Changes to the Principal Residence Exemption

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In Canada, the sale of capital property, which includes real estate, for an amount greater than its cost will result in a capital gain, 50% of which is taxable. If the property being sold is a family home, designating the property as a "principal residence" will result in an elimination of all or part of the taxable capital gain depending on the circumstances. This is commonly known as the "principal residence exemption."

The "Plus One Rule"

The formula used to determine how much of the capital gain can be eliminated requires a proration for the number of years during which the property was the taxpayer's "principal residence" as compared to the total number of years that the taxpayer owned the property. (To be a "principal residence," the taxpayer must ordinarily use and occupy it.) In order to account for situations where a taxpayer sells one home and purchases a new home in the same year, the formula adds "1" to the "principal residence" years. This "plus one rule" ensures that a taxpayer who sold one home and purchased another in the same year can eliminate the full gain in value on the first home for the year in which it was sold and can also eliminate the full gain in value on the second home for the year in which it was purchased.

Filing the Designation Form

On October 3, 2016, the federal government announced changes to the tax rules regarding the exemption from capital gains tax for a principal residence. Until now, if a taxpayer sold a home and did not report a taxable capital gain for the year of sale, the Canada Revenue Agency ("CRA") accepted that the home was a principal residence without a designation actually being made by the taxpayer. Beginning in 2017, when a taxpayer sells a home which qualifies as his or her principal residence, in order to exempt the gain from tax, the taxpayer must designate the home as such in his or her tax return for the year of the sale by filing the appropriate form.

Changes for Non-Residents

Until October 3, 2016, the exemption from tax on the gain in value of a home being sold was available to a non-resident of Canada for at least one year because of the "plus one rule." A taxpayer must be a Canadian resident for each year the designation of principal residence is made. However, a non-resident could obtain the exemption for at least one year because the non-resident was able to add "1" to the number of years he or she owned the property. Although the taxpayer had to be a resident of Canada to get the exemption for the years the property was owned, adding one year allowed foreigners to purchase and sell residences within the same year and pay no capital gains tax. The changes to the rules will now prevent a non-resident of Canada from being able to use the "plus one rule" unless the person was resident in Canada in the year the home was purchased.

Principal Residence Held as an Asset of a Trust

The rules regarding a principal residence held as an asset of a trust will also be changed beginning in 2017. Until now, where a home was owned by a trust and was "ordinarily occupied" by a certain type of beneficiary of the trust, the trustees could designate it as a principal residence for the beneficiary for the years the trust held the home. This avoided the application of tax on the capital gain resulting from a sale of the home by the trust or from the "deemed disposition" of the property, which occurs on the 21st anniversary of the trust and every 21 years thereafter.

The announcement made on October 3, 2016, changes these rules as they apply to trusts. Beginning on January 1, 2017, the types of trusts that may claim the principal residence exemption are limited to:

1. alter ego trusts;
2. joint spousal or common-law partner trusts;
3. spousal or common-law partner trusts;
4. qualified disability trusts; and
5. trusts for minor children of a deceased parent.

This means that if a trust was established to own a home for the purpose of reducing the amount of estate administration tax payable on death (formerly known as probate fees) or to ensure the smooth transition of a home from generation to generation, it will no longer qualify for the principal residence exemption when the home is sold or on the 21st anniversary of the trust unless the trust is one of the types described above. A trust which owns a home and is not one of the types described above can still designate the home as a principal residence for the years it was owned until 2016, but not in any future years.

If a home is owned by a trust which does not qualify for the exemption, it is still possible to eliminate the capital gains tax on the gain in value after 2016 as long as it is distributed to the beneficiary who used and occupied it before it is sold or before it is deemed to be disposed of on the 21st anniversary of the trust. The beneficiary can designate the property as his or her principal residence for all the years that the trust owned the home. However, if the person who ordinarily uses and occupies the home dies after the end of 2016, but before the home is distributed out of the trust, the ability to designate it as a principal residence will be lost for the years it is owned by the trust after 2016. A valuation as at January 1, 2017 would be required and any gain in value after that date will be taxable.

If a home which is a principal residence is held by a trust for probate planning purposes, distributing that home to a beneficiary now, who can designate it as a principal residence, will avoid the possibility that the exemption could be lost after 2016 if the beneficiary dies while the trust still owns the home. There are other effective ways of planning to reduce estate administration tax (probate fees), which can be discussed with legal advisors.

If the home is held by a trust for other reasons and it is not appropriate to distribute the home now, the trustees may wish to obtain a fair market value appraisal of the home as of January 1, 2017, which will be used as the cost base for the purposes of calculating any gain in value of the home after 2016. The trust will still be able to designate the home as a principal residence for the years up to 2016, but will be subject to tax on any gain subsequent to 2016.

These new rules will also affect trusts established in Wills to hold homes. If the trust created by Will is a spousal trust established for the benefit of a surviving spouse during his or her lifetime, the trust can still designate the home as a principal residence. If the trust created by Will holds a home for children, it can only be designated by the trust as a principal residence for a child who is under 18. Therefore, once the youngest living child turns 18, the home should be sold or rolled out of such trust.

If you have questions regarding this document or another aspect of estates and trusts law, please contact any member of the Aird & Berlis LLP Estates & Trusts Group:

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