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THE PRINCIPAL RESIDENCE EXEMPTION - NEW RESTRICTIONS AND REPORTING REQUIREMENTS

By Ian V. MacInnis

The principal residence exemption ("**PRE**") is one of the most significant "tax breaks" available under the *Income Tax Act* (Canada) (the "**Act**"). The PRE is a special exemption that reduces, and, in most cases, completely eliminates, the capital gain realized on the disposition of real property that constitutes a "principal residence". In light of the significant rise in house prices in certain cities (e.g., Vancouver and Toronto), there is a concern that certain persons, including non-residents of Canada, may be misusing the PRE to avoid paying tax on profits derived from buying and selling a property in the same year. On October 3, 2016, the Department of Finance introduced significant changes to the PRE rules under the Act in an effort to "improve tax fairness by closing loopholes surrounding the capital gains exemption on the sale of a principal residence". The result of these proposed amendments is that some individuals and certain trusts will no longer be able to designate their property as a principal residence.

In addition, the Canada Revenue Agency (the "**CRA**") announced on October 3, 2016 that it will reverse its long-standing policy of not requiring the reporting of a disposition of a principal residence if there would not be any tax payable after applying the PRE rules. In particular, commencing in 2016, all dispositions of real property by individuals must be reported, even where the gain is fully sheltered by the PRE.

Proposed Restrictions on the PRE

The proposed amendments contain a new rule that will deny the ability of an individual, who is not resident in Canada in the year the individual acquires a residence, to designate the property as their principal residence for that year. This proposed amendment will apply to dispositions that occur on or after October 3, 2016. It appears that the proposed amendments will not provide any relief to a non-resident individual who acquires real estate in Canada and then immigrates to Canada in a subsequent year.

The proposed amendments also introduce additional eligibility requirements in order for a trust to be able to designate a property as a principal residence for a taxation year that begins after 2016. A trust will be required to be a spousal or common-law partner trust, an alter-ego trust (or a similar trust for the exclusive benefit of a settlor during the settlor's lifetime), a qualifying disability trust or a trust for the benefit of a minor child of deceased parents in each year that begins after 2016. The effect of these proposed amendments will be that gains accruing after 2016 on real property held by non-qualifying trusts will not be sheltered by the PRE.

Tammy J. Anklewicz
Partner

t: 416.365.3710
tanklewicz@foglers.com

Leonard P. Bosschart
Partner

t: 416.864.7600
lbosschart@foglers.com

Shaun M. Doody
Associate

t: 416.864.7602
sdoody@foglers.com

John M. Fuke
Counsel

t: 416.464.5552
jfuke@foglers.com

In addition, the proposed amendments will require that the trust's beneficiary who (or whose family member) occupies the residence in the year be resident in Canada in that year, and also be a family member of the individual who created the trust. There are transitional rules that will provide relief for non-qualifying trusts that owned property at the end of 2016 and disposed of such property after 2016.

The proposed amendments will provide the CRA with the ability to reassess tax beyond the normal reassessment period if the taxpayer (or a partnership) fails to report a disposition of real property in the tax return for the year in which the disposition occurs. It should be noted that this proposed amendment applies to any unreported disposition of real estate (subject to certain exceptions), and not just the disposition of a principal residence. Where the disposition is not reported in the taxpayer's tax return for the year of disposition, the CRA will have the authority to assess the taxpayer indefinitely with respect to the disposition.

Reporting Now Required to Claim the PRE

The long-standing administrative policy of the CRA was not to require an individual to report the disposition of a principal residence if there was no capital gain remaining after applying the PRE. It was only necessary for individual taxpayers to file the Form T2091 to designate a property as a principal residence where there was a capital gain to report (e.g., in a situation where the property was not the taxpayer's principal residence for all of the years or if some portion of the property did not qualify for the PRE).

Starting in 2016 (i.e., for dispositions of a principal residence that occur on or after January 1, 2016), the CRA now requires that the sale of a principal residence be reported on Schedule 3, Capital Gains on the taxpayer's T1 return in order to qualify for the PRE.

