Changes to principal residence exemption–trusts and non-residents

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> *"Canadians have told us they are concerned about growing household debt and rapidly rising house prices in some of our biggest cities, particularly in markets like Toronto and Vancouver. These concerns have grown over many years, and there are no quick fixes. The federal government plays an important role in ensuring that housing markets are stable and function efficiently. My colleagues and I are committed to continuing to work with provinces and municipalities to address the concerns of middle class families, and to ensure Canada's housing markets and financial system remain strong, stable and resilient well into the future."*
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> -Bill Morneau, Minister of Finance

On October 3, 2016, Federal Finance Minister Bill Morneau announced changes which will affect trusts and non-residents owning residential property in an effort to ensure "housing markets are stable and functioning efficiently."

This would be accomplished by tightening the use of the principal residence exemption, which many believe was being abused by foreign buyers. Under the current rules, a Canadian resident individual who disposes of his/her "principal residence" may claim an exemption to shelter the gain, thereby eliminating or reducing taxes that would otherwise be payable.

Changes for non-residents

The principal residence exemption rules do not permit an individual to designate more than one property per year as his or her principal residence.[1] This is intended to limit the tax benefit to one property. As a result, an individual who disposes of a principal residence in one year and acquires a replacement residence in the same year is precluded from designating both properties as a principal residence for the year. To ensure that an individual in this circumstance is not denied an exemption in respect of both properties for the year, the formula for the exemption currently provides for the inclusion of one additional taxation year of exemption room (the one-plus rule).

Under the proposed rules, this one-plus rule is eliminated if the individual was not resident in

[1] For tax years after 1981, a taxpayer and members of the taxpayer's family, including the taxpayer's spouse and minor children, cannot designate more than one property as the family's principal residence for the taxation year.

Canada during the year in which he/she acquired the property. This change is intended to capture situations in which the one-plus rule would have enabled a property to be treated as a principal residence for a year throughout which the owner was not resident in Canada.

This amendment will apply to dispositions that occur after October 2, 2016.

Changes for trusts

The proposed rules will also limit the type of trusts that will be able to designate a property as a principal residence. Eligible trusts must fall into one of the following three categories:

- an alter ego trust, spousal or common-law partner trust, joint spousal or common-law partner trust, or certain trusts for the exclusive benefit of the settlor during the settlor's lifetime;
- a testamentary trust that is a "qualified disability trust"; or
- an inter vivos 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.

In addition, the trust's beneficiary who, or whose family member, occupies the residence for the year will be required to be resident in Canada in the year, and will be required to be a family member of the individual who created the trust. Where the trust acquires the property after October 2, 2016, the trust's term must provide the eligible beneficiary with a right to use and enjoy the residence throughout the period in the year that the trust owns the property.

Families typically use trusts to hold their principal residence as part of a succession and/or estate plan, for example, to facilitate the transfer of properties to desired beneficiaries. Because of these new rules, such plans will now need to be carefully reviewed and any necessary changes made to ensure that the estate planning is still appropriate. Non-residents who wish to hold their property through a trust will now also be affected.

These changes apply in determining whether a trust that disposes of property in (or after) its first taxation year that begins after 2016 may designate the property as its principal residence for years after 2016.

Extended reassessment period

For taxation years ending after October 2, 2016, the proposed rules permit the CRA to reassess tax, after the end of the normal reassessment period (three years after the date of the initial notice of assessment, for most taxpayers), on a gain from the disposition of real or immovable property if the taxpayer does not initially report the disposition.

This change also applies when the taxpayer owned the property indirectly through a partnership and the partnership did not report the disposition of the property in the partnership return. Going forward, taxpayers will generally want to ensure that such dispositions are reported to ensure that the extended reassessment period cannot apply.

New reporting requirement

Under the Canada Revenue Agency's (CRA's) current administrative position,[2] an individual who disposes of his/her principal residence and has no tax liability because the principal residence exemption eliminated all of the taxable gain is not required to report the disposition.

However, starting with the 2016 taxation year, an individual will be required to report basic information (i.e., the date of acquisition, the proceeds of disposition and a description of the property) on his/her income tax return on the sale of the residence, in order to claim the full principal residence exemption.

The CRA will modify Schedule 3, "Summary of dispositions - Capital Gains (or Losses)," to handle the new required information. If the property was the individual's principal residence for all years of ownership, the designation can be made on Schedule 3. Otherwise, a separate prescribed form must be completed in addition to the Schedule 3 reporting. The CRA's revised position applies to actual, as well as deemed, dispositions.

If an individual did not report the sale or the principal residence designation in the year of sale, he/she can request the CRA to amend the income tax return. Under the proposed changes, the CRA can accept a late principal residence designation in certain cases, but a penalty may apply equal to the lesser of

- $8,000, or
- $100 for each complete month from the original due date to the date the amendment request was made.

However, the CRA indicates that for dispositions occurring in 2016, the late-filing penalty will be assessed only in the most excessive cases.

Please contact us if you have any questions about the effect of these tax changes on your particular situation.

[2] Refer to paragraph 2.15 of CRA's Income Tax Folio S1-F3-C2, Principal Residence