



The CRA Proposes Serious Tax Implications for Homes Sold Within 365 Days of Ownership

September 2022 Tax Alert

The CRA continues to target those it believes are failing to properly report the income from the sale of residential real estate. This includes requiring the reporting of the use of the principal residence exemption, targeted audits (focusing largely on those in real estate and construction sectors), and new proposed harsh tax implications for homes sold within 365 days of ownership. For any taxpayer who has sold or will be selling more than one home in a decade, attention should be paid.

As an overview, a taxpayer can designate a residential property as their “principal residence” and not pay tax on the gain. Only one property can be designated as the principal residence, at a time. The taxpayer may elect under s. 40 of the *Income Tax Act*, to have the property be their principal residence during only part of the years of ownership. To that end, they would have to pay an apportioned tax based on the years the property was not the principal residence.

If a property is not a “principal residence”, the gain on the sale must be reported as business income or capital income. The *Income Tax Act* does not expressly define a test for distinguishing between business income and capital income. Instead, the matter is determined by the Court, in reviewing the intentions at the time of acquisition. Essentially, the focus is on whether, at the moment of purchase, the hope was to be able to resell the property at a profit. For example, if a taxpayer purchases a property to rent the

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property, then the income on the subsequent sale will be capital income. Indeed, the Tax Court of Canada has confirmed that the income is capital income, even where the owner purchased a property as a rental property, but later changed their intentions to sell it for a profit. It is important to stress that, a property can be owned for more than 2 years and still have the sale income treated as business income. Duration of ownership is a considered under the test, but is not determinative in itself.

Over the years, the CRA became concerned that the principal residence exemption was being improperly relied on and that it was unable to catch the abuse. As such, on October 3, 2016, the CRA announced that taxpayers were required to report any residential real estate sale which involved claiming the principal residence exemption. Accordingly, taxpayer must use **form T2091** to designate a property as a principle residence, when they sell all or part of a principal residence and when they grant someone an option to buy all or part of a principal residence.

The CRA has also commenced auditing those who have relied on the principal residence exemption, focusing on: i) those who have sold multiple homes in the last ten years (but have always relied on the principal residence exemption or only reported capital income); ii) those work in the real estate sector; and iii) those work in the construction industry. These audits have involved using both the T2091 forms and the drivers licence address records.

To further step-up its efforts, the CRA is now looking at additional tax legislation amendments. In the 2022 federal budget, it was proposed that where Canadian residential real estate is sold after being owned for less than 365 days, any income would be deemed to be business income, unless an exemption applies. As such, it would be ineligible for the principal residence exemption and could not be declared as capital income. In August 2022, the Department of Finance released for public comment **draft tax legislative proposals (and accompanying explanatory notes)**. The proposals include introducing this new 365-days rule. Proposed exemptions to the 365-days rule would include where the sale

was triggered by certain life events (e.g. the death of the taxpayer, a separation or divorce, a concern about personal safety, disability or illness, a relevant employment change, insolvency, expropriation, etc.). Of course, owning a property for more than 365 days, even under the proposed rule, would not mean it would automatically be eligible for the principal residence exemption or capital income declaration. For those sales, the test would remain the same, focusing on the intention of the taxpayer.

Where a taxpayer is audited, that taxpayer bares the burden to establish that the sale was properly reported. To establish that the sale of a property was properly reported, the taxpayer needs to establish intention. Various documents can be produced as evidence, such as emails and text messages with the real estate agent speaking to the intentions, purchases of décor, furniture, and paint confirming the intentions, photographs of using the property further to the intentions, etc.

As the CRA may be doubtful as to the intentions behind a taxpayer's sale of a property, taxpayers should be prepared to confirm their intentions, potentially before Courts. In the Federal Court of Appeal decision of *Wall v. Canada*, the issue before the Court was whether the taxpayer had improperly relied on the principal residence exemption. The taxpayer was a real estate agent and developer, who had torn-down, rebuilt, and sold 3 homes in 6 years. The CRA reassessed the taxpayer on the basis that the principal residence exemption did not apply and that the profit from the sales was business income. The Tax Court of Canada held that the taxpayer was entirely an unreliable witness and confirmed the reassessments. On appeal, the Federal Court of Appeal agreed. While the taxpayer was largely unsuccessful due to his problematic testimony, the lack of supporting documents certainly made it near impossible to establish the principal residence exemption. Beyond a few pieces of mail, to suggest he may have lived at the homes, the taxpayer produced little other documentary evidence. The Federal Court of Appeal's decision emphasizes the importance of creating and maintaining contemporaneous records when buying and selling a property, especially if the taxpayer is engaged in regular home sales or is

in the construction or real estate industries. The decision also emphasizes that taxpayers need to be mindful of whether they are properly claiming the principal residence exemption, while preparing and filing their return.

Given the above, it is important for taxpayers to keep proper records related to the purchase and sale of any residential real estate and to be mindful of how they report the sale.

For more information or to discuss any current tax disputes regarding the sale of any residential real estate, **please contact our firm.**

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