The CRA indicates that the Schedule 3 will be revised to permit a designation of a property that was disposed of to be a principal residence. The Schedule will also be modified to require the disclosure of the year of acquisition, the proceeds of disposition and a description of the property being designated as a principal residence. It should be noted that deemed dispositions of a principal residence (i.e. personal-use property converted to rental use or vice versa) will also be required to be reported on the T1 return, such as deemed dispositions arising as a result of a change-in-use or the death of the owner.

As a result of these new reporting requirements, the PRE will only be allowed where the sale and designation of the principal residence is reported on the taxpayer's tax return. This is a substantial change in administrative policy and may have harsh consequences to taxpayers unaware of the change.

The proposed amendments also allow the CRA to accept a late-filed designation in respect of a principal residence. This may, however, result in penalties equal to the lesser of $8,000, or $100 for each complete month from the original due date of the relevant T1 return to the date of request to the

Peter K. Guselle
Partner

t: 416.941.8818
pguselle@foglers.com

Suzanne I.R. Hanson
Counsel

t: 416.941.8865
shanson@foglers.com

Ian V. MacInnis
Partner

t: 416.941.8813
imacinnis@foglers.com

Heather Marshall
Associate

t: 416.365.3730
hmarshall@foglers.com

CRA to accept a late-filed designation. The CRA recognizes that this administrative change will likely catch many taxpayers unaware. The CRA stated that it will only assess penalties for a late-filed principal residence designation in respect of dispositions occurring in 2016 in the "most excessive" cases. There was no indication given as to what would be considered an "excessive" case.

The CRA indicated that it will focus efforts on communicating to taxpayers and the tax community about the new requirement to report the sale and designation of a principal residence in the income tax return. Notwithstanding this effort, it might be expected that there will be significant non-compliance by taxpayers with the new requirement to designate a principal residence on the tax return in order to be eligible to claim the PRE - especially for those individuals who prepare their own tax returns.

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In the 2014 federal budget, the Department of Finance announced a public consultation on the proposed repeal of the existing eligible capital property (ECP) regime and to replace it with a new capital cost allowance (CCA) class for depreciable capital property. The 2016 federal budget introduced draft legislation to implement this change.[1]

Some common types of ECP include goodwill, customer lists, trademarks, franchise rights, some patents and other intangible assets of a business. Certain expenses of incorporation, reorganization or amalgamation also qualify as ECP.

Under the proposed amendments, the cost of property acquired on and after January 1, 2017, that would previously have been ECP, will be added to new Class 14.1 depreciable property. The CCA depreciation rate for Class 14.1 will be five (5%) percent on a declining balance basis. New Class 14.1 will generally include goodwill, property that was ECP before 2017 and property acquired on or after January 1, 2017, the cost of which would be treated as an eligible capital expenditure under the ECP rules. The full cost of property of this new class acquired on or after January 1, 2017, will be added to the undepreciated capital cost (UCC) of the class, instead of only 75% of the cost being added to cumulative eligible capital (CEC) under the ECP rules.

When property in Class 14.1 is sold, amounts previously claimed as CCA would be reported as income to the extent the sale proceeds exceed the UCC of the class (up to the original cost of the property). If the proceeds exceed the original cost of the property, 50% would be reported as a taxable capital gain and the other 50% would be added to the corporation's capital dividend account.[2]

[1] This draft legislation was released on July 29, 2016.

[2] For a corporation that is a Canadian controlled private corporation.

William T. Perks
Counsel

t: 416.941.8864
wperks@foglers.com

Sheldon Silver
Counsel

t: 416.365.3734
ssilver@foglers.com

Mary Wahbi
Partner

t: 416.864.7629
mwahbi@foglers.com

The proposed amendments contain new rules[3] that will allow a deduction for incorporation costs of up to $3,000 per corporation. Incorporation expenses in excess of $3,000 will be included in new Class 14.1. It appears that expenses for the formation of a partnership will also be included in new Class 14.1. These new rules will apply to such expenses incurred after 2016.

[3] New paragraph 20(1)(b) of the *Income Tax Act* (Canada).