HOME BUILDERS BEWARE . . . TAX DANGERS ABOUND!

It is generally known that there is **no tax on the gain on your principal residence** when you sell it. The *Income Tax Act* deems the capital gain to be zero, and in practice you need not even report the gain to the Canada Revenue Agency, unless you have more than one residence for a given year and need to file a designation choosing one of them as your "principal residence".

Some small home builders try to profit from this rule. They build a home, move into it for a short time, and then sell it. They may do this repeatedly, building and selling one home after another every year or so. The Canada Revenue Agency calls these builders "house hoppers".

Such builders are in for two nasty surprises when the CRA catches up with them – and many of them are ruined financially when the chickens finally come home to roost.

INCOME TAX – FULL TAX ON THE PROFIT . . .

The first problem the builder faces is an **income tax** problem. The "principal residence" exemption applies only the ***capital*** gains; it does not apply to business profit or to an 'adventure in the nature of trade'.

If the purpose of building a home was to sell it, then the gain will be **fully taxable as income** (business profit) when the home is sold. Thus, not only will the principal residence exemption not apply, but the one-half taxation of capital gains will also not apply, and high tax rates (up to about 46% depending on the province) will apply to the profit.

If the builder did not keep good records of expenses, or paid cash to some of the subcontractors and suppliers, the problem will be even worse, because the 'profit' calculated by the CRA auditor will be higher than the actual profit. It may take a lot of work to convince an auditor of the real costs of building the home, if the builder does not have proper documentation.

GST "SELF-SUPPLY RULE" . . .

The second problem the building faces will be a **GST assessment**. Tax will apply under the GST "self-supply" rule, even before selling the home, **simply because the building and his family moved in.**

The "self-supply" rule works as follows. If the builder builds a new home and sells it, the sale is taxable. If the builder, instead of selling the home, leases it out or occupies it personally (or allows a family member to do so), then the builder is deemed to have sold the home (to himself), and GST is payable immediately on the full fair market value of the home, including the land value. This GST must normally be remitted to the CRA within one month after the end of the current reporting period. (Offsetting input tax credits will be available for the GST paid on construction materials and to subcontractors,

but ***only*** if the builder has kept invoices showing GST registration numbers of the suppliers and only if the builder did not already claim these credits when the expenses were incurred).

After that, a sale of the home is normally exempt. The idea is to tax the home as soon as it is occupied as a new home, and not to allow a lease or personal occupancy to postpone the application of the GST.

The same principle also applies to residential condominium units and apartment buildings; in the latter case, the *entire building* is deemed to have been sold at its fair market value as soon as the *first unit* is occupied.

These rules (in Section 191 of the Excise Tax Act) have numerous conditions and exceptions. For example:

- If the builder can show that he built the home purely for personal occupancy and not for resale, he will not be a 'builder' as defined, and the GST rule will not apply.
- Even if he is a 'builder', if he occupied the home as his primary place of residence (rather than, for example, to enhance its saleability), the self-supply rule may not apply.

However, the Courts have held that, where the home was built with the intention of selling it, the fact the builder moved in with his family does not help him. In these cases, the Court will usually hold that the property was primarily part of the builder's 'inventory' rather than primarily being the builder's residence, and is subject to the self-supply rule.

BE WARNED . . .

The CRA (and, in Quebec, Revenue Quebec) will audit 'house hoppers' with a vengeance.

Real estate and property transfer records are kept very accurately for legal reasons, and are now electronic records in many provinces, so it is not difficult for the tax authorities to find such builders. It is often a simple matter for an auditor to trace a builder's recent addresses, whether from tax returns or any other source, and to research electronically the history of ownership of each of these addresses.

Small builders must be careful in this minefield. Those who play the 'build-it-move-in-and-sell' game must be particularly aware of the double hit they will take, on both income tax and GST, if the tax authorities figure out what they are up to. Note also that, on the GST side, if the builder has not filed a GST return for the reporting period, he can be assessed *at any time* – even 10 or 15 years after the transaction. Some builders, even in 2007, are being assessed on homes that they built and moved into in the early 1990s.