TRICK OR TREAT

For a real estate investor, few things are scarier than an audit. **Andrew Ku** offers a cautionary tale that can go a long way toward lessening the horrors wrought by that most hated monster: The Taxman

It was around nine o'clock on Halloween of 2019. Most of the night's trick-or-treaters had already returned home, peeled off their second skins and dumped their sugary spoils onto their bedroom floors. But a solitary figure continued his way through the town, the rasp of dead leaves against his loafers the only sound.

The figure approached a home nestled into the snug dark of a cul-de-sac. As he glided up the stone pathway to the front door and its feeble porch light, his black silhouette was slight and, upon first glance, unthreatening. Until one looked at his hands … or what should have been his hands.

The right: a calculator with buttons of bone. The left: a flesh-covered Federal Income Tax Act. It is *The Taxman*.

He knocked on the door. When it opened, there stood Homer, an active real estate investor, holding a near-empty plastic bowl. Before he could apologize for only having Smarties left, The Taxman showed his ghastly non-hands to Homer and hissed, "Trick or treat. Give me all of your … *receipts*."

Homer screamed. He passed out. When he came to, he found an appointment card in his mouth.

The next day, Homer ran straight to his accountant, Dan. "Why are we being audited?" he whispered, looking over his shoulder.

Dan explained that the CRA picks its targets based on risk assessment. "The assessment looks at a number of factors, such as the likelihood or frequency of errors in tax returns or whether there are indications of non-compliance with tax obligations," Dan said. "The CRA also looks at the information it has on file for the taxpayer and may compare that information to similar files or consider information from other audits or investigations."

Looking no less haunted, Homer asked, "What's the process? What's going to *happen* to me?"

"It typically starts off with a written audit information request letter from the auditor," Dan said gently. "If this were a desk audit, you'd usually mail in or submit the information online. If it's a field audit, the auditor will visit where your books and records are held. Once the audit fieldwork is completed, the auditor may share with you his or her proposal. You'll then have an opportunity to review, communicate and provide additional supporting documents to the auditor, if needed. The auditor will then process the adjustments, and the CRA will send you a reassessment. You have up to 90 days to appeal to the reassessment."

Homer was silent for a moment as he chewed his bottom lip. "But what if I'm a real estate investor?"

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Dan held out his right hand. "Watch," he said.

A vermilion flame emerged from his palm, spreading until it engulfed Dan's entire hand. Homer's eyes were shut tight, tears falling from their corners. When he finally opened his eyes and wiped away the tears, he saw no Dan, no flame. He was back in his home office with a pamphlet called *Surviving the Audit: Four Tips for Real Estate Investors*.

He opened it, breathless. This is what it said:

1. Principal residence capital gain exemption

There are numerous cases of the CRA challenging a taxpayer's qualification of the capital gain exemption during an audit. This mostly concerns real estate sales professionals and individual real estate investors who own multiple properties. Some of the proposals from auditors may involve treating any gains on a sale as business income as opposed to capital gains, which are only 50% taxable.

2. Capital gains versus business income

Generally, capital gains are only 50% taxable, while investment or business income is fully taxable. The tax treatment could depend on the nature of the transaction, the background of the taxpayer and the frequency of such transactions. Be prepared to support your filing position.

3. Valuation of properties

The CRA has its own dedicated real estate valuation team. Be prepared to be challenged in a few situations:

- Change in use, especially when you turn a new, unsold residential property from inventory into a rental property.
- Allocation between land and building when you capitalize your rental property. Land is not a depreciable asset, but a building is. The change in depreciation one can claim can adversely affect the tax deferral effect of such investments.
- The sale of real estate to related parties for below fair market value. This could potentially lead to double-tax scenarios.

4. Unreported transactions

The CRA has access to provincial land registry records, and they often review transactions involving properties that have changed hands in a short period of time. For pre-construction condos, the CRA has been requesting assignment transactions directly from the builders. On the GST/HST front, this applies to newly built or substantially renovated residential properties, as well as new residential property assignments for profit.

The CRA also gains access to business account activities from certain big-box hardware and home improvement retailers. The agency reviews the account holder's activities, such as purchase history and frequency, to determine potential unreported business activities.

The consequences: Aside from income inclusion, penalties and interest will likely be added to the amount owing. Generally, false statements or omission penalties can be as high as 50% of the understated tax and/or the overstated credits in question. Interest and penalties are generally non-deductible in computing taxable income. Assuming a tax rate of 40%, $60 worth of penalties/interest is equivalent to $100 of pre-tax income.

His horror subsided, but Homer's hands were shaking. He heard Dan's voice calling to him from some far-off place.

"Good tax planning will typically cover audit risk assessment and leave an audit trail when the time comes, including appropriate legal documentation and proper flow of funds," the voice said. "Don't panic … and call your tax advisor." ■

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