Significant changes to the Canadian Principal Residence Deduction

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Oh, give me a home where the buffalo roam

Where the deer and the antelope play;

Where seldom is heard a discouraging word,

And the sky is not cloudy all day [unless the home is in a Canadian trust]

Many of us are familiar with the above opening words of "Home on the Range" – a classic western folk song that has its roots in the early 1870s. "Home on the Range" is a sentimental song that waxes about the longings and importance of a person's home. With that in mind, the Department of Finance released a series of measures on October 3, 2016, aimed at "…protecting the financial security of Canadians, supporting the long-term stability of the housing market and improving the integrity and fairness of the tax system, including ensuring the principal residence exemption is available only in appropriate cases." The measures released included changes to the mortgage default insurance rules for lenders and the announcement of a public consultation to "seek information and feedback on how modifying the distribution of risk in the housing finance framework by introducing a modest level of lender risk sharing for government-backed insured mortgages could enhance the current system." Details on the public consultation should be available shortly with the release of a public consultation paper by the Department of Finance. With British Columbia recently introducing a new tax on foreign purchasers for the Vancouver area, yesterday's announcement by the federal government is likely part of a continuing series of overall amendments that Canadian governments will make to ensure the stability of Canada's housing market. Home on the Range.

Before discussing the changes to the income tax regime, let's first discuss some basics. First, it is well known that Canadian resident individuals who dispose of their principal residence and realize an economic gain may claim an exemption when computing the taxable amount of their gain. The income tax exemption is contained in paragraph 40(2)(b) of the *Income Tax Act* (*Act*) and relies on a formula contained therein. The formula requires a taxpayer to compute the eligible amount of the gain that is exempt from taxation and is only applicable if the individual disposes of a property that was the individual's "principal residence". The formula also requires a proration for the number of years during which the property was the taxpayer's principal residence and the taxpayer was resident in Canada as compared to the total number of years that the taxpayer owned the property (jointly or otherwise with another person). In order to accommodate years where a taxpayer disposes of an old property and acquires a new property in the same year, the formula automatically adds '1' to the "principal residence" years – commonly known as the "1+ rule".

Second, the principal residence exemption in paragraph 40(2)(b) relies on the definition of "principal residence" in section 54 of the *Act*. The definition is very long and complex. This surprises the average Canadian since conceptually the understanding of a principal residence is easy to understand: "It's my

house!" Oh, if tax law was only that simple. The definition contains nuanced requirements that require the taxpayer (or the spouse or common-law partner or child of the taxpayer) to have "ordinarily inhabited" the property with no such definition of what that phrase means. One has to look to the courts to determine what is meant by "ordinarily inhabited". The property also has to be a "capital property" of the taxpayer. Accordingly, "house flippers" are not eligible for the principal residence exemption since properties that are quickly sold after the acquisition will likely not be considered capital property but rather inventory. Any resulting profits would be considered business income that would not be entitled to the principal residence exemption and would be fully taxed rather than only 50 per cent taxable as a capital gain. The definition of principal residence also contains a size restriction on the immediately contiguous land to the housing unit (not to exceed a half hectare unless the taxpayer can establish that any excess was necessary for the use and enjoyment of such property – the courts are littered with cases where the taxpayer has argued that the excess land is necessary for the use and enjoyment of the property). In addition, the definition of principal residence in section 54 contains detailed rules (in paragraph c.1) that prohibits a trust (which is considered to be an individual for income tax purposes pursuant to the rule in subsection 104(2) of the *Act*) from considering a property as its principal residence unless very specific conditions are met. Simplified, such conditions require that no corporation be a beneficiary of the trust and the trust must designate in prescribed form each individual – a "specified beneficiary" – who is a beneficiary of the trust and ordinarily inhabited the property (or the beneficiary's spouse or common-law partner or child ordinarily inhabited the property). In addition, the trust must be a "personal trust" as defined in subsection 248(1) of the *Act*.

Third, the principal residence exemption under paragraph 40(2)(b) has been the subject of significant change over the years. One of the more significant changes occurred in 1982 when spouses could no longer each claim a principal residence exemption which enabled a "double-up" of the principal residence exemption. For years after 1981, spouses must, in effect, share the principal residence exemption.

Fourth, properties do not need to be Canadian properties to be considered principal residences as long as all of the other conditions are met in the definition of principal residence.

Fifth, the principal residence exemption as provided for in paragraph 40(2)(b) in conjunction with paragraph (c) [for individuals] and paragraph (c.1) [for trusts] of the definition of principal residence in section 54 of the *Act* requires the taxpayer to file a prescribed form – Form T2091 for individuals and Form 1079 for trusts. However, the Canada Revenue Agency's (CRA) longstanding administrative position was that prescribed form T2091 was not required to be filed for individuals if the principal residence exemption eliminated all of the taxable gain. The CRA did not provide similar administrative relief for trusts.

With the above background in mind, the Department of Finance proposed the following income tax amendments:

1. Changes to the "1+ Rule" in Paragraph 40(2)(b) of the Act

An individual who was a non-resident of Canada in the year of the acquisition of the principal residence property will no longer be able to automatically add "1" to the number of "principal residence" years in the calculation of the proration as discussed above. This new rule applies for dispositions after October 3, 2016. In effect, this will prevent a non-resident of Canada from being able to dilute their taxable capital gain on the disposition of an otherwise principal residence in years where they acquire and dispose of properties. In my opinion, this amendment makes sense from a policy perspective. However, will we now see non-residents gifting funds to their resident spouse or child to acquire the property and thus be able

to continue to take advantage of the “1+ rule”? Likely.

