



Newsletter

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Heads up!

What to look out for with the Principal Residence Exemption

The implementation of various amendments to the *Income Tax Act* (Canada)¹ on December 14, 2017, saw a marked tightening of the mechanisms that allow a taxpayer to qualify for, and make use of, the principal residence exemption (“PRE”). The PRE provides an exemption from income tax on a taxpayer’s capital gain on the sale of their principal residence.² While Canada remains a country where the sale of one’s principal residence is (generally) exempt from capital gains tax, the ability to apply the PRE has become much less intuitive.

1. RSC 1985 (5th Supp.), as amended (the “ITA”). For the purposes of this article, all references to a statute refer to the ITA unless otherwise specified.

2. ITA, section 54 and subsection 40(2).



The aim of this paper is to provide a short summary of some of the road blocks a taxpayer may encounter, and some potential options to negotiate them.

General Understanding of the PRE rules since 2017

In order to be eligible for the PRE, there are several requirements that must be met; these requirements are in respect of both the property being disposed of and the taxpayer claiming the benefit. In no particular order, the following should be considered by any taxpayer wanting to claim the PRE:

- The property must be a “principal residence” as defined in the ITA. The definition includes, among other types of properties: houses (including the adjacent land, up to half a hectare), vacation homes, condominiums, and a share in a co-operative housing corporation;
- As a general rule, only one residence can be claimed by the family unit at a time.³ For the purposes of the PRE, the “family unit” includes the taxpayer, the taxpayer’s spouse, and any unmarried children under 18;
- The property must be ordinarily inhabited by an individual, their spouse or former spouse, or a child;⁴

3. The determination over which property to classify as the “principal residence” may be challenging when the taxpayer owns both a home and a cottage. Samantha Prasad’s article “Cottage Life: Selling your Cottage”, 2017 *The Tax Letter* 35:7, provides a more in-depth look at how a taxpayer may make this determination.

4. The term “ordinarily inhabited” is not defined in the ITA, it is considered a question of fact. For example, the Canada Revenue Agency (CRA) describes in its *Income Tax Folio S1-F3-C2: Principal Residence* that a person who disposes of a property in the same year they acquired it will still be “ordinarily inhabiting it,” while a person who purchases a property and keeps it for a longer period of time, but uses it as rental income, will not necessarily fit the criteria. It should be noted that an election under the ITA s.45(2) can be made if a property does not meet the “ordinarily inhabited” test in certain circumstances.



- The property must be a “capital property”. Practically, this means that if the property was “flipped” a short time after the purchase, it may not qualify for the PRE;
- A change in Canadian residency status can affect the ability to claim the PRE; and
- Restrictions can apply to any property that was rented out for a part of the ownership time.⁵

The PRE eligibility is considered on a year-to-year basis for each year of ownership. This is reflected in the formula used to calculate PRE, as set out in paragraph 40(2)(b):⁶

$$\frac{\text{1+ number of years after 1971 the house was used and designated as a principal residence}}{\text{Number of years of ownership after 1971}} \times \text{Capital gain otherwise calculated}$$

5. The rental of the home does not need to be restricted to the entire home; it can apply to part of the home as well. This provides an interesting aspect of the PRE to consider with the rise of households using letting services such as Airbnb to rent out a room or even their entire households for weekends in order to gain additional income.

6. The visualization of this formula is taken from Samantha Prasad and Ryan Chua “Changes to the Principal Residence Exemption: Home Sweet Home?” 2017, *Minden Gross Newsletter* 1-7.

PRE & Non-Resident Individuals

The PRE can be claimed only by an individual who has been a resident in Canada throughout the year(s) that the exemption is being claimed. For a resident, the “plus one” in the above-noted formula corrects for the fact that (usually) an individual will sell one property and purchase a new one in the same year. However, the same leniency is not granted to non-residents. Indeed, with the recent amendment to s. 40(2)(b), there is a removal of the “plus one” in the formula if the person disposing of the property is a non-resident after December 31, 2016. Previously, a person who was a non-resident throughout the entire ownership of the property could

have a portion (or even all) of the gain on disposition exempt from tax.

Individuals who are selling a property and who are thinking of emigrating would be prudent to consider their timing so as to maximize the amount of years the PRE is available to them.

