TaxTalk

# CHANGES TO THE PRINCIPAL RESIDENCE EXEMPTION RULES

On October 3, 2016, the Department of Finance introduced some significant changes to the principal residence exemption (PRE) rules. The idea was specifically to improve tax fairness by closing loopholes surrounding the capital gains exemption on the sale of a principal residence.

The proposed changes to the PRE rules effectively limit the ability of certain taxpayers to reduce or eliminate the capital gain on the sale of their home.

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 (including their spouse, common-law partner or child, if applicable) must designate the property as a principal residence for each year the property is owned.

A principal residence of the taxpayer means a property which the taxpayer (including spouse, common-law partner or child) 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 designated as the taxpayer's principal residence compared to the total number of years that the taxpayer owned the property.

**Proposed rule changes**

1. While the PRE rules only allow one property to be designated as a taxpayer's principal residence for a particular tax year, the PRE rules recognize that a taxpayer can have two residences in the same year. For example, where one residence is sold and another is bought in the same year. In such cases, the formula adds one year (the "one-plus rule") to the principal residence years to allow both properties to be treated as a principal residence.

   The one-plus rule will apply after October 3, 2016 only when the taxpayer is a resident in Canada during the year in which the taxpayer acquired the property. Thus, an individual who was not a resident of Canada in the year they acquired the residence will not (on a disposition of property after October 2, 2016) be able to claim the PRE for that additional year. This measure has been put in place to ensure that permanent non-residents are not eligible for the PRE on any part of the gain from the sale of a residence. However, it appears that the proposed rules do not provide any relief to a non-resident taxpayer who acquires a real estate property and then immigrates to Canada in a subsequent year and resides in that property. Furthermore, the rules do not penalize a taxpayer who emigrates from Canada and continues to own the property that was acquired while being a resident of Canada.

2. The proposed rules introduce additional requirements in order for a property to qualify as a trust's principal residence for a taxation year that begins after 2016. The proposed rules limit the principal residence designation to only the following types of

trusts with a beneficiary who is a Canadian resident and also a "specified beneficiary":

i. An alter ego trust, a spousal or common-law partner trust, a joint spousal or common-law partner trust or a trust that holds the property for the exclusive benefit of the settlor during the settlor's lifetime;
ii. A testamentary trust that is a qualifying disability trust; or
iii. A trust for the benefit of a minor child of deceased parents.

There are transitional rules to provide relief for affected trusts for property owned at the end of 2016 and disposed of after 2016. A common family estate planning strategy is to hold real estate properties in a personal trust with a consideration that the PRE may be claimed on that property in the future.

A personal trust affected by the proposed rules may still continue to hold such properties, however, it would be wise for the taxpayer to assess whether the original planning objectives are still being met without being able to claim the PRE.

3. Under normal circumstances, CRA may only assess tax paid by a taxpayer for a taxation year during the "normal reassessment period". The normal reassessment period for individuals and trusts is three years from the date of the original notice of assessment issued by CRA.

   The proposed rules indicate that CRA has the ability to reassess tax beyond the normal reassessment period if the taxpayer or a partnership does not report a disposition of a real estate property on the appropriate tax return. This proposed change is much broader since it applies to all unreported disposition of a real estate property and not just the disposition of a principal residence. This reassessment beyond the normal reassessment period would only be limited to the unreported disposition of a real estate property. If the return is amended to include a previously unreported disposition of a real estate property, then the normal reassessment period for that disposition would begin on the date of the notice of reassessment issued by CRA.

   The proposed rule will apply to taxation years ending after October 2, 2016. Accordingly, starting with the 2016 taxation year, vendors who sell their principal residence including deemed dispositions on or after January 1, 2016 are now required to report the sale on their income tax return and make an appropriate principal residence designation to claim their PRE.

   This proposed rule replaces CRA's administrative policy which was that an individual is not required to report of the sale or file the Form T2091 when the PRE eliminates the entire taxable gain.

4. Finally, when the sale of a home has been reported but a principal residence designation was not made in the taxpayer's tax return, the CRA will be able to accept a late-filed principal residence designation subject to a penalty of $100 per month to a maximum $8,000.

A memorandum of this nature cannot be all-encompassing and is not intended to replace professional advice. Its purpose is to highlight tax planning possibilities and identify areas of possible concern. Anyone wishing to discuss the contents or to make any comments or suggestions about this *TaxTalk* is invited to contact one of our offices.

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