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Principal residence exemption: A reporting reboot coming this April

For more information on the tax rules and other considerations, please refer to our *Tax & Estate InfoPages*, which are available on our website.

The principal residence exemption (PRE) is one of the most valuable tax benefits we have, entitling homeowners to tax-free returns on increases in their homes' value. (For more on the mechanics of the PRE, see our June 2016 article *The principal residence exemption: Tax relief on the home front*.)

So compelling is this feature of our tax system that it attracts interest from *non*-residents. And according to government communications this past October, some of those non-residents are not only using the PRE, but abusing it to the detriment of Canadian tax revenues.

Of course, this is part of a larger discussion as to whether Canadian residential real estate is overinflated and the extent to which foreign involvement exacerbates this condition. Regardless how that plays out – which I leave to politicians and economists – among the actions taken, a new reporting regime now requires formal reporting of all principal residence transactions as a condition to claiming the PRE.

Limitation on non-residents

The PRE has always been intended to be available to Canadian-resident individuals and certain trusts. In the lead-up to the announced changes, the government had observed that some non-residents had claimed the PRE when buying and selling a property in the same year.

As a result, the rules were changed, making the PRE no longer available for property dispositions by non-residents after October 2, 2016.

Where a trust with foreign connections is used, more stringent eligibility criteria apply. It must be a spousal/common-law partner trust, alter ego trust, qualifying disability trust or trust for a minor child of deceased parents. Furthermore, the beneficiary must be a Canadian resident for all years for which the PRE is claimed and must be a family member of the settlor. Even if a family member of the beneficiary is the occupant, the beneficiary must meet the residency requirement.

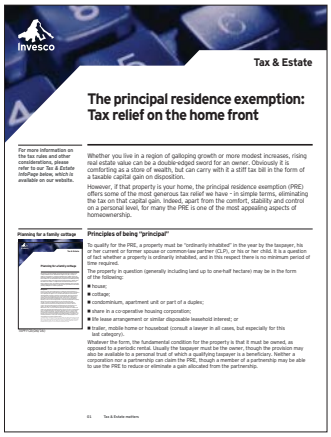
Past reporting for PRE claim

Put simply, in the past if the PRE was claimed on a property that was the taxpayer's principal residence for every year it was owned, there was absolutely nothing to be reported.

Reporting has long applied if the property was not the principal residence for every year it was owned. Form 2091 had to be filed with the person's tax return for the year in which the disposition occurred. Where the claim was made by the legal representative of a deceased person, Form 1255 would be filed. As well, if the property was owned by a trust (a beneficiary of which was the occupant), the trust had to file Form T1079 regardless how many years were being claimed for the PRE.

The partial year and trust ownership situations continue as before, unaffected by the added general reporting obligations discussed following.

The principal residence exemption: Tax relief on the home front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Tax & Estate

The principal residence exemption: Tax relief on the home front

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Whether you live in a region of galloping growth or more modest increases, rising real estate value can be a double-edged sword for an owner. Obviously it is comforting as a store of wealth, but can carry with it a stiff tax bill in the form of a taxable capital gain on disposition.

However, if that property is your home, the principal residence exemption (PRE) offers some of the most generous tax relief we have – in simple terms, eliminating the tax on that capital gain. Indeed, apart from the comfort, stability and control on a personal level, for many the PRE is one of the most appealing aspects of homeownership.

Planning for a family cottage

Principles of being "principal"

To qualify for the PRE, a property must be "ordinarily inhabited" in the year by the taxpayer, his or her current or former spouse or common-law partner (CLP), or his or her child. It is a question of fact whether a property is ordinarily inhabited, and in this respect there is no minimum period of time required.

The property in question (generally including land up to one-half hectare) may be in the form of the following:

- house;
- cottage;
- condominium, apartment unit or part of a duplex;
- share in a co-operative housing corporation;
- life lease arrangement or similar disposable leasehold interest; or
- trailer, mobile home or houseboat (consult a lawyer in all cases, but especially for this last category).

Whatever the form, the fundamental condition for the property is that it must be owned, as opposed to a periodic rental. Usually the taxpayer must be the owner, though the provision may also be available to a personal trust of which a qualifying taxpayer is a beneficiary. Neither a corporation nor a partnership can claim the PRE, though a member of a partnership may be able to use the PRE to reduce or eliminate a gain allocated from the partnership.

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Future reporting of PRE

On October 3, 2016, the government announced that any disposition of a principal residence is now reportable by an individual, regardless how many years are intended to be claimed under the PRE. The reporting is retroactive to transactions completed from the beginning of the year, January 1, 2016.

Important to note, the new rules apply both to actual and deemed dispositions. In addition to death and emigration, deemed disposition includes changes in use, where part or all of a principal residence begins to be rented or is used in a business operation. A change back from rental or business use to principal residence would also be caught. All of these situations are now reportable under the new rules.

As part of the 2016 T1 *Income Tax and Benefit Return* package, *Schedule 3, Capital Gains* is being modified so that principal residence dispositions can be disclosed and elected there. The reportable information is the year of acquisition, proceeds of disposition and description of the property. For properties that have been used in part for rental or business purposes, separate adjusted cost bases and selling prices will have to be tracked for the PRE and non-PRE uses.

Compliance is critical, as the Canada Revenue Agency (CRA) will only allow the PRE if the sale and designation of principal residence is included in the taxpayer's income tax return. It is expected that late-filed designations will be accepted, but that will require an amendment to the income tax return for that year and a penalty may apply.

The proposed penalty is the lesser of $8,000 and $100 for each month the form is overdue. As this is a novel process, the CRA will be making extra effort to communicate the change to taxpayers and the professional community, and, at least for 2016 reporting, penalties are expected to be applied only in the most excessive cases.

Contact
Invesco Canada Ltd.

5140 Yonge Street, Suite 800
Toronto, Ontario M2N 6X7

Telephone: 416.590.9855 or 1.800.874.6275
Facsimile: 416.590.9868 or 1.800.631.7008

inquiries@invesco.ca
invesco.ca

For more information about this topic, contact your advisor, call us at 1.800.874.6275 or visit our website at invesco.ca.

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