New Principal Residence Exemption Rules

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On October 3, 2016, the Minister of Finance, the Honourable William Morneau, tabled a Notice of Ways and Means Motion in the House of Commons to address what are widely perceived to be abuses by some taxpayers of Canada's principal residence rules. As is well known, those rules generally permit a Canadian resident to eliminate all or most of the capital gain realized on disposition of a principal residence.

Extended Limitation Period for Unreported Dispositions of Real Property

Perhaps the most important new rule will extend indefinitely the CRA's ability to assess taxpayers who fail to report the disposition of a principal residence in their tax returns.

Under current rules the limitation period within which the CRA may assess or reassess an individual (including most trusts) for a taxation year ends on the third anniversary of the day on which the CRA issued its original assessment for the year. After this date, reassessment of the taxpayer's taxation year is statute barred, except in limited circumstances.

In the past, the CRA did not require taxpayers to report the disposition of a taxpayer's principal residence if the principal residence exemption eliminated all capital gains on the disposition. This has led to the perception that some taxpayers may have relied on the CRA's policy and not reported dispositions in cases where the property's status as a principal residence was far from certain, and then escaped any risk of assessment on the gain once the three year limitation period expired. Since the disposition was not reported, the risk of discovery during the limitation period is low.

The new rules take direct aim at this practice. Under the new rules, no limitation period will apply in respect of a taxpayer's disposition of capital real property (note: not just a principal residence) if the taxpayer does not report the disposition in his, her, or its tax return for the year of disposition. The CRA may assess or reassess the disposition at any time.

A taxpayer who fails to report the disposition can file an amended return to correct the failure. The three-year limitation period will begin to run from the day the amended return is filed.

This amendment applies to taxation years that end on or after October 3, 2016.

Changes to the "One-Plus" Rule

A taxpayer is only entitled to designate one property as a principal residence for any one taxation year.

Accordingly, a taxpayer who sells a principal residence and replaces it with a new one in the same taxation year is only permitted to designate one of those properties as his or her principal residence for the year, raising the possibility that he or she may have some liability for capital gains tax in respect of one of the properties.

The so-called "one-plus rule" in the principal residence rules was designed to overcome this problem. The rule effectively deems a taxpayer to have occupied his or her principal residence as such for one year in addition to actual years of occupancy. Thus in the example above the individual could effectively claim the full principal residence exemption in respect of both properties, even though he or she owned both properties in the same taxation year.

The amendments will limit the availability of the one-plus rule to taxpayers who are resident in Canada in the year in which they acquire the property. The change will eliminate the benefit of the one-plus rule for individuals who acquire a property as a principal residence before he or she becomes resident in Canada. The explanation for the amendment provided by the Department of Finance is that it was not intended to permit a year throughout which an individual is not a Canadian resident to count as a year of occupancy for principal residence exemption purposes.

This change will apply to dispositions of property which occur on or after October 3, 2016.

Tightening of Principal Exemption Rules for Personal Trusts

Finally, the amendments will tighten up the circumstances in which a trust may designate a property as the trust's principal residence.

Currently virtually any "personal trust" can designate a property as its principal residence for a year provided that the trust designates each individual beneficiary of the trust who ordinarily inhabited the property as a principal residence in the year, or whose spouse, common-law spouse or child did. Under the current rules the trust itself, but not the relevant occupant of the property, must be resident in Canada to claim the principal residence exemption.

The amendments will require that the occupant of the property be a beneficiary (an "eligible beneficiary") of the trust (and not merely a spouse or child of a beneficiary of the trust) who is a resident of Canada in the year and satisfies certain criteria described below.

In addition the amendments will restrict the types of trusts that may designate a principal residence to the following:

- *alter ego*, spousal or common-law partner, and joint spousal or common-law partner, trusts, and certain trusts for the exclusive benefit of the settlor, in which case the eligible beneficiary must be, depending on the type of trust, the settlor of the trust or the joint spouse or common-law partner of the settlor;
- a testamentary trust that is a "qualified disability trust", in which case the eligible beneficiary must be the spouse, common-law partner, or child of the settlor of the trust; or
- an *inter vivos* or testamentary trust the settlor of which died in a preceding year, the eligible beneficiary of which is the minor child of the settlor and whose parents (i.e. the settlor and the other parent) died in a preceding year or years.

The new rules will apply to dispositions by trusts in taxation years that begin after 2016.

Many existing trusts established as "principal residence trusts" will no longer qualify for the principal residence exemption after 2016. A special transitional rule will allow such trusts to use the existing principal residence rules to shelter gains accrued up to the end of 2016.

Trustees of affected trusts should review their trusts in light of the amendments to determine whether to take remedial action before 2017, including possibly winding up the trust before that time. The amendments include certain transitional rules to facilitate the timely implementation of some remedies.

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