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SIGNIFICANT CHANGES TO THE PRINCIPAL RESIDENCE EXEMPTION – WHAT YOU NEED TO KNOW BEFORE DECEMBER 31, 2016

On October 3, 2016, the Minister of Finance tabled a Notice of Ways and Means Motion to amend the principal residence exemption rules relating to, amongst other things, certain trusts, non-residents, assessment periods, and reporting requirements. While the changes are purportedly intended to avoid abuses of the principal residence exemption, there are a number of traps for many existing trusts and individual homeowners.

The Principal Residence Exemption (the "PRE") – What is it?

This exemption generally allows a Canadian taxpayer to be exempt from paying tax on the capital gain realised on the disposition of the taxpayer's principal residence. It is important to note that only one property per family unit can be designated as a principal residence for a particular tax year.

New Restrictions for Trusts

The changes under this heading are those that are likely to have adverse effects on the greatest number of existing taxpayers. Under the current system, the PRE can be claimed by individuals as well as personal trusts, subject to certain limitations. For example, the beneficiary must not be a corporation and must ordinarily inhabit the property, but the beneficiary is not required to be a Canadian resident.

However, in order for a trust to be eligible for the PRE under the new regime, which takes effect after December 31 of 2016, the beneficiaries who occupy the principal residence must be Canadian residents for income tax purposes as well as family members of the individual who created the trust. Furthermore, the Department of Finance has limited the types of eligible trusts to, primarily, the following:

- alter ego trusts, joint spousal/common-law partner trusts, spousal/common-law partner trusts;
- testamentary trusts that are "qualified disability trusts"; and
- inter vivos or testamentary trusts for the benefit of a Canadian resident minor child of deceased parents.

Further, where the property is acquired after October 3, 2016, the terms of the trust must provide the individual with a right to use and enjoy the subject residence.

Some examples of common trust situations that will no longer be eligible for the PRE include:

- principal residence trusts and family trusts that don't fit within one of the categories of permissible trusts outlined above;
- trusts where the beneficiary is a non-resident of Canada; and
- certain testamentary trusts, such as *Henson* trusts, spendthrift trusts, and trusts for residences that don't constitute spousal/common-law partner trusts.

Therefore, individuals and families with trusts that that hold properties for tax or estate planning purposes that do not fall within these categories, will likely be adversely impacted. Although these trusts may continue to hold properties, it is important for those affected to assess whether the original planning objectives will still be met.

Trusts no longer eligible under the proposed changes can still claim the PRE on any gain accrued on a subject principal residence up to the end of 2016.

New Reporting Requirements and Extension to Reassessment Period

Under the new requirements, in order to claim the PRE a taxpayer must disclose the disposition of the principal residence in the year in which it is disposed, together with the amount of the proceeds of disposition and the acquisition date of the property. In the past, the CRA did not require such reporting from taxpayers in most circumstances. Under the new rules, which apply going forward, failure to report or a late designation of a principal residence could result in a penalty of $100 per month up to a maximum of $8,000.

As a general rule, the normal reassessment period for a tax return is three years from the date of the original notice of assessment for a given tax year. Thereafter, the Canada Revenue Agency (the "**CRA**") cannot reassess the tax return unless the taxpayer made a misrepresentation due to negligence, carelessness, or willful default, or committed any fraud in filing the return. However, the new rules will also allow the CRA to extend the reassessment period in respect of the subject property indefinitely if the taxpayer fails to report the disposition of real property.

The "One Plus" Rule to Exclude Non-Residents

In calculating the years that a property was a taxpayer's principal residence, one additional year is added to reflect the common occurrence where a taxpayer may own two principal residences; i.e. in the year where there is the sale of an existing principal residence and the acquisition of a new principal residence. For example, I dispose of my current home in February and acquire another in March of the same year, both as my principal residence. Under the new rules, the ability to claim this year in addition to each full calendar

year during which the property is a taxpayer's principal residence, referred to as the "one plus" rule, no longer applies where the taxpayer is a non-resident in the year of acquisition.

Conclusion

The stated intention of the Minister of Finance behind these proposed changes is to "improve tax fairness by closing loopholes surrounding the capital gains exemption on the sale of a principal residence". Family Trusts and Principal Residence Trusts may no longer qualify, even if the beneficiaries are Canadian residents. If you have a trust that owns real estate, it is recommended that it be reviewed in order to assess the impact of the new rules.

Individuals, beneficiaries, and trustees of trusts with property that may have qualified as a principal residence prior to December 31, 2016 should carefully review the new rules and determine the appropriate measures going forward.

Our team would be happy to review your estate plan, and to discuss how these changes may affect you:

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