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TAX MATTERS

Buying and selling assets? Understand how to protect capital gains tax treatment

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When my kids were little, I taught them about taxes. If they had an ice cream, I'd grab it from them and take a bite. I'd tell them it was a tax. Five minutes later, I'd ask if they still had any ice cream. “No Dad, it's all gone,” they'd say. But then I'd tell them to show me what was in their hands. Reluctantly they'd pull out the ice cream again. I'd take another bite. “That's called a tax audit,” I'd say. “I just wanted a little more.”

When it comes to tax audits, some taxpayers face greater risk than others. Let me explain why.

Opinion: Beware the pitfalls of not tracking employment tax deductions

The risk

Suppose you buy an investment – real estate, securities or anything else – hold it for a while, then later sell it for a profit. You report a capital gain, expecting just one half of gain to be included in income. Then the Canada Revenue Agency comes knocking with a different view: You were not simply acquiring and then selling an investment, but you were carrying on a business or undertaking an “adventure in the nature of trade,” so the entire profit is recharacterized as business income – which is fully taxable – and penalties can apply to boot.

It's a real risk for entrepreneurs, real estate investors, active private investors, cryptocurrency traders and high-net-worth taxpayers who enter certain transactions repeatedly. Intention matters here.

Where your intention was to buy and sell something quickly to make a buck, the CRA may say that the asset is more akin to business inventory and profit should be taxed as business income. Tax auditors are increasingly able to examine patterns across years, compare financing arrangements, review e-mails and study what you've actually done rather than listen to what you say your intentions were.

The taxman's playbook is fairly predictable. First, the CRA will group your transactions together to create a pattern. Next, it highlights the facts that look commercial: short holding periods, repeated sales, improvements, marketing efforts, leverage and your sophistication.

It then reconstructs your intention at the time of purchase and turns those conclusions into factual assumptions supporting a reassessment. You'll have to produce credible evidence to knock those assumptions down.

With growth of sports betting and prediction markets, how are winnings taxed?

The case

The leading case on this issue is Happy Valley Farms Ltd. v. The Queen, 86 D.T.C. 6421 (F.C.T.D.). The taxpayer bought farmland, subdivided it and sold portions at a profit, reporting capital gains. The court sided with the tax authorities and found that the activity looked more like a commercial operation than passive investing.

The court identified six factors that still guide these disputes: the nature of the property; how long it was owned; how often similar transactions occurred; the work done on the property; the circumstances that caused the sale; and the taxpayer's motive when acquiring it. No factor decides the issue alone.

The lesson is that actions speak louder than explanations. You might insist that an asset was purchased as a long-term investment, but short-term financing, development work and a quick resale may tell another story.

There's also the doctrine of "secondary intention." Even where the primary plan was investment, a gain may be business income if, at the time of purchase, you also had a genuine fallback plan to resell at a profit. Your mere willingness to sell if circumstances change is not necessarily enough to trap you, but documentation matters.

The newer residential property-flipping rules raise the stakes further. A gain on certain residential property sold within 12 months is deemed to be business income – with some exceptions. Holding for more than 12 months doesn't guarantee capital treatment, because the traditional Happy Valley analysis still applies.

Cross-border advisors split on Trump accounts for children of Americans living in Canada

The solution

Your best defence begins before an audit. Keep records at the time you acquire an asset, explaining why an asset was purchased, how the financing was structured (short-term financing might suggest the intention to own the asset was short-term), what income was expected and why a later sale occurred.

E-mails, investment analyses and professional advice at the time of your purchase will generally carry more weight than a polished explanation prepared years later when the tax audit takes place.

Decisions made when a transaction is structured can matter more than arguments raised after an auditor has already formed a conclusion. Consider the narrative the CRA is building.

Separate genuinely independent transactions (just because you flipped a property once and faced tax on business income doesn't mean every transaction you complete should be treated the same way). Explain market-driven decisions, distinguish ordinary flexibility from a resale plan and identify every factual assumption made by the CRA that is wrong or incomplete.

Here's the bottom line: Tax disputes of this kind are won when your conduct, documents and explanation all point in the same direction. The law supplies the test, but your evidence tells the story.

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