts of a particular situation, your intention or motivation for purchasing the land and building the house is significant.

If your primary or secondary intention is to sell the house at a profit at the earliest opportunity and not to live in it as your personal residence for the long term, the Canada Revenue Agency will generally consider the gain on its sale to be business income.

Principal residence exemption

The principal residence exemption is available to offset an individual's capital gain from the sale of a property that was the individual's principal residence at any time after it was acquired.

Generally, for a house to qualify for designation as your principal residence for a particular year:

- you must **own it** (either alone or jointly with another person);
- you or your family members must **inhabit it** at some time during the year; and
- **no other property may be designated as the principal residence** of any other member of your family unit for that year.

Although you can only designate one property as your principal residence for a particular year, the rules recognize that you can have two residences in the same year, that is, where one residence is sold and another acquired in the same year.

If the land on which your house is situated does not exceed one-half hectare, it usually qualifies as part of your principal residence. Land in excess of one-half hectare may also qualify, but only to the extent that it is established to be necessary for the use and enjoyment of the house as a residence.

Full principal residence exemption

If the house was designated as your principal residence for every year you owned the land and building, you do not have to report any gain on its sale on your income tax return or file Form T2091(IND), *Designation of a Property as a Principal Residence by an Individual (Other Than a Personal Trust)*, with your return.

Partial principal residence exemption

However, if at any time during the period you owned the property it was not your principal residence, **you have to report the part of the capital gain that relates to the years for which you did not designate the property as your principal residence**. You will have to complete Form T2091(IND) (and file it with your income tax return) to calculate the number of years that you can designate your house as your principal residence, as well as the part of the capital gain, if any, that you have to report.

For example, if you acquire vacant land in one year and construct a house on it in a subsequent year, the property may not be designated as your principal residence for the years prior to the year in which you or your family members inhabit the house. Therefore, it is possible that when the house is later disposed of, only part of the gain on the sale will be eliminated by the principal residence exemption.

Frequently Asked Questions

Question # 1

Recently, I had a house built on a lot that I own that I had intended to live in on a permanent basis. I lived in the house for only two months. Then my employer transferred me to another city. Consequently, I have to sell my new house. Do I have to report the gain, if any, for income tax purposes?

Answer # 1

Any gain from the sale of your house will be on capital account (assuming that the reason you give for the sale is consistent with the actual facts of the situation). Your intention was to live in the house for the long term, and you did not build the house as an adventure or concern in the nature of trade. Circumstances beyond your control resulted in the need to sell your house. The capital gain may be reduced or eliminated to the extent of the principal residence exemption available to you (see *Principal Residence Exemption* above).

Question # 2

My main source of income is from building houses on land that I have purchased and then sold at a profit. I usually build a new house for my own temporary use with the intention of building another house, which I will move into as soon as I find a purchaser for the house I currently occupy. Do I have to report my gains from these house sales for income tax purposes?

Answer # 2

You are considered to be in the business of building and selling houses. As a result, any gain on the sale of a house is business income that you must include in your income in the year the house is sold. A reserve (deduction) in respect of the gain may be claimed for the year to the extent that the proceeds from the sale are payable after the end of the year.

Question # 3

I am the same individual as in question 2. When I started building a house, I had intended to sell it to make a profit. Prior to the completion of the house, I abandoned that intention and now plan to live in the house on a permanent basis. Will the house qualify as my principal residence and will the gain be tax-free when it is sold?

Answer # 3

If you live in the house for a reasonable period of time before you sell it, and your subsequent actions indicate that your primary (and secondary) intention was not to sell it at a profit when the opportunity arose to do so, then any gain on the sale will be a capital gain. That gain may be reduced or eliminated to the extent of the principal residence exemption available to you (see *Principal Residence Exemption* above).

If, however, you change your mind again, and sell the house within a short time period for a profit, your actual course of conduct will be seen as supporting your original intention. The onus will be on you to prove that you did not have a primary or secondary intention to sell the house at a profit as soon as a suitable opportunity arose. If you are unable to do so, the gain will be business income.

