

2015 CANADA REVENUE AGENCY FOR AUDITS OF REAL ESTATE SALES & INCORPORATION STATUS FOR REAL ESTATE AGENTS

The Canada Revenue Agency (CRA) has a new state-of-the-art computer system with well-written software designed to review virtually every sale of a residential property - - condos, townhouses, semi-detached and detached homes - - to reassess for taxes payable. The CRA Audit Divisions are reviewing virtually EVERY sale of a residential home back to 2009 and earlier to reassess for extra taxes payable as values of GTA homes have risen by about 7% a year since 1997. The CRA is being opportunistic and engaging in abusive audits of home sales. This is a pure 'tax grab' on their part. The CRA is tracking activity on the MLS Service and checking titles using the Teranet Service.

There are only 4 types of treatment on the sale of residential homes. The **Principal Residence Exemption (PRE)** exempts the FULL gain from taxation if the home is used primarily for personal usage during the entire period of ownership. If you rent out the basement - - 34% of floor-space - - and claim a 10% home/office expense for business, the entire gain is still exempt so long as the primary purpose - - 51% or more - - was personal usage. Business usage of less than 50% of the floor-space amounts to only '**incidental business usage**' to the primary purpose of personal usage.

The **PRE** is a 'year-by-year designation' for each year or part-year of personal usage PLUS 1 '**bonus year**'. If you live in a home for 7 years and rent it out for 5 years then the property is treated as a '**mixed-usage property**'. You can designate it for each full or part year of personal usage. So, if you designate 7 years of the 12 years of ownership, your partial exemption will be calculated as:

7 + 1 over 12 or 8/12ths (2/3) of the calculated net gain on sale.

The third tax treatment is treating the sale as a capital disposition in which case only ONE-HALF of the net gain is taxable. This 50% exemption applies to gains on stocks, mutual funds, rental properties and such as cottages or a Florida condo on which you do not claim the **PRE**. Always save the **PRE** for your home with the largest increase in value.

Lastly, FULL taxation of a gain as '**regular income**' where: (a) you sell/assign an offer before getting title or (b) relist for sale on MLS too soon after getting title - - known as 'flipping' a property or (c) where investors in rental properties re-sell the property within the first 18 months of ownership and you will lose capital disposition status which exempts one-half of the gain on sale.

COMBINED 2015 FEDERAL/ONTARIO TAX BRACKETS

- 46.4%** FEDERAL/ONT. RATE ON TAXABLE INCOME OVER \$138,586;
- 43.1%** FEDERAL/ONT. RATE ON TAXABLE INCOME FROM \$89,401 TO \$138,586;
- 33.3%** FEDERAL/ONT. RATE ON TAXABLE INCOME FROM \$ 44,701 TO \$89,401;
- 20.05%** FEDERAL/ONT. RATE ON TAXABLE INCOME FROM \$ 0 to \$44,701

[Ontario has a 1% surtax on taxable income over \$150,000 and another 1% at \$220,000.]

1. FULL TAXATION ON THE SALE OF OFFERS.

Developers must provide the CRA with a digitalized list of all individuals who sign an agreement of purchase and sale on new condos, townhouses and homes.

If a taxpayer 'flips' the offer, the CRA will identify the sale by comparing the name(s) on the deed to the name(s) on the offer. Where the name(s) are different, the CRA has found a 'flip'. Gotcha!! If you 'flip' an offer and fail to declare the FULL gain in your tax return, file a '**Voluntary Disclosure Application**'.

The application must be: (a) "voluntary" meaning the CRA has not commenced action; (b) provide full disclosure; (c) involve a penalty, and (d) the information must 1 year overdue. The CRA is happy to waive the 50% penalties under s. 163 (2). If you sell more than 1 offer without declaring the income, you WILL pay the 50% penalty and face prosecution in the criminal courts under s. 239 (1) of the **Income Tax Act (ITA)** and face up to 200% penalties and 2 years in jail.

A shocking 2015 development is that the CRA is demanding that those who assign/sell offers or resell a new pre-construction condo/townhouse within 6-7 months of getting title obtain a Business Number and charge and remit 13% HST on the calculated gain on sale. This practice will not stand up to court challenge.