When a US Citizen is Involved

Unlike Canada, the United States taxes its citizens (whether residing in the US or not) on their worldwide income. This income includes capital gains on the sale of their principal residence. A Canadian resident who maintains their US citizenship may face taxes in the US on the sale of their principal residence. Indeed, the

Internal Revenue Service (IRS) permits only a partial exclusion of the capital gains on the sale of the principal residence: USD\$250,000 if the taxpayer files as a single, and USD\$500,000 if for a US citizen married couple who file jointly. Any excess amount will be taxed at a rate up to 24%.⁷

While the exclusion amounts may seem generous, especially with the dramatic rise in real estate prices in cities such as Toronto, Montreal, and Vancouver, this may result in Canadians residents who maintain their US citizenship owing US taxes unexpectedly come filing season (while having no Canadian tax liability in respect of the sale of this home).

There are some ways for US citizens living in Canada to mitigate their potential tax exposure with the sale of their principal residence. If the US citizen is married to a Canadian citizen, the easiest solution is to simply put the property in the name of the non-US citizen from the outset. This solution is ideal for both spouses. On the one hand, the couple is able to avoid US tax upon the sale of the property, as the property in question is strictly the Canadian spouse's property. On the other hand, should the marriage dissolve (either through a breakdown or a death), the US citizen would also be protected: given that they are married, they are afforded statutory property rights by the *Family Act*,⁸ meaning that should the marriage dissolve, the US citizen would still be entitled to their portion of the matrimonial home. Evidently, this requires some thoughtfulness at the time of purchase, which, depending on the status of the relationship at the time of purchase, may not always be possible.

There are other options available, such as the gradual gifting of the interest in the property from the US citizen to the non-US citizen within the US gift tax limits; any such planning should be done with US counsel's tax advice and are beyond the scope of this overview.

PRE & Trust Law

With the recent amendments to the ITA, new restrictions on a trust's ability to designate a property as a principal residence were introduced by limiting the type of trust that is eligible as well as the beneficiaries. In order to claim PRE, the trust that holds the property must fit into one of the following categories:

1. Alter ego trust;
2. Spousal or common-law partner trust, joint spousal or common-law partner trust, or certain trusts that are for the exclusive benefit of the settlor's life;
3. A testamentary trust that is a qualified disability trust; or
4. A trust for the benefit of a minor child of deceased parents.

In addition to the above-mentioned criteria, the trust must also have a "special beneficiary". A special beneficiary is a beneficiary of the trust that has ordinarily inhabited the property,⁹ and is a Canadian resident in that particular year.

Creating New Trusts

If the intent is to form a new trust to be settled for the purpose of estate-planning and with the view that it will own a principal residence, the trust will have to fit within one of the above described categories. If the trust does not and/or there is no special beneficiary, the trust will not be able to claim the PRE at the time of sale.

Pre-existing Trusts – moving forward:

There is a high likelihood that trusts that were settled prior to the amendments will not meet the criteria to qualify for the PRE. The slight "silver lining" is that the Minister of Finance has provided transitional rules which enable trusts to claim the PRE up to and including

7. Matthew Getzler "Buyer Beware: The Sale of your Principal Residence May Not be Tax-Free After All" 2016, *Minden Gross Newsletter* 11 - 3.

8. It should be noted that common-law partners have different statutory rights depending on the province or territory in which they reside. In particular, only British Columbia, Saskatchewan, Northwest Territories, and Nunavut expressly provide that common-law and married couples share in property rights; all other provinces do not provide this protection for common-law couples.

9. The special beneficiary also includes a beneficiary who has had a spouse or common-law partner, former spouse or common-law partner, or child that ordinarily inhabited the property.



2016. This is done as a two-step process that splits the ownership of the property into a “pre-2017” period and a “post-2017” period.

For these purposes, the trust is deemed to have “disposed” of the property on December 31, 2016, at fair market value. The capital gain is then calculated for the property at this point in time, and, provided that the trust is eligible under the pre-amendment rules, this amount qualifies for the PRE.

The Minister of Finance’s transitional rules then treat the trust as having “re-acquired” the property on January 1, 2017, at a cost equal to the sum for which the trust “disposed” of the property during the “pre-2017 period.” Unless the trust meets the criteria outlined above, the PRE will not be available to the trust after such date, and any gain realized after January 1, 2017, will be subject to tax.

The values found in both periods are then added and that is the total taxable gain for the disposition of the property.

A second potential way to reduce the capital gains that must be included at disposition pursuant to the amended rules in the ITA is the allocation of the property to a beneficiary prior to its disposition. Indeed, should the situation arise where a beneficiary of the trust is a Canadian resident who occupies and designates the property as their principal residence post-2017, the PRE can be applied by the Canadian resident.

There are of course limitations to this strategy.

First, should the beneficiary of the trust die prior to the distribution, the trust would lose any ability to access the PRE for the post-2017 years. This strategy would also not be applicable if the beneficiary in question did not comply with the other parameters of the PRE rules (i.e. he or she did not ordinarily inhabit the property). It should also be noted that a valuation on January 1, 2017, would be required and if there was any gain realized in the hands of the trust, this option would also be unavailable to the taxpayer.

