SELLING REAL ESTATE? THE CRA IS WATCHING

CI GLOBAL ASSET MANAGEMENT

In 2019, the Canada Revenue Agency (CRA) announced results for audits in the real estate sector. According to the report, since 2015, CRA audits within the sector have resulted in over $1 billion in additional gross taxes. During the same period, CRA auditors reviewed over 41,700 files in Ontario and British Columbia alone, resulting in over $100 million in assessed penalties.

Looking specifically at 2018, the CRA assessed $171 million more in additional taxes related to real estate than the prior year – a 65% increase. Also, penalties more than doubled to more than $57 million over the same period. Associated reports state that, since 2015, there has been a significant focus on major population centres, such as the greater Toronto area (GTA) and the Lower Mainland in British Columbia, where consistently high numbers of real estate transactions occur.

Clearly, the CRA is concerned about non-compliance in the real estate sector, and it has taken steps to curb what it deems to be inappropriate behaviour. Through experience and the use of third party data, the CRA has aimed to gain a better understanding of non-compliant behaviour, leading to more audits and compliance actions. To support its efforts, the 2019 federal budget proposed to provide the CRA with $50 million over five years to create four new dedicated residential and commercial real estate audit teams – all part of a Real Estate Task Force – in high-risk regions, notably British Columbia and Ontario, following the risk as it evolves over time. The teams will work to ensure that tax provisions regarding real estate are being followed, with a focus on ensuring that:

- taxpayers report all sales of their principal residence on their tax returns;
- any capital gain derived from a real estate sale, where the principal residence tax exemption does not apply, is identified as taxable;
- money made on real estate flipping is reported as income;
- commissions earned are reported as taxable income; and
- for Goods and Services Tax/Harmonized Sales Tax (GST/HST) purposes, builders of new residential properties remit the appropriate amount of GST/HST to the CRA.

According to the federal Department of Finance, expected revenue from this initiative is projected to be $68 million over five years, starting in 2019–20.

Results of audit activities related to real estate in Ontario from April 2015 to June 2019		
Programs	Number of files completed	Audit assessments*
Income Tax	3,631	$63.5 million
GST/HST	1,897	$176.3 million
GST/HST New Housing and New Residential Rental Property Rebates	31,342	($426.4 million
Total	36,870	$666.2 million

*Source: CRA, as of August 2019. Note: Amounts include penalties assessed.

Results of audit activities related to real estate in Ontario from April 2015 to June 2019		
Programs	Number of files completed	Audit assessments*
Income Tax	1,864	$303.2 million
GST/HST	1,557	$157.2 million
GST/HST New Housing and New Residential Rental Property Rebates	4,485	$21.1 million
Total	7,906	$481.5 million

*Source: CRA, as of August 2019. Note: Amounts include penalties assessed.

WHAT THIS MEANS FOR TAXPAYERS

Since audits related to real estate occur regularly across the country, taxpayers should exercise diligence in ensuring real estate transactions are correctly defined and reported for tax purposes. Failing to do so may result in unwanted audits, potential back taxes and related interest and penalties.

TAX IMPLICATIONS ON THE SALE OF REAL ESTATE

From a tax perspective, much of the discussion about real estate transactions focuses on two things. When appreciated property is sold:

i) Is the transaction taxable?

ii) If yes, is the net profit taxed as business income or a capital gain?

The answers to the above questions depend on the circumstances. Normally, the gain on the sale of real estate is the difference between what the property is sold for and its cost. In some situations, the gain is considered business income and fully taxed (based on a 100% inclusion rate); in other situations, it is considered a capital gain. Sometimes the capital gain is taxable (based on a 50% inclusion rate), and sometimes (for example, where the property is eligible for the principal residence exemption) it is not taxable.

How a sale should be reported for tax purposes depends on a number of factors (see "Factors the CRA Considers in an Audit" below). Clients should work with their tax advisors to determine the nature of their property sales. Since 2016, it is mandatory to report all property sales to the CRA, including a principal residence. The tax characteristics of the sale would normally depend on whether the property was bought primarily to:

- live in as a principal residence,
- build or renovate and sell (often referred to as a "flip"), or
- create rental income.

Buying to live in as a Principal Residence

In this scenario, a taxpayer buys a property to live in as his/her principal residence (or for his/her spouse, common-law partner or child to live in). When the property is sold, although the sale must be reported to the CRA on the taxpayer's tax return for the year of sale, any resulting capital gain is often fully sheltered from tax because the conditions for claiming the principal residence exemption are satisfied and the property is designated as such for each year of ownership.

Buying to Build or Renovate and Then Sell (i.e., Flipping)

In this scenario, a taxpayer buys a property (or buys vacant land and builds a property), takes possession and does some renovating. After the home is improved, the taxpayer sells the property and the gains (or losses) form part of his/her income. The taxpayer may have lived in the property while making improvements. However, this does not entitle him/her to the principal residence exemption if the intention was always to buy, improve and sell for profit. In this case, profits realized on sale would normally be considered fully taxable business income.

Buying to Create Rental Income

In this scenario, a taxpayer buys a property primarily to earn rental income, which he/she pays tax on as it is earned. When the property is sold, the profit would normally be taxed as a capital gain, subject to a 50% capital gains inclusion rate. If a property is used primarily as a principal residence but a portion is used to earn rental income, the property can be fully sheltered from tax using the principal residence exemption provided the income-producing use is ancillary to the main use as a principal residence, there is no structural change to the property and no capital cost allowance is claimed on the property.

FACTORS THE CRA CONSIDERS IN AN AUDIT

During an audit, the CRA considers a number of factors to determine whether a property sale was reported correctly. The factors include:

- The type of property sold
- How long it was owned by the seller
- The seller's history of selling similar properties
- Whether the seller did any work on the property
- Why the property was sold
- The seller's original intention in buying the property
- With the assistance of their tax advisor(s), understanding these factors can help clients appropriately define the nature of their property sales.

CORRECTING A PREVIOUS RETURN(S)

Where a client has made a mistake or left out details about income on an income tax return, he/she can request an adjustment using CRA Form T1-ADJ – T1 Adjustment Request. Alternatively, for more complex scenarios and where significant penalties may be assessed, the Voluntary Disclosures Program (VDP) may be appropriate. For information on the VDP, visit https://www.canada.ca/en/revenue-agency/news/2017/12/backgrounder_-_voluntarydisclosuresprogram.html

MORE INFORMATION

During For more information on recent audits and the CRA's plan to address non-compliance in the real estate sector, visit https://www.canada.ca/en/revenue-agency/news/2019/05/the-government-of-canada-identifies-more-than-a-billion-dollars-in-additional-taxes-in-british-columbia-and-ontario-real-estate-markets-over-the-la.html?utm_source=mediaroom&utm_medium=eml

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