2. NEW AND RENTAL HOME BUYER'S REBATES.

The **New Home Buyer's Rebate (NHBR)** applies to homes bought for personal usage. The rebate is \$24,000 of HST for all homes purchased for \$400,000 and higher. The corresponding **Tenant Home Buyer's Rebate (THBR)** applies to rental properties and you must supply a lease showing at least 1 year of tenancy. You will be forced to repay the **NHBR** if you fail to take personal occupancy, and with the **THBR** you will be forced to repay the tenant rebate if you re-sell the home within 12-18 months of getting title.

A recent development for those deemed to be "trading" in real estate such as 'flipping' an offer and a 'quick sale' of either a personal home or a rental property is to re-characterize the net gain as "business income" and levy 13% HST on the amount of the gain under the **Excise Tax Act**. This practice will not stand up to court challenge. It verges on being ridiculous.

3. DENYING PRINCIPAL RESIDENCE EXEMPT STATUS.

The CRA is denying tax-free **PRE** status to taxpayers who get title of pre-construction condos which have gone up 30% to 40% or more and re-sell the new condo within 8 to 9 months of getting title. The CRA is taxing the full gain as "business income" plus levying 50% penalties under *Section 163 (2)* of the **ITA** plus interest. Disgraceful! Three points here. (a) A CRA Interpretation Bulletin says that **PRE** status will be conferred if there is personal occupancy for "...a short period of time". (b) Since the number of months is not defined, we took a case to the Toronto Federal Tax Court - - *Mostashari v. Her Majesty the Queen* - - and on a consent judgment got a period of 5 months and 3 days of personal occupancy as sufficient to get the **PRE** status. This is a start.

(c) The Federal Tax Court said in the **Venne** decision that for the 50% penalties on taxes owed to be levied that the onus on the CRA is to prove that the taxpayer "...knowingly filed a false return." This penalty is thus ONLY justified with 'tax cheats'.

4. TAXING THE FULL GAINS AS "REGULAR INCOME".

'Flips' of offers and rental properties will always be taxed on the full gain on sale. Investors in rental properties should hold the property for at least 18 months to ensure that they get capital gains treatment with ½ of the gain exempt. The CRA will look at "the number and frequency" of transactions and the "length of the holding period" and will tax the full income by concluding that you are engaging in "an adventure in the nature of trade" - - business activity.

5. DISREGARDING THE 3-YEAR LIMITATION ON RE-ASSESSING TAX RETURNS.

The CRA is citing s. 152(4) of the *ITA* to get around the 3-year limitation to reassess a tax return by stating that a taxpayer has made a "misrepresentation" or shown "carelessness" in a statute-barred tax return. Auditors use the most trifling of errors including the failure to claim **PRE** status on the sale of their home in a tax year as cause to reassess. "Misrepresentation" can be "negligent" or "innocent" in nature with the last involving mere inadvertence to be recognized by the courts as sufficient grounds to re-assess. The failure to claim **PRE** status in a personal tax return might open that tax year to audit.

6. UNFAIR AUDITS OF REAL ESTATE AGENTS.

This is a painful area of tax law. Real estate agents are an easy target for CRA personal tax auditors since they are the last profession which is not allowed to incorporate and the rules for deducting expenses are very restrictive.

CRA auditors are trained by management to be militant and unreasonably harsh on audits and to reassess for the maximum amount of taxes payable. Expenses such as high costs of customized sales seminars, which can cost up to \$15,000 to \$18,000 or more, will be disallowed with the auditor citing s. 67 of the *Income Tax Act* to conclude that they are "unreasonable in scale". Our firm argues that these courses are customized for the real estate industry and comply with trade and industry practices in real estate and we have **NEVER** lost this deduction. You have to stand up to auditors.

The agent will be asked to produce an auto logbook - - which is not required under the *ITA* or its related Regulations - - knowing that 99% of agents do not keep a logbook. You will get no more than 75% business driving without a logbook and will face a reduction to 60% or less. There are several GPS-based computerized logging software products. They are inexpensive and user-friendly and the data tracked is virtually unchallengeable. Get one!

