LAPOINTE ROSENSTEIN MARCHAND MELANÇON
L.L.P. Attorneys

Newsletter

Tax, Estate Planning and Tax Litigation

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Notary

Canadian tax authorities attack the principal residence exemption!

A principal residence, whether it be a cottage or a house lived in permanently, represents a significant portion of the middle class taxpayers' personal wealth and even their retirement fund!

Since 1981, unlike our American neighbours, who benefit from a tax deduction for interest on their mortgages, Canadian lawmakers chose to exempt capital gains from the sale of a principal residence by a Canadian resident. It is called the Principle Residence Exemption ("**PRE**"), one of the rare universal tax measures thought to be sacred.

Well, we were wrong! On October 3, 2016, the Department of Finance Canada[1] presented draft legislation affecting the PRE for sales completed[2] as of 2016. We believed it is important to inform taxpayers like yourselves of this change and allow you to plan accordingly.

2016 tax changes

An important side note to this new draft legislation are the technical changes attempting to improve compliance with the tax laws which taxpayers usually accept without complaint. These changes will apply starting in FY 2016, thus impacting income tax returns due April 30, 2017.

Insofar, only sales of partially exempted residences, for example if the PRE was claimed on another house for the same period, as well as sales made via a trust must be reported. However, starting in 2016, any sale of a principal residence must be reported in the individual's or the trust's tax return. Should you forget to do so, you can modify your personal income tax return to add the sale and request the PRE. The ministry will have the discretion to either accept or refuse the PRE, and, in certain cases, apply a penalty of up to $8,000.

These measures also mark the end of a fiscal trick whereby a residence in Canada is held by non-residents who benefit from a year-long exemption pursuant to a technical provision of the law, which will now be repealed. This marks the end of what practitioners call the +1 RULE, which will only be reserved for Canadian residents.

That taken care of, here are the real issues.

A new twist for principal residence trusts

Our concern deals mainly with the announcements made relating to personal trusts holding principal residences ("**PR Trusts**"), whether they were created during a taxpayer's lifetime or after their death in accordance with their will.

– The current system

The current system, which applies to all types of PR Trusts, is clear. In short, the trust must make a choice based on the prescribed form and indicate the beneficiaries, the spouse and/or the children, who lived in the asset. Additionally, no beneficiary or member of the family of the beneficiary (spouse, child, father and mother, or brother and sister in certain cases) can claim the PRE for this period. The trust agreement must also respect some constraints with regards to the identity of the beneficiaries.

– The new system

The new system is much more complex and introduces tax relief measures reserved for some specific trusts. It also affects contract terms for trusts and testamentary trusts, which are private legal acts, by requiring mentions of the use of a residence acquired after October 3, 2016.

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– You are a beneficiary or a trustee for a DISCRETIONARY TRUST? YES ☐ NO ☐

If you checked yes, you should know that these measures most drastically affect the DISCRETIONARY TRUST. This is because it is a very common tool for holding a principal residence. It is popular as it offers a means of protection against financial risks for a taxpayer. Many people with high risk jobs have chosen this type of trust to hold their residence.

The new rule is simple: any growth in the value of a principal residence starting from January 1, 2017 will be taxable if it is earned through a discretionary PR Trust, meaning a trust with more than one beneficiary and where the trustees have full discretion for the management of income and capital.

If you are in this situation, don't make the error of running off to your legal counsel and demanding that they liquidate your trust. The liquidation could, in fact, counteract other objectives, for example protection against your creditors. Due consideration must be given.

If you wish to sell in the short term, it is possible that the capital gain accumulated since January 1, 2017 is not material, and in that case the sale via the trust could be an option. Your legal counsel can calculate the real tax risk. If, on the other hand, the accumulated growth since January 1, 2017 is significant, you can consider having the trust distribute the residence to the beneficiary, who could then sell it using their EPR. But be careful – this transaction presents two important tax issues, specifically in matters of property transfer fees or income tax for the trust, in addition to involving the personal liability of the beneficiary, specifically in matters of hidden defects.

If you do not plan on selling in the short term, do make sure that you document your residence's evaluation on December 31, 2016. Also, take time to discuss possible options with your legal counsel before acting in haste.

A. *Are you a beneficiary or a trustee of a PR TRUST BENEFITTING A HANDICAPPED FAMILY MEMBER?*

YES ☐ NO ☐

B. *Are you a beneficiary or trustee of a PR TRUST BENEFITTING A MINOR CHILD?*

YES ☐ NO ☐

C. *Are you a beneficiary or trustee of a PR TRUST BENEFITTING YOURSELF OR A SPOUSE (OR BOTH)?*

YES ☐ NO ☐

If you have checked yes for one of these questions, the good news is that your trust can take advantage of the EPR. However, strict conditions apply in the current draft legislation. On closer examination, we also note that not only is it inappropriate given the current social context, it also discriminates against certain groups of taxpayers. Here are a couple of examples:

– Handicapped persons

The draft legislation categorises handicapped persons by excluding trusts created to benefit aging parents that are handicapped or handicapped children not born at the time the trust was created. Additionally, among other conditions, a certificate recognizing the right of a beneficiary to the disability tax credit must be issued by the CRA. In practice, however, many handicapped children cared for by their parents cannot receive this certificate due to their type of handicap. Is this really the best option?

– Minor children

The minister's draft legislation tries to maintain the EPR for trusts created to benefit minors. Unfortunately, a PR Trust created for a grandchild by a grandparent cannot benefit from this relief. Additionally, it will be reserved for capital gains accumulated AFTER the death of the TWO parents AND until the child turns 18. In the current social context, what is the advantage of creating a trust for a child if the residence must be transferred to them when they reach majority? The minister must provide explanations.

– Blended families

With regards to trusts established to benefit yourself or a spouse, we submit that it really does not fit with the reality of families today or the current testamentary intentions of our clients. For example, if you wish to bequeath the use of your residence in trust to your current spouse to ensure a transition period after your death while at the same time granting the sale price to your children from another union when the former will have left the house, your succession must pay taxes on the capital gains stemming from the sale. However, the sale of the residence will have been fully exempted if it was directly bequeathed to your children!

Draft legislation still being studied

The draft legislation is currently being examined by many tax associations and social groups. There is strong pressure on the minister to return to the table and make appropriate changes. It would not be surprising that the changes improve the draft legislation, but in the meantime, it would be prudent to plan for and declare the sale of your home under the assumption that the measures will be adopted. There is also a very strong likelihood that they will continue to apply retroactively starting from 2016.

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1. On the date of publication of this article, the Quebec Ministry of Finance has not presented any harmonisation measures.
2. These rules will also apply to certain tax issues leading to fictitious sales, especially during a change in the use of the residence or the departure of a Canadian resident to another legal jurisdiction.

The content of this newsletter is intended to provide general comment only and should not be relied upon as legal advice.

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