HOUSING RULE CHANGES EFFECTS ON THE PRINCIPAL RESIDENCE EXEMPTION

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On October 3, 2016, the Department of Finance introduced changes to the principal residence exemption ("PRE") rules "to improve tax fairness for Canadian homeowners." There were three significant changes:

- The period during which the Canada Revenue Agency ("CRA") can assess or reassess taxpayers that do not report the sale of real property has been extended;
- Limits regarding the types of trusts that can claim the PRE have been imposed; and
- Non-residents who acquire residential properties in Canada will no longer be able to claim a portion of the PRE to shelter gains on a later sale.

The remainder of this newsletter will review the existing rules and what these changes mean for taxpayers.

Summary of the Existing PRE Rules

Before reviewing the recent changes, it would be useful to summarize the existing rules:

Canadian resident individuals who realize a capital gain on the sale of their home may claim the PRE to reduce or eliminate the capital gain for tax purposes. To claim the PRE, the taxpayer must designate the property as a "principal residence" for each year the property is owned. Where specific conditions are met, non-Canadian properties may also qualify for the PRE. Generally, if a taxpayer is in the business of buying and selling real estate, the principal residence exemption may not be available.

The term "principal residence" of a taxpayer means a property which the taxpayer and their family unit (spouse and minor children) has "ordinarily inhabited." The amount of exemption available is determined by a formula that prorates the amount of gain by the number of years in which the property was

Our goal is to provide updates on topical accounting and tax issues. Information contained in this newsletter is not meant to be a comprehensive summary of the issues raised. Rather, we wish to bring what we believe to be important issues to the attention of our valued clients and readers. We would be pleased to discuss any questions that you, the reader, might have in greater detail.

designated as the taxpayer's principal residence compared to the total number of years that the taxpayer owned the property.

The rules only allow one property to be designated as a taxpayer's principal residence for a particular tax year. Where a taxpayer has two residences in the same year, the taxpayer must choose which property to designate and which will be subject to tax for that year. The rules also contemplate a situation where one residence is sold and another is acquired in the same year. It would be unfair if only one of the two properties could be designated as the principal residence for that year in this scenario. The PRE formula simply adds "1" to the years eligible for principal residence treatment to, in effect, allow both properties as a principal residence.

It is also possible for a personal trust to claim the principal residence exemption to reduce or eliminate the gain that the trust would otherwise have on the sale of a home. For this purpose specific conditions must be met: most importantly that the trust must designate a "specified beneficiary," meaning a beneficiary (the taxpayer, spouse or their children) of the trust who "ordinarily inhabited" the property during the year.

The designation of a property as a principal residence for one or more years is required to be made on the income tax return for the year in which the taxpayer has sold the property. Where the principal residence exemption eliminates the entire taxable gain on the property for an individual, the CRA administratively does not require reporting of the sale or the filing of the related principal residence designation form.

> *"There is now no limitation on how far back the CRA can reassess tax on unreported dispositions"*

Limitations on Assessment and Reassessment Period

For 2016 and future taxation years, the new rules permit the CRA to reassess tax after the end of the normal reassessment on a disposition of real or immovable property if the taxpayer does not initially report the disposition. The normal reassessment period for most taxpayers, including individuals and trusts, is 3 years after the date of the initial note of assessment.

As outlined above, taxpayers are not required to report the disposition of their principal residence provided all of the related gain is exempted with the PRE. This is pursuant to a CRA administrative policy even though the Income Tax Act requires the disposition to be reported on a prescribed form. There is now no limitation on how far back the CRA can reassess tax on an unreported disposition of real property, which will make it easier for CRA to catch errors and collect additional tax.

It is unclear if CRA will update its current administrative policy and require that all dispositions, including those to which the principal residence exemption applies, be reported given the changes. It is worth noting that CRA will accept late filed PRE designation forms, so it would be possible to claim the PRE even where the disposition was not originally reported. However, the maximum penalty for late filing the form is $8,000. We therefore recommend that for 2016 and future taxation years all dispositions of real property, including the disposition of a principal residence that is fully exempted by the PRE, be reported and the PRE designation form be filed in a timely manner.

The PRE Rules Applicable to Trusts

The new rules limit the types of trusts that can designate a property as a principal residence. For taxation years beginning after 2016, a trust must fall within one of the categories below in order to qualify:

- Alter-ego trusts, spousal or common-law partner trusts, joint spousal or common-law partner trusts, or similar trusts created for the exclusive benefit of the settlor;
- Testamentary trusts that are qualifying disability trusts; or
- Inter vivos or testamentary trusts the settlor of which died before the start of the year

In any of the above cases, the trust must be resident of Canada and occupy the property in the year for which the PRE is being claimed. There is still a requirement for a specified beneficiary to have ordinarily inhabited the property in the year. While it is still possible for trusts to hold real estate, given the restrictions placed on the ability for trusts to claim the PRE, taxpayers should obtain professional advice regarding the merits of a given trust continuing to hold real estate subsequent to 2016.

Limitation on the "One Plus" Rule

Effective October 3, 2016, the "one plus" rule described above now only applies where the taxpayer is resident of Canada during the year in which the taxpayer acquires the property. Accordingly, an individual who was not a resident of Canada in the year of acquisition of a property disposed of after October 2, 2016 will not be able to claim the "one plus" rule in the PRE formula. This measure has been put in place to ensure that non-residents are not eligible for the PRE on any part of the disposition. This change follows the province of British Columbia's new 15% property transfer tax, which applies to foreign purchases of residential properties in Vancouver and appears to be an additional measure aimed at stabilizing the Canadian housing market.

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