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## Not For Profit

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Tax Forum

Not For Profit

The principal residence rule won't necessarily protect a taxpayer's profits from the sale of a home from being reassessed.

FROM: [FEBRUARY 1999 ISSUE](#) | BY [DON GOODISON](#)

One of the things that I don't like about tax work is that I am often perceived as a bearer of bad tidings. If I tell clients that they are wasting their time appealing an assessment or that their fantastic tax avoidance scheme will not work, they view me as a naysayer. Outside the office, I find myself setting the record straight when people happily expound on something they or someone else is doing that is "completely tax free." I really should keep my mouth shut, but I don't.

Recently, a friend told me about people she knows who build a house, live in it for a year and then sell it. They put the profit from the first house into building the next one. Eventually, these people will have a very expensive house mortgage free, and, because they have lived in each house, the profits won't be taxed. "Hardly," I replied, using my most authoritative tone. "If Revenue Canada finds out about it, they will be considered to be in the business of building and selling houses and will be taxed on the profits. They will probably have to sell their house in order to pay all the back taxes, penalties and interest." I then watched the light go out in my friend's eyes and yet another dream go down the drain.

### TAXPAYER REASSESSED ON SALE

But, I wasn't wrong. In *Jeffrey Watson (appellant) v. Her Majesty the Queen (respondent)* [98 DTC 1680], the Tax Court of Canada dealt with a taxpayer who built houses, lived in them for a short while and moved on, making a profit on each of them. From 1989 to 1993, Watson built four houses, lived in them with his family and then sold them. All the houses were within a one-mile radius. Revenue Canada chose to assess Watson on only two of the four houses, which were both sold in 1992.

In August 1988, Watson worked as a carpenter in his father's foundation construction business. He and his wife bought a lot, built a house on it and moved into the house in March 1989. In January 1990, they sold it and made a profit of \$20,000. In March 1990, they moved into a new house on a lot they purchased earlier in January. They lived in the second home until February 1992, when they sold it for a profit of \$26,290. They then moved into a rental home for two months while their next house was being constructed.

The Watsons' third home was built on a lot they acquired in January 1992; in April they moved in. In November they sold this house and lived with Watson's mother for the next four months. In January 1993, they purchased another lot, built a house on it and moved into it in April. They sold it the following year in February 1994. Revenue Canada assessed Watson on the two houses sold in 1992. He then appealed to the Tax Court of Canada.

### REASON FOR SALE

In Court, the Watsons detailed their reasons for selling the houses, none of which involved making a profit. House No. 1 fronted on a busy street and they feared for their young children's safety. The back of the property sloped steeply down to a gully and the back deck was 16 feet above the ground. Their concern was that this also posed a threat to the children, who would be badly injured if they were to fall.

House No. 2 was on a sudden blind curve, which they considered too dangerous for the children. They stated that the family dog was run over shortly before they put the house up for sale. However, Revenue Canada pointed out that the rental property they occupied for two months was adjacent to a parking area for trucks and heavy equipment, and was probably more dangerous to the children than the house they sold. When it came to House No. 3, Watson discovered during construction that they simply could not afford it. His father, the owner of Watson's construction business, wanted him to repay money he had borrowed from the company and to pay for materials he had purchased using the company account.

Revenue Canada did not assess House No. 4, but Watson told the Court that he sold it because the moisture in the basement gave his children allergies. The Watsons built their next house on a slab to prevent the moisture problem from recurring.

### **TO SELL AT A PROFIT**

Watson argued that he had neither the primary nor the secondary intention of selling the houses in question at a profit. In his opinion, his explanations were acceptable and all the houses were principal residences. Revenue Canada countered that Watson worked in the family business during the summer and built houses in the winter while collecting unemployment insurance. In support, it submitted evidence of both Mr. and Mrs. Watson's income for the years 1990 through 1994. This showed that the Watsons' yearly income was about \$25,000, while Watson consistently built houses worth more than \$100,000. Revenue Canada argued that the only way Watson could afford houses of that value was to sell them quickly at a profit.

### **APPEAL DENIED**

In denying the appeal, the Court found that Watson was quite prepared at all times to sell the two houses in question at a profit. It concluded that he had at least a secondary intention to sell them at a profit even if he initially acquired them to live in. The Court found that the Watsons' explanations were valid if taken in isolation; however, taken as a whole, they did not stand up. The fact that House No. 1 was on a busy street and that the backyard had a dangerous slope were conditions that existed when the Watsons purchased the land and which would have been quite evident. The 16-foot drop from the back deck was their doing.

The Court noted that Watson sold House No. 2 because it had a dangerous location, but that the family immediately moved to a home that had a far more dangerous one. In view of Watson's building experience, the Court found it hard to conceive that he would have concluded prior to completion that he would have to sell House No. 3 because it was too expensive. In the Court's view, Watson was in the business of building basements, yet he stated that he had to sell House No. 4 because the basement had a humidity problem. Watson provided no evidence to corroborate the testimony, and he apparently made no effort to rectify the problem.

### **PROFIT PATTERN**

Even though Revenue Canada only assessed Watson's second and third houses, the Court looked at Watson's pattern with respect to all the houses during the period. Based on that pattern, it concluded that the houses had been built to sell at a profit.

In making its decision, the Court looked at *Happy Valley Farms Ltd. v. The Minister of National Revenue* [86 DTC 642], where the Federal Court – Trial Division set out the following six tests for the profit motive:

1. *The nature of the property sold.* All Watson's properties were single family homes.
2. *The length of period of ownership.* Watson sold the two houses in question in the same year.
3. *The frequency or number of other similar transactions by the taxpayer.* Watson built and sold four houses over a four-year period.
4. *Work expended on or in connection with the property realized.* Watson built the houses in marketable areas and advertised them for sale.

5. *The circumstances that caused the sales.*
6. *Motive.* Based on evidence, the Court concluded that Watson's motive was to sell at a profit.

So, not only was I right in stating that Revenue Canada would attack the scheme, but this case proved that the Tax Department would more than likely win. One cannot just rely on what one part of the *Income Tax Act* says to safeguard a transaction. Yes, on the surface, houses appear to qualify as principal residences. However, the frequency of transactions, the fact that the taxpayer makes a profit on each sale and the taxpayer's expertise in the area of home building spells business, not home. A taxpayer in this situation will not be able to hide behind the principal residence provisions to avoid tax.

I explained this case to my friend and offered to copy the reasons for judgment so she could pass it on to the people she told me about. She declined, saying that she did not want to be perceived as someone who throws cold water on everyone's ideas. I protested that I was not being negative for the sake of being negative; I was just trying to keep her friends out of trouble. I don't enjoy handing out the bad news; I do it because it's my job. I never told my kids the truth about Santa Claus or the Tooth Fairy, though. Those dreams are meant to last.

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