It would seem that for trusts that have been settled prior to the amendments, the most prudent course of action is to crystalize the gains up to January 1, 2017, apply the PRE to that amount, and distribute the property out to the beneficiaries.

Concluding Thoughts

The new rules have followed a discernible trend that has seen the federal government tightening the strings on deductions available to taxpayers: the rules are stricter, they provide less flexibility with regards to family and estate planning, and the new rules also enable the CRA to reassess the sale of a principal property beyond the three year mark. While it is unlikely that there will be a complete elimination of the PRE, it is clear that practitioners and home owners alike will have to continue to be vigilant in the planning and disposition of real property in Canada.



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Firm News

Minden Gross LLP welcomes...



David Holmes to our Commercial Leasing Group and Commercial Real Estate Group as a Partner. His practice focuses on providing clients with advice on the acquisition and disposition of commercial property, development, financing, leasing, and franchising of commercial, industrial, retail, and mixed-use properties.



Ryan Ghuman to our Business Law Group as an Associate. His practice primarily focuses on commercial transactions, drafting and negotiating commercial agreements, and assisting clients with corporate governance issues.



Leonidas Mylonopoulos to our Commercial Leasing Group as an Associate. His practice focuses on acting for commercial landlords and tenants in retail, office, and industrial leasing matters.

Top 10 Regional Law Firm

Minden Gross LLP is again ranked in the Top 10 Ontario Regional Law Firms by *Canadian Lawyer* magazine. Thank you to all of our clients, friends, and colleagues who voted for us.

Canadian Legal Lexpert Directory

The *2019 Canadian Legal Lexpert Directory* acknowledged our lawyers as leaders

in their fields. The firm received leading ranking in Property Leasing and Property Development and congratulates **Joan Jung** (Estate & Personal Tax Planning); **Howard Black** (Estate & Personal Tax Planning – Estate Litigation); **Reuben Rosenblatt, LLD, QC, LSM** (Property Development); and **Michael Horowitz, Christina Kobi,** and **Stephen Posen** (Property Leasing). We congratulate **Yosef Adler** who was ranked as a “Corporate - Mid Market Leading Lawyer to Watch.”

Congratulations Christina!

Minden Gross LLP congratulates **Christina Kobi** on being appointed to the Commercial Real Estate Advisory Board of *Practical Law Canada*.

Congratulations Marta Lewycky!

Minden Gross LLP congratulates **Marta Lewycky** on being appointed as a Member of the Advisory Board of the Advanced Commercial Leasing Institute (ACLI) at Georgetown Law School.

Congratulations Irvin Schein!

Minden Gross LLP congratulates **Irvin Schein** who has been appointed to the Board of Directors for Meritas Law Firms Worldwide.

Minden Gross LLP runs to raise money for Camp Ooch

Our team of nine spirited runners braved the cold and wind to raise money for kids with cancer at the Sporting Life 10k for Camp Ooch held in Toronto on May 12.

Professional Notes

Members of our Tax and Estates group attended the 2019 STEP National Conference on June 6-7 in Toronto. **Joan Jung, Michael Goldberg, Samantha Prasad, Caroline Elias, and Sheila Morris** attended. **Joan Jung** spoke on a 2-part panel at the conference titled “The Estate Freeze from Hell Redux”. She also co-chaired a Law Society program on the annotated alter ego trust and discretionary trust on Feb. 21.

Michael Goldberg hosted the third and fourth sessions of Tax Talk on Feb. 20 and May 8. His articles “Shareholders Agreements, the Act, and the Non-Specialist Advisor - The Impact of Control” (part 1 & 2) appeared in the Apr. & May editions of *Tax Topics*. Part 1 of his article also appeared in the May edition of *The Estate Planner*.

Samantha Prasad published five articles in *The Fund Library* including “Yes, you can fix a tax-filing mistake” on May 2. *The TaxLetter* published four articles including “Federal Budget Roundup - Tax 101” in May.

Matthew Getzler spoke on tax and estate planning at the second session of UNTOLD: Adult Lecture Series held by the Prosserman JCC on May 21.

Melissa Muskat posted “Municipal Tax Law Update - February 2019” on Feb. 8.

Danna Fichtenbaum spoke at an OBA program on Estate Administration on Apr. 10.

Sheila Morris and **Danna Fichtenbaum** represented three sisters who obtained a rare summary judgment decision in a will challenge hinging on mistaken belief in Apr.