2. Restrictions on the Use of the Principal Residence Exemption for Trusts

As discussed above, paragraph (c.1) of the definition of principal residence in section 54 of the *Act* enables a trust, in effect, to claim the principal residence exemption if very specific conditions are met. However, the Department of Finance proposes to add new conditions to paragraph (c.1). Essentially, such conditions will eliminate all “vanilla” personal trusts from being able to designate a property as its principal residence unless such trust is:

1. An alter ego trust, joint spousal or common-law partner trust, spousal or common-law partner trust, or trusts that are commonly referred to as “self-benefit” trusts;
2. A testamentary trust that is considered a “qualified disability trust”; or
3. An intervivos or testamentary trust the settlor of which died before the start of the year with an eligible beneficiary being a Canadian resident minor child of the settlor.

While the carve-outs for (a) – (c) above are beyond the scope of this blog, suffice it to say that many trusts who hold principal residence properties will be affected by this change. It is very common to have a carefully crafted trust hold personal-use properties that could be considered principal residence properties. Such trusts are often used to effectuate better succession of properties to desired beneficiaries, avoid succession duties and avoid the application of certain dependent relief legislation that otherwise might be applicable or available to a person who might feel disenfranchised. While trusts may still have a place in family estate planning to hold principal residences, one will need to be very careful and cognizant of the new restrictions and consider using one of the above trusts referred to in (a) – (c) above if appropriate.

Canadians who are not United States (US) citizens or residents of the US often acquire US vacation property. Such property may be considered a principal residence of the individual under Canadian law if all of the other requirements of the definition of a principal residence are met. Often, but not always, it is advisable for these Canadians to acquire such property through a carefully crafted Canadian trust so as to provide efficient US income tax results upon sale and avoid US estate tax upon death. With the above amendments, most trusts that have been utilized to acquire such properties will be affected. However, in most cases, because the US does not have a principal residence exemption for non-US citizens or non-residents and because the US tax will tax the gains on sale it will not usually be advisable for such trusts to attempt to designate such property as a principal residence. Accordingly, for such trusts, the amendments announced by the Department of Finance should have no real impact on the overall planning. One exception would be if there were not a taxable gain from a US perspective but a gain from a Canadian perspective (likely because of foreign currency fluctuation). Of course, this should be reviewed on a case-by-case basis.

Families that have utilized trusts to hold principal residences will need to carefully review the amendments and make any necessary changes to ensure that their estate planning is still appropriate. Non-residents who utilized trusts to acquire property and claim the principal residence exemption will be greatly affected. Our firm has previously discussed the use of trusts with non-residents to acquire principal residences, but such planning is now effectively dead.

The trust amendments apply for trust dispositions of property in (or after) the trust’s first taxation year that begins after 2016. If a trust owned the principal residence property before 2017, the new rules do not apply in determining whether the property may be designated as a principal residence of the trust for taxation years that begins before 2017. Ultimately, this means that affected trusts that currently own a

principal residence property will no longer be able to add the number of years in the proration formula in paragraph 40(2)(b) for years of ownership after 2016.

3. Extended Reassessment Period

The rules for when the CRA may reassess a taxation year are laid out in section 152 of the *Act*. Overly simplified, the "normal reassessment period" for an individual is three years after the day of sending of an original notice of assessment by the CRA for a particular taxation year. However, subsection 152(4) sets out conditions where the Minister can reassess beyond the normal reassessment period. The Department of Finance is proposing to add paragraph (b.3) to subsection 152(4) to add a set of conditions that, if met, will enable the CRA to reassess tax beyond the normal three-year period. Simplified, if the taxpayer does not report a disposition of real property in a taxation year, the CRA may reassess for tax for an unlimited period beyond the normal reassessment period. In other words, the statute barred clock will never start ticking. Fortunately, companion amendments to subsection 152(4.01) will limit the Minister to reassess for only the unreported disposition of the real property.

What about taxpayers who dispose of their principal residence and have no tax liability and intend to rely on the CRA's old administrative position that form T2091 did not need to be filed to report the disposition? Well, see below.

4. Changes to CRA's Administrative Position for Reportings of Principal Residence Dispositions

Concurrent with the Department of Finance's announcement, the CRA announced significant changes to its administrative position regarding the reporting of principal residence dispositions. Briefly, the CRA states the following:

Starting with the 2016 tax year, individuals who sell their principal residence will have to report the sale on Schedule 3, Capital Gains of the T1 Income Tax and Benefit Return. Reporting will be required for sales that occur on or after January 1, 2016.

You will complete Schedule 3 and file it with your T1 Income Tax and Benefit Return for the year you sell the property. If the property was your principal residence for every year that you owned it, you will make the principal residence designation in your Schedule 3. In this case, the year of acquisition, proceeds of disposition and the description of the property are the information that will have to be reported. Schedule 3 will be modified accordingly. Form T2091 (or Form T1255) will still be required for the designation in the case the property was not your principal residence for all of the years that you owned it.

Significant changes! You will want to ensure that such dispositions together with all necessary disclosures are reported to ensure that the extended reassessment period as discussed in #3 above will not apply! Accountants/tax preparers get ready for more work!

Overall, the above changes are very significant. Affected taxpayers – and there are many – should take note and adjust course accordingly. "Home on the Range" states: [Home]… *where seldom is heard a discouraging word.* Well, the Department of Finance has released some discouraging words that will take some time for tax practitioners and estate planners to absorb. We'll stay positive though and encourage you to do the same.