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Deductibility of Carrying Charges of Vacant Land

Investment in vacant land has always been an attractive proposition for Canadian investors.

The typical investor sees an opportunity in a parcel of land for future development, speculation, or mere enjoyment and buys the land with cash or uses an existing line of credit. Usually, the land is kept for years. The holding costs are minimal, just property taxes and, if the purchase was financed with a loan, interest charges.

The most common question our clients ask is this: Can the interest and property taxes paid be deducted to reduce any capital gains when the land is sold?

The basic principle is found in paragraph 18(2) of the *Income Tax Act*: **Interest on debt relating to the acquisition of land or property taxes paid in respect of land to a province or to a Canadian municipality is not tax deductible.**

Can the interest and property taxes paid be deducted annually to reduce any capital gains or only when the land is sold?

There are some exceptions to the rule.

- If the land was used at any time during the year in the course of a business, the provision of the section does not apply. For example, if the land was used at any time to store inventory as part of the business, the rule does not apply and the expenses would be fully deductible in computing income in the year. That exception

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does not apply to land developers where land is held for resale or development.

- If the land was used for rental, you may deduct interest and taxes to the extent of the income from the land for the year; the expenses can be claimed to offset the rental income but no loss can be generated in any particular year by claiming the expenses.

There is some relief to the taxpayer for the lost deductibility of the expenses. Paragraph 53(1)(h) allows for the expenses denied under paragraph 18(2) to be added to the cost of the land that is capital property or that is held as inventory.

Much attention must be paid to paragraph at 53(1)(h). The addition-to-the-cost basis of the land is allowed for the expenses disallowed by virtue of 18(2), in the calculation of net income from ***business or property.*** Therefore, the land must be held as part of a business or for rental purposes. In any other cases, the addition-to-the-cost basis is not allowed.

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The problem is found when a taxpayer purchased a parcel of land, held it for many years, then sells it at a profit. In calculating the cost basis of the land, the taxpayer adds the interest and property taxes for all the years he or she owned it. In this case, paragraph 53(1)(h) does not apply to increase the cost because the land was not used in connection with earning income from a business or property. All the expenses are then nondeductible and are lost.

An adjustment to the cost of land is also available under paragraph 10(1.1) for land held as inventory by a developer or a dealer. In this case, any profit or loss from the sale of the land is treated as ordinary income and taxed at 100 percent, as opposed to a capital gain, which is taxed at 50 percent.

An isolated purchase of land could raise the concept of an adventure or concern in the nature of trade. Such purchase could classify the land as inventory and the disallowed expenses would be added to the cost—but any profits from the sale would be fully taxable as business income. On the other hand, any losses would be fully deductible.

Whether a purchase of land is *an adventure or concern in the nature of trade or is for investment purposes* is a question of fact; all the circumstances must be analyzed, such as the taxpayer's conduct, the nature of the property, the taxpayer's intention, and length of holding.

As mentioned earlier, the isolated purchase of land *for investment purposes only* may cause the carrying costs to be disallowed, although any profits will be taxed at 50 percent as capital gain. Therefore in such cases it is recommended to rent out the land to enable the costs to be deducted to the extent of rental income or at least to be added to the cost of the land.

Because of the complex nature of this subject, it is strongly recommended that you consult a legal professional and a tax accountant for assistance with this challenging topic.

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