A real-estate agent's home has been their "primary place of business" - - *Section 18 (12) (a)(i) of the *ITA** - - since they were required to pay for the MLS service and installed it in their home. This change made the whole industry 'home-based'. Our firm has **NEVER** lost the home/office expense on audit. On audits, Get professional representation to minimize the damage.

INCORPORATION STATUS FOR REAL ESTATE AGENTS

The *Tax Fairness for Realtors Act, 2014 (TFRA)* passed first reading of three required readings in April of 2014. The Act amends s. 30 (c) of the *Real Estate and Business Brokers Act, 2002 (REBBA)* and allows agents to incorporate. The Act requires that the agent own ALL of the "equity shares" - - voting shares - - of the corporation and reads that non-equity - - non-voting - - shares can be issued to "... the members of the immediate family of that person...". This confers the huge benefit of being able to favourably split both salary and dividends with family members.

There are benefits to incorporating as well as bookkeeping and audit problems which might arise. You get lower taxation by getting the commission income of the corporation into the hands of shareholders while paying the least taxes possible - - known as 'tax optimization'. Get a corporate credit card and pay all expenses from the corporation but **NEVER** commingle personal expenses in with business expenses.

Directors are personally liable for the balance of unremitted payroll and HST. If you are involved in day-to-day operations, you will not be able to raise the 'due diligence' defense if you are personally assessed for unremitted corporate payroll and HST.

1. CANADIAN-CONTROLLED PRIVATE CORPORATION (CCPC) FAVOURABLE TAX RATES

The **Small Business Deduction (SBD)** allows active Small Corporations (**CCPCs**) offering a service and/or product to the public a low combined Federal/Provincial tax rate of **15.5%** on their first \$500,000 of taxable income. Over \$500,000, the combined rate is **26.5%**. Corporate interest, dividends, net rent and capital gains - - "passive income"- - is taxed at a **PUNITIVE RATE** of **46.17%**. **CAUTION: NEVER buy rental properties in the name of a company as rents and capital gains are taxed at the punitive rate.** 'Bonus' yourself **DOWN** to the \$500,000 threshold. "Bonuses" are immediately deductible but payable up to 6 months later in the next personal tax year. Dividends may also pay paid in the next personal tax year. You can cut short your self-employed tax year by timing the conversion to corporate status. All of these are tax deferrals.

2. THE DIVIDEND/SALARY 'MIX' & CPP PREMIUMS

You and your spouse, if applicable, **MUST** be employees of the corporation - - see the **Wiebe Doors** case. You cannot bill your corporation for services as an independent contractor. You can select the blend of salary and dividends which is most favourable in tax terms. Salary payments are subject to tax and Canada Plan premiums withholding. The employee and the corporation must make matching CPP contributions up to the 2015 limit of \$53,600. Do not withhold CPP premiums beyond the limit as the excess amounts will be repaid to the employee as a tax refund but the corporation will get only a deduction on the excess amounts saving at **ONLY** the 15.5% tax rate.

3. INDIVIDUAL PENSION PLANS

Each employee of a corporation can set up an **Individual Pension Plan (IPP)**. These plans are separate from RRSP plans but the contribution room is about 50% more generous than with RRSP plans and there is no taxable benefit levied. Higher earning agents and full-blown brokers should have an IPP. The corporate contributions are fully deductible to the corporation and 'top-up' contributions - - also deductible to the corporation - - must be made to provide an annual 7% return. Get advice as the **IPP** must be approved by the CRA before it can be set up.

4. BENEFITS FROM INCORPORATION

The designated **HEAD OFFICE** of the corporation will be your home address. You can get an annual non-taxable reimbursement from the corporation for its proportionate usage of your home and the corporation can deduct the payment as a rent expense and save 15.5% in taxes. Nice!

There is a taxable benefit called a "STAND-BY CHARGE" calculated when an agent is driving an employer-provided vehicle and the corporation is paying ALL vehicle expenses. The general calculation is two-thirds of the capital and operating costs but you can use a second calculation where the benefit corresponds to the ACTUAL personal usage which might be only 5% to 10% of total driving. Get one of the GPS-based tracking products to reduce the taxable benefits.

You can 'roll' furniture, computers and vehicles into a corporation and the corporation will owe you an amount equal to their undepreciated cost or fair-market value.

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