Members of the Commercial Leasing Group attended the ICSC Whistler Conference from Jan. 27-29. **Michael Horowitz, Christina Kobi, Benjamin Radcliffe, and Boris Zayachkowski** were in attendance. The Group attended the ICSC Canadian Law Conference on Mar. 27-28 including **Stephen Posen, Christina Kobi, Marta Lewycky, Michael Horowitz, Benjamin Radcliffe, Steven Birken, Melissa Muskat, and Ladi Onayemi. Christina** was on the program planning committee and moderated a session on “Mental Health in the Legal Profession – The Paradox and Perils of High Functioning Depression.” **Stephen** was a panelist on “What Lies Beneath: The Complexities of Mixed-Use and Mixed Ownership Projects and Implications for the Landlord Tenant Relationship.” **Marta** was a panelist on “Hammering It All Out: Construction Law in the Leasing Context” and led a roundtable on “What Happens when a Catastrophic Event Occurs? How Insurance Plays Out in Real Life.” **Benjamin** and **Steven** led a roundtable on “Releases, Indemnities & Waivers of Subrogation.” **Melissa** and **Ladi** led a roundtable on “Realty Taxes.” **Christina** also attended ICSC RECon in Las Vegas from May 19-22.

Whitney Abrams posted two articles on *Canada Cannabis Legal* including “Taxing ‘New Classes’ of Cannabis addressed in the 2019 Federal Budget” on Mar. 21. Two of her articles were published in *Cannainvestor* including “Putting the C in Confusion - the Legal Status of CBD” in the Mar. Edition. She was quoted in *Canadian Lawyer* in “Budget 2019 clears the air on cannabis taxes” on Mar. 26 and in *The Leaf* on “City weed stores’ loyalty-points program may not be legal, lawyers say” on Apr. 11. **Whitney** moderated a panel on retail recreational cannabis stores at a conference hosted by INFONEX from Apr. 16-17.

Ethan Eisen’s article “Purchasing a cannabis related property? Three key considerations not to overlook” was published in the Feb. edition of *Cannainvestor*.

Adam Quirk (summer student) posted “Veterinarians lobby MPs to legalize medical cannabis for pets” on *Canada Cannabis Legal* on May 22.

Benjamin Bloom attended the Collision Conference held in Toronto from May 20-23.

Yosef Adler attended the ACG InterGrowth Conference in Orlando in May.

Sepideh Nassabi posted “Trademark Update: Amendments to the Trademarks Act finally coming into force June 2019” on Mar. 19 and “You say ‘Local’, I say ‘Locale’: Joey Tomato’s Trademark Dispute” on Mar. 29.

Raymond Slattery was quoted in “Provincially created trusts deemed valid” in *Law Times* on Jan. 21.

Andrew Elbaz, Sasha Toten, and Alex Katznelson acted for Freckle I.O.T Ltd. as it closed its first tranche of up to \$6.5M Offering in Mar. They also acted for Freckle I.O.T Ltd. as it closed its second tranche private placement.

Andrew Elbaz and **Alex Katznelson** acted for Eguana Technologies Inc. as Doughty Hanson invested \$3M in Feb. They acted for GTEC Holdings Ltd. as it announced a \$6.1M first tranche closing led by Sprott Capital Partners LP and again as GTEC Holdings Ltd. closed a \$12.5M offering led by Sprott Capital Partners LP. **Andrew** and **Alex** acted for Haywood Securities Inc. in connection with Nutritional High International Inc. closing a \$5.1M private placement offering, which was co-led with Foundation Markets Inc. in late May.

Andrew Elbaz, David Judson, and Alex Katznelson acted for Aura Health Inc. as it closed a first tranche of an up to \$7M brokered private placement in late Feb. They also acted for Aura Health Inc. as they closed the second tranche of this private placement subscription receipt offering as well as a share exchange transaction with FSD Pharma Inc. in Apr. **Andrew, David, and Alex** acted for Aura Health Inc. as it closed its flagship German acquisition of 80% of Pharmadrug GmbH in May.



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Brian Temins participated in “The Canadian Transactional Landscape” webinar hosted by Meritas on Feb. 14. **Brian** and **Jessica Thrower** acted on behalf of Lynx Equity Ltd. on its acquisition of Alpine Shredders in Feb. This deal was mentioned in “Lynx Equity acquires document shredder, Alpine Shredders” in *Private*

Capital Journal on Feb. 11. They also acted on behalf of Lynx Equity Ltd. on the \$6M mezzanine financing for Lynx’s acquisition of Alpine Shredders in May. **Brian** and **Jessica** acted on behalf of Last Call Analytics on its sale to Ample Organics Inc. in Jan.

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