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Vern Krishna summarizes the meaning of principal residence, changes to rules regarding how a taxpayer must designate the property as his sole principal residence for the year in his tax return, and how the new rules in respect of principal residences make the process more cumbersome for individuals who do not remember to make the appropriate designations, and retain purchase and sale records.

Government Tightens Rules for Principal Residences (Vern Krishna)

Date: November 14, 2016

By Vern Krishna

Canadian residents are generally not taxable on capital gains from the sale of their principal residences. The entire gain is exempt from tax, regardless of the value of the property sold. Thus, the principal residence exemption is the most generous exemption in the Act, and individuals cherish the tax benefits of home ownership as a source of retirement income. New anti-avoidance rules, however, require particular attention in order to avoid disputes with the Canada Revenue Agency, which are always unpleasant.

Meaning of “Principal Residence”

There are several requirements to qualify a property as a “principal residence”[1] and the 2016 amendments have tightened the rules to prevent foreign investors (principally non-resident Chinese investors) from claiming the exemption for Canadian tax purposes.

1. -- The type of property:

A principal residence may consist of a housing unit, a leasehold interest in a housing unit, or a share in a co-operative housing corporation. The expression “housing unit” is broad, and includes virtually any structure that an individual can inhabit. For example, apart from obvious housing structures such as a house or apartment, a housing unit includes a mobile home, a trailer, a houseboat, or even a tent. The law draws the line, however, at garden sheds without water, heating, cooking facilities, or electricity, which some taxpayers have attempted to claim as a principal residence.

2. -- Owner occupation:

The taxpayer must own, either solely, with another person, or beneficially, the property and ordinarily inhabit it during the year for which he or she claims the residence. An individual may own a principal residence jointly with his/her spouse or “common-law partner”.

Beneficial ownership qualifies as ownership in certain circumstances. “Beneficial ownership” refers to the right of an individual to use and benefit from the property, regardless whether he or she has concurrent legal ownership.

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The beneficial ownership rules target foreign investors and requires the "eligible beneficiary" of a trust (and not merely his spouse or child) to be a resident of Canada and occupy the property during the year. The following types of trusts qualify to designate a principal residence:

• *Alter ego*, spousal, common-law partner, and joint spousal or common-law partner, trusts;

• 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 where the settlor died in a preceding year, and the eligible beneficiary 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.

However, ownership by a company does not qualify for the exemption even if the individual owns 100% of the corporation's shares.

The term "ordinarily inhabit" requires careful consideration. The Supreme Court's analysis of "ordinarily resident" [now in subsection 250(3)] in *Thomson v MNR,* [1946] C.T.C. 51, as denoting "conformity with rule or established custom or practice", "as a matter of regular practice or occurrence", "in the ordinary or usual course of events", "usually", "commonly", "as is normal or usual" is helpful in determining residence, but has a different nuance for describing ordinary habitation.

For the purposes of the principal residence exemption, an individual may ordinarily inhabit more than one property, even though he or she may designate only one property for each year of occupation. For example, an individual may have a city home and a cottage, or ski chalet, qualify as principal residences, but may generally designate only one for each year.

3. -- Designation

The taxpayer must designate the property as his sole principal residence for the year in his tax return. This is a significant change in the rules and has important implications on limitation periods. Taxpayers were not previously required to actually file a designation if there was not tax payable on the gain. Taxpayers relied on this policy to ignore reporting their gains on multiple gains resulting from "flipping" residential properties. In doing so, they took advantage of the normal three-year limitation period applicable to assessments, and banked on the low risk of discovery.

Under the new rules applicable in 2016, there is no limitation period in respect of a taxpayer's disposition of capital real property 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.

Conclusion

The new rules in respect of principal residences retain all of the tax advantages in respect of the exemption. They do, however, make the process more cumbersome for individuals who do not remember to make the appropriate designations, and retain purchase and sale records. That is the price that Canadian residents must pay for what had become a form of blatant tax avoidance by residents and foreign investors. Anti-avoidance rules inevitably introduce complexity, but are necessary to maintain the integrity of the tax system and prevent tax abuse.

Vern Krishna, CM, QC, FRSC, Counsel, Tax Chambers LLP (Toronto), and professor of law, University of Ottawa Law School.

vern.krishna@taxchambers.ca

www.Vernkrishna.com

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Footnotes

1 S. 54“principal residence”.

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