CRA cracking down on abuse of principal residence exemptions, but their assessments aren't written in stone

FINANCIAL POST

Jamie Golombek: If it’s determined that you’re regularly buying and selling homes, you can be denied the PRE

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There are very few things that are tax-free: investment income in your TFSA, lottery and casino winnings, purchasing six or more doughnuts (see what happens to the GST/HST next time you try it) and the gain from the sale of your principal residence are among the limited exceptions. With the odds of winning the lottery being slim at best, it’s the sale of one’s home that offers Canadians the best opportunity for a major tax-free gain.

In recent years, however, the Canada Revenue Agency has been cracking down on taxpayers who, in its view, are inappropriately claiming the principal residence exemption (PRE), particularly as it relates to flipping houses. If it’s determined that you’re regularly buying and selling homes, you can be denied the PRE, and be taxed on any profits as 100 per cent taxable business income, versus 50 per cent taxable capital gains. Take the recent case, decided in September, of an Ontario couple who bought and sold multiple homes between 2007 and 2012.

The couple, who live in the Ottawa area, bought and sold houses in each of 2007, 2008, 2009, 2011 and 2012 and claimed the PRE to shelter the gain on each sale from tax. The CRA disagreed and sought to tax the income from the disposition of each of the five houses as business income. The CRA also levied gross negligence penalties.

Homes #1, #2 and #3

The taxpayer operated a concrete pouring business, and later, a foundation repair business.

In August 2006, the couple bought House #1. After moving in and doing some renovations and painting, they soon became dissatisfied with the house — it was located close to an industrial site and large trucks passed the house from 6 a.m. until late at night.

The noise from the trucks was loud and the vibrations made the house shake. As a result, the couple, having only lived there for approximately ten months, decided to move, selling the home for a gain of $69,801 in 2007.

They then constructed House #2, their "dream home," with substantial upgrades, and moved in September of 2007; however, the couple "quickly became unhappy with the neighbourhood…(and)…became concerned for (their twin) girls' security, due to a 'coyote invasion.'" The couple sold the home, moving out in Aug. 2008 having lived there for eleven months. The profit from the 2008 sale was $273,434.

The following month, the couple moved into House #3, which they had constructed. Soon after they moved in, the real estate agent who had sold them their prior home approached them and asked if he could show their new house to his clients who apparently made an offer that the taxpayer couldn't refuse. It was sold in Sept. 2009 for a substantial profit of $403,776 above the cost of the land and construction.

Houses #4 and #5

In Dec. 2009, the couple moved into newly purchased House #4, a townhouse on which they had made improvements. It turned out that the townhouse "was not a good buy" for the couple: the taxpayer's truck was too large to be parked properly in the laneway and the neighbours complained about the couple "having loud social gatherings." In Jan. 2011, they sold the home for a profit of $54,913.

They then moved into Home #5, making some improvements and doing some landscaping. But, in the end, this home, too, was "not their dream home," and they sold it and moved out in July 2012, making a profit of $187,574. After selling it, they moved into a sixth home, where they still resided at the time of the trial.

The decision

In determining whether the sale of real estate is considered business income, the courts have traditionally considered the following factors: the nature of the property sold and how the taxpayer used it; the length of the ownership period; the frequency or number of other similar transactions by the taxpayer; the work expended on or in connection with the property; the circumstances giving rise to the sale of the property; and the taxpayer's motive regarding the sale of the property at the time of purchase.

At the time of each purchase, the couple argued that it was clear that their motivation was not to sell the houses, testifying that "if their motivations had been to sell the houses at a profit, they would have not customized the houses and added the many upgrades."

With respect to the sales in 2007, 2008 and 2009, the taxpayer also argued that it was too late for the CRA to reassess those tax years as they should be considered "statute barred." The CRA is generally prohibited from reassessing an individual taxpayer more than three years after the original reassessment unless it can be shown that the taxpayer made "a false statement attributable to misrepresentation arising from carelessness, neglect or wilful default."

Each year, the taxpayer consulted his accountant to obtain professional advice at the time of filing his tax returns. He explained to his CPA that his intentions were to stay in the houses, but "for legitimate reasons and circumstances beyond his control, he and his spouse had decided to sell the houses."

The judge agreed that there was no misrepresentation attributable to neglect, carelessness or willful default. "It is clear … that simply because a taxpayer has adopted a position that contradicts the (CRA's) position does not in itself mean a taxpayer has made a misrepresentation that would allow the (CRA) to reassess after the normal period." Thus, the CRA was precluded from reassessing the taxpayer on the sales of Home #1, #2 and #3 in the three statute-barred years.

The judge, however, was of the view that the taxpayer's "primary intention at the time of purchase of both (House #4 and #5) was to resell them at a profit. If it was not his primary intention, then the possibility of reselling them at profit was certainly a secondary intention motivating him to purchase both houses." She thus ruled that the PREs did not apply to the gains on the sales of Houses #4 and #5 and they were properly taxable as business income.

Finally, the judge dismissed all gross negligence penalties assessed by the CRA since the taxpayer, based on the advice of his accountant, was under the impression that he could claim the PRE each year. As she wrote, "In my view, the (CRA) did not establish that (the taxpayer) knowingly make a false statement or omission when filing his income tax returns for the 2011 and 2012 taxation years."

Note that since 2016, you are required to report all dispositions of a principal residence on Schedule 3 of your tax return, making it much easier for the CRA to review your PRE claim.

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