Question # 4

I am employed as an electrician with ABC Construction (ABC Inc.). I purchased three vacant lots from a developer. I hired ABC Inc. to build on one of the lots a house that my spouse and I planned to live in for six months, during which time we would have our permanent residence (a larger house) built on another of my lots.

The first house was listed with a real estate agent after completion and before we moved into it. We lived in the first house for six months then we sold it at a profit, and moved into the second larger house.

After having lived in the second house for five months, my spouse and I determined that the house was too small because my spouse's parents had moved in with us due to unforeseen personal circumstances. We have put a conditional offer on an existing house that is twice the size of our second house. I am now selling the second house.

How should the sales of these two houses be treated for income tax purposes?

Answer # 4

Your first house was built with the primary intention to sell it at a profit and is considered to be an adventure in the nature of trade. As a result, the gain from that sale should be reported as business income. A reserve (deduction) in respect of the gain may be claimed for the year, to the extent that the proceeds from the sale are payable after the end of the year.

In the case of the second house, it was constructed with the intention of being your permanent place of residence. Although your plans to live in this house had to be abandoned and the house was listed for sale soon after you had moved into it, the sole motivation for doing so arose out of unforeseen personal circumstances. Assuming that the reason you give for the sale is consistent with the actual facts of the situation, any gain on the sale will be on capital account. The capital gain may be reduced or eliminated to the extent of the principal residence exemption available to you (see *Principal Residence Exemption* above).

Question # 5

In June of 2003, I finished building a house on a lot that I own. I moved into the house shortly after. My main purpose or intention of building this house was to sell it for a profit at the earliest opportunity and to use the proceeds to build a larger house. In August of 2003, I listed that house with a real estate agent with the intention of selling it if a suitable price was offered. With this in mind, I obtained short-term financing and purchased a second lot in October 2003. I began construction of a second larger house on that lot at that time.

My first house sold in February 2004, around the same time that the second house was completed. At that time, I also listed the second house with a real estate agent. Shortly after, I moved into the second house and advertised that I was willing to vacate the house at the convenience of the purchaser.

In April 2004, I sold the second house and repaid the balance of the financing without incurring penalties. I then moved into an apartment where I will live until I finish building my third house, which is currently under construction. I intend to reside in this house permanently.

Do I have to include the gains on these houses in my income in the year they are sold?

Answer # 5

Your actions with respect to the first two houses you sold show that you built them primarily to sell them at a profit when a suitable opportunity arose. These sales occurred in the course of business, or as an adventure or concern in the nature of trade. Therefore, the gains on the sales of the first two houses should be reported as business income in the year of sale. You may claim a reserve (deduction) for the gain for the year, to the extent that the proceeds from the sale are payable after the end of the year.

Provided you use the third house as your place of residence for the long term, and your subsequent actions show that your primary (and secondary) intention was not to sell it at a profit when the opportunity arose to do so, the gain on its sale will be on capital account. The capital gain may be reduced or eliminated to the extent of the principal residence exemption available to you (see *Principal Residence Exemption* above).

For more information

See the current version of:

- Interpretation Bulletin IT-120, *Principal Residence*
- Interpretation Bulletin IT-218, *Profit, Capital Gains and Losses from the Sale of Real Estate, Including Farmland and Inherited Land and Conversion of Real Estate from Capital Property to Inventory and Vice Versa*
- Interpretation Bulletin IT-459, *Adventure or Concern in the Nature of Trade*
- The *Capital Gains* (T4037) guide

If you are still not certain about how a gain in your particular situation should be reported, you should contact your local tax services office.

This Info Sheet does not replace the law found in *the Income Tax Act* (the Act) and its Regulations. It is provided for your reference. As it may not completely address your particular operation, you may wish to refer to the Act or appropriate regulation, or contact your local tax services office.

All Interpretation Bulletins are available at the CRA's Web site at http://www.cra-arc.gc.ca/menu/EmenuKLA.html. The Capital Gains guide is available at http://www.cra-arc.gc.ca/E/pub/tg/t4037/README.html.