Canadian Housing Legislation Will Limit Deductions for Trusts and Nonresidents

By

J.P. Finet

Contact Author

A legislative package introduced by Canadian Minister of Finance Bill Morneau to address concerns over housing affordability would reduce the ability of trusts and nonresidents to claim a deduction on capital gains from the disposition or sale of a principal residence, practitioners say.

The package, released October 4, 2016, includes changes to the Canadian Income Tax Act that would place significant restrictions on the types of trusts that may designate property as a principal residence for the purposes of claiming the deductions.

The legislation would also eliminate the ability of nonresidents to take advantage of Canada's "one-plus" rule, which allows a taxpayer to claim the exemption for the year the principal residence was purchased, extends the assessment period for unreported property sales, and implements new reporting requirements for principal residences.

The Canadian Parliament has yet to vote on the package, but it is widely expected to become law, practitioners told Tax Analysts.

Many of the measures proposed by Morneau were prompted by the significant increase in real estate prices that some have blamed on overseas buyers purchasing property in Vancouver and Toronto, according to Marie-Claire Dy of Dentons in Vancouver. Dy said the package also includes several provisions addressing the mortgage market.

Kim Moody of Moodys Gartner Tax Law LLP in Calgary said the social policy objective of the package is to curb the use of the principal residence exemption to avoid tax in some cases.

"In some cases, there was some [tax] planning utilizing trusts to avoid capital gains tax on an eventual disposition by the nonresident, and obviously the government figured that they want to shut that planning down," explained Moody. "So instead of just trying to target that kind of planning, they pretty much took what I call a shotgun approach and said: 'No trusts.' If you acquire property with a trust, [there is] no principal residence exemption except for very limited types of trusts."

Dy said the trusts eligible to designate a property as a principal residence would generally be limited to spousal or common law partner trusts, joint spousal or common law partner trusts, alter ego trusts, qualified disability trusts, and some trusts for the benefit of a minor child of deceased parents. "The list they've provided is very limited, and I personally do not know why they limited it that way because given the policy and what Morneau was trying to get at, I'm not sure that limiting the list this way was necessary," she said.

Dy also noted that the new package would require not only that a trust be Canadian to claim the principal residence exemption, but that the beneficiary who occupies the residence be Canadian as well.

The trust limitations represent a departure from the current law under which nonresidents can use a Canadian trust to claim the principal residence exemption.

One-Plus Rule Eliminated for Nonresidents

When a principal residence is sold, the formula used to determine the amount of capital gain to be eliminated under the principal residence exemption requires a proration for the number of years the property was the taxpayer's principal residence compared with the years the taxpayer owned the property.
Dy said the reason for the one-plus rule is that it allows a Canadian resident who sells one home and purchases another in the same year to claim the exemption value for both properties that year. Absent the sale, Dy said, the exemption can only be claimed on one residence per year.

Under the new rules, a nonresident individual who purchases a Canadian residence will no longer be able to claim the principal residence exemption for the year it was purchased when she disposes of the property, Dy said.

Moody said the formulas for prorating the capital gain on a residential property are set out in the Income Tax Act, so the change should not create any real difficulties in preparing returns for nonresidents who are no longer able to use the one-plus rule.

"Where I do see a problem is that nonresidents who are taking advantage of that rule had better be prepared to pay the tax because they are not going to get that one-plus free, if you want to call it that," explained Moody. "But it's just mechanical. It's not that complicated."

Assessment Period Extended

Under the new rules, a taxpayer may be assessed beyond the typical three-year assessment period if the taxpayer failed to report the sale of real property on the tax return for the year it occurred, Dy said. She added that the three-year period still applied for reported sales.
According to Dy, the non-reporting issue stemmed from a Canada Revenue Agency administrative policy that said if a taxpayer was disposing of a principal residence and the entire amount of capital gain was exempt, the taxpayer was not required to report it.

"So, because of the exemption, a lot of people never reported [their disposition of property]," explained Moody. "Now, if you don't do that, it's forever open."

Moody said part of the issue with the former administrative policy was that taxpayers were claiming the exemption for principal residences when it was very debatable as to whether they were eligible, and thus, such taxpayers were simply not reporting sales.

"So, from a public policy perspective, do I like the fact it's forever open, and taxpayers who take aggressive positions and do not report dispositions will perhaps get caught? Yeah, I think that probably makes some sense," Moody said. "On the whole, I don't have too much of a problem with it, and I don't think most practitioners do, frankly."