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TAX MATTERS

Tax department on lookout for property flippers

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Maybe you've heard the old saying, "Don't wait to buy real estate. Buy real estate and wait." It's been a lucrative strategy for many. But some people don't like the idea of buying and waiting. They'd rather buy, then sell quickly.

The recent federal budget announced a new "residential property flipping rule," which takes effect Jan. 1, 2023, and applies if you sell a property within 12 months of buying it. In this case, the taxman will deny your ability to classify any profit as a capital gain and to use the principal residence exemption to shelter the gain from tax. Instead, the rule will deem the profit to be business income. There are some exceptions.

Our tax law has always treated profits on the sale of properties as business income when your intention is to resell the property at a profit in a short period of time (the idea is that, in this case, the property is akin to business inventory). The problem? Proving a taxpayer's intention is not always easy. So, this change to the law removes any debate by applying a 12-month holding test.

The letters

So, you've got a few months before the new rule comes into effect. Does this mean you're safe from the Canada Revenue Agency? Don't count on it. A couple of readers have reached out with examples of letters they've received from the CRA that are basically a shot across the bow, giving these folks a chance to correct prior tax filings where they might have incorrectly reported their recent real estate sales.

As it turns out, the taxman has sent about 1,700 of these letters to certain taxpayers since the start of this year. The government calls these "educational letters" and aims to educate folks about how the tax rules work around sales of real estate and encourages them to correct past tax filings where they might have, for example, incorrectly reported the sale of a property as a capital gain or claimed the principal residence exemption to shelter a property from tax.

The scenarios

There are two scenarios that the taxman appears to be targeting with its letters. The first is where you've claimed the principal residence exemption (PRE) in back-to-back years. As most homeowners know, you're able to sell your principal residence tax-free in Canada if you "ordinarily inhabited" the home and it was capital property (not business inventory). This is accomplished by claiming the PRE.

There's no definition of "ordinarily inhabited" but the taxman has said that living in a residence for even a short time (a week or two in a seasonal cottage or cabin, for example) would be enough. And so, some people have claimed the PRE even when the intention from the start was to flip the property for a profit after a short time. They buy a place, move in, perhaps make some repairs, then sell for a profit and shelter that sale from tax using the PRE. If you've claimed the PRE in back-to-back years on the sale of different properties, it's definitely a red flag.

The second scenario in which folks have received educational letters from the CRA is where the PRE was claimed on a property and the taxpayer had previously reported gross rental income on their tax return. If a property is primarily a rental property, then the PRE would not be available to shelter any gain on its sale from tax. Now, unlike property-flipping, buying a property to hold it and generate rental income does generally make it a capital property. This means that any profit on a sale should typically qualify as a capital gain – not business income. But claiming the PRE to shelter that capital gain from tax would be a no-no.

The good news? This is different than renting out a portion of your home where the rental is ancillary to the primary use of the property as your residence, in which case you should be able to preserve the ability to use the PRE.

The response

If you receive one of these educational letters from CRA you'll notice that it's not initiating an audit. The letter simply asks you to review your tax return to make sure that you've accurately reported your real property dispositions. Talk to a tax professional about your situation. If you're concerned about how you've reported a sale you can, if you choose, file an adjustment to your tax return. On the other hand, if you have a defensible position and don't want to make a change to your tax return, it would be a good idea to document the rationale for your filing position (you might even want a written tax opinion from a tax professional) and keep that information handy in case CRA contacts you again to review your tax return.

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