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Marmer Penner Inc. Newsletter

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Abuse of the Principal Residence Exemption

Many Canadians look enviously at our neighbours to the south who famously have been able to deduct the mortgage interest on their personal homes when calculating taxable income on their federal and state personal income tax returns. In the midst of this tax envy, we conveniently forget that the United States taxes gains made on these residences. Here in Canada, we have our dearly loved principal residence exemption which is our best tax strategy during real estate booms such as the one we have experienced for the last 20 years.

Some have become so enamoured with the opportunity to earn such tax free gains that they have taken to buying fixer-uppers, making some improvements while living in the home and then selling the home all in a short period of time. Given the length of this current real estate boom, it seems to be a no-brainer for anyone who is handy to do this and, much like the instructions on your shampoo bottle: “rinse and repeat”.

We have seen such situations in matrimonial disputes where the builder-spouse naturally takes the position that gains on a principal residence are not considered for support purposes. We would normally agree except where we have seen either or both of the following:

a) Frequent gains on such flips; or

b) Significant efforts made to improve the home during a short ownership period.

Now, our position appears to be shared by Canada Revenue Agency ("CRA") and the tax court. In September 2012, the Tax Court of Canada ruled on the *Giguère* case. Ms. Giguère and her spouse sold seven single-family residences within a six year period, claiming the principal residence exemption each time. They had owned properties for periods ranging from as little as three months to as long as two years. CRA successfully argued that the profits should be taxed as business income and that, in addition, gross negligence penalties should apply for failure to report the income. In this case, the court concluded that the intention of the taxpayers was to buy the properties and to sell them for a profit and not to live in each property as a principal residence. This intention, along with the frequency of the transactions led the court to the conclusion that, for this taxpayer, the real estate sales were on "adventure in the nature of trade".

CRA defines an "adventure in the nature of trade" as a situation where a person habitually does a thing that is capable of producing a profit notwithstanding that these activities may be quite separate and apart from his ordinary occupation. From now on, the courts and CRA will look at a taxpayer's intention at the time a property is purchased in addition to the frequency of real estate "flips". Where a taxpayer is a builder and does this with his own home, albeit less frequently, the same argument may apply because he is earning income from a "habitual" activity.

It appears that the family courts now have the tax court's backing if they wish to view such gains in a similar manner. The next question to be asked is whether the income tax gross-up for income taxed at a preferential rate should apply. After all, the principal residence exemption eliminates the capital gain and a capital gain taxed at zero percent is rather "preferential".