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Significant Changes to the Principal Residence Rule

On October 3, 2016, Finance Minister Bill Morneau announced a change to the reporting requirement for the sale of a principal residence.

It is well known that a Canadian resident who sold their principal residence with a gain may claim a principal residence (PR) exemption. The CRA has not required you to report the sale of your principal residence if you are eligible for the full principal residence exemption and all of the capital gain was fully exempted from income taxes.

This administrative nicety from the CRA also extended to the deemed dispositions, where you either converted your rental or business property to a principal residence or vice versa. You were not required to report the deemed dispositions until the year you actually sell the property.

In the year of actual sale, if the property was not your principal residence for some of the years that you owned it, then you were required to file a form, reporting the years claimed for PR exemption and a capital gain would be calculated under a formula based on the ratio of the number of years claimed under PR +1 and the total number of years of ownership.

The 'plus one' rule in the formula was intended to accommodate the year where a taxpayer disposed of a former property and acquired a new property in the same year, so that both properties would enjoy the full PR exemption.

With the proposed changes, starting in 2016 tax year, you will be required to report the sale of your home and PR designation on your tax return, with details such as description of the property, the year of acquisition, the property's cost and the proceeds of disposition, regardless of whether the capital gain will be fully offset by the PR exemption. In addition, you will be required to report the deemed dispositions in the year the change occurred (even though you did not actually sell it), if you changed your rental or business property into your principal residence or vice versa.

The 'plus one' rule will not be available for an individual who was non-resident in the year of acquisition.

Failure to report an actual disposition or deemed disposition may incur financial penalty, and more seriously, the extension of reassessment period. Normally, the CRA was able to reassess a tax year within three years from the date of the Notice of Assessment. Under the new rules, if a taxpayer failed to report a disposition of residential property, the CRA may reassess for an unlimited period beyond the normal reassessment period.

The proposed changes will add complexities to the already-complex tax rules around real estate ownership. We remind you to first, keep all records related to purchase or renovation of your properties. Second, inform us immediately if you contemplate selling or changing the use of your real estate properties, so that the full implications may be considered and to ensure that proper disclosures are filed and the extended reassessment period will not apply.

If you own both a city home and a cottage, careful planning will be needed to optimize the PR exemption (after 1981, a couple can only claim one property as their PR) and minimize income taxes. An expanded discussion about the situation of owning multiple real estate properties will be featured in our next newsletter.

Significant changes are coming, but proactive financial planning will help you smoothly navigate the road ahead. Talk to us if you have any questions, we are in your corner!