Explanatory Notes

Legislative Proposals – Income Tax

These notes are intended for information purposes only and should not be construed as an official interpretation of the provisions they describe.

Principal residence – reduction of gain

ITA
40(2)(b)

Paragraph 40(2)(b) of the *Income Tax Act* (the “Act”) applies in computing the gain for a taxation year of an individual or trust (the “taxpayer”) from the taxpayer’s disposition in the year of a property that is the taxpayer’s principal residence at any time after the taxpayer acquired (or last acquired) the property. The paragraph reduces the taxpayer’s gain, otherwise determined, from the disposition by the amount computed under the formula in that paragraph.

Under the formula, a taxpayer’s gain from the disposition is effectively reduced to nil (i.e., is exempt from taxation) if each of the taxpayer’s taxation years during the taxpayer’s ownership period is an eligible taxation year. The taxpayer’s ownership period begins with the year in which the taxpayer acquired (or last acquired) the property and ends with the year in which the disposition occurs.

Element B of the formula is the sum of one plus (the “one-plus rule”) the number of the taxpayer’s eligible taxation years in the taxpayer’s ownership period. Under element B, an eligible taxation year is a taxation year of the taxpayer during which the taxpayer is resident in Canada and for which the property is the taxpayer’s principal residence.

The definition “principal residence” in section 54 does not allow a taxpayer (and members of the taxpayer’s family unit) to designate more than one property as the family’s principal residence for a taxation year. This is intended to limit the tax benefit to one property per family unit. However, this limit precludes a taxpayer who disposes of a principal residence in one year and acquires a replacement residence in the same year from designating both properties as a principal residence for the year. The one-property limit is not meant in this circumstance to deny the taxpayer the exemption in respect of both properties for the year.

The special one-plus rule in element B responds to this issue by effectively allowing taxpayers one extra taxation year of exemption room. The one-plus rule is not intended, however, to permit a taxation year throughout which a taxpayer is non-resident to be an eligible taxation year in the taxpayer’s ownership period.

Element B of the formula is amended so that the “one plus” factor in element B applies only where the taxpayer is resident in Canada during the year in which the taxpayer acquires the property.

This amendment applies to dispositions that occur on or after Announcement Date.

Principal residence – transitional rules

ITA
40(6) and (6.1)

The definition "principal residence" in section 54 of the Act does not allow a taxpayer and members of the taxpayer's family unit to designate more than one property as the family unit's principal residence for a taxation year. For this purpose, a family unit generally refers to a taxpayer, the taxpayer's spouse and their minor children. This one-property requirement also applies to a family unit whose additional residence is owned by a personal trust that is otherwise eligible to designate a property as its principal residence. The one-property requirement applies to designations for tax years after 1981.

Subsection 40(6) contains transitional rules that apply where more than one property was owned by members of a family unit at the end of 1981 – including through a personal trust that was eligible at the end of 1981 to designate a property as a principal residence – and the property is, on its first subsequent disposition after 1981, designated as a principal residence of a member of the family unit (or, in the case of a trust, by the trust). The transitional rule generally ensures that, in computing under paragraph 40(2)(b) the exempt portion of the taxpayer's gain from the disposition, the portion of the gain that accrued before 1982 is computed without reference to the one-property requirement.

Subsection 40(6) is amended consequential on the introduction of new subsection 40(6.1). A trust otherwise eligible to compute a gain by reference to subsection 40(6) will no longer apply that subsection if subsection 40(6.1) applies to the disposition. In these cases, the transitional relief otherwise provided to the trust by subsection 40(6) is provided under subsection 40(6.1).

New subsection 40(6.1) of the Act is introduced consequential on the introduction of new paragraph (c.1)(iii) of the principal residence definition. That subparagraph limits the types of trusts that are eligible to designate a property as a principal residence for a taxation year that begins after 2016.

Subsection 40(6.1) applies if a trust owns a property at the end of 2016, the trust is not described in subparagraph (c.1)(iii.1) of the principal residence definition for the trust's first taxation year that begins after 2016 and on the trust's first disposition of the property after 2016 the trust chooses to designate the property as its principal residence for any of its taxation years in which it owns the property. In this case, the trust's gain determined under the principal residence rules (i.e., under paragraph 40(2)(b)) is the amount determined under subsection 40(6.1).

The formula in subsection 40(6.1) separates the computation of the trust's gain into two separate periods. Under element A of the formula, the trust computes its "first" gain under paragraph 40(2)(b) on the basis that the trust notionally disposed of the property on December 31, 2016 for proceeds equal to its fair market value on that date. Under this element, that first gain is computed as normally under the principal residence exemption rules that apply to the trust for taxation years that begin before 2017 (i.e., those rules apply in computing the first gain without regard to the new requirements found in subparagraph (c.1)(iii.1) of the principal residence definition). Under element B of the formula, the trust computes its "second" gain under paragraph 40(2)(b) on the basis that the trust notionally acquired the property at the start of 2017 at a cost equal to the proceeds used in determining the first gain. This second gain is computed as normally under the principal residence exemption rules as they apply to dispositions in taxation

years that begin after 2016, but on the assumption that the "one-plus rule" in paragraph 40(2)(b) does not apply. Element C of the formula reduces the total of A and B to the extent that the proceeds from the first notional disposition (i.e., the property's fair market value on December 31, 2016) exceeds the proceeds of disposition of the property on its actual disposition (i.e., the total of A + B is reduced by the amount of any actual loss that accrued on the period after December 31, 2016).

This transitional rule is intended to ensure that a trust that owns a principal residence at the end of 2016, but no longer qualifies to designate the property as its principal residence because of new subparagraph (c.1)(iii.1) of the principal residence definition, may on the trust's first disposition of the property after 2016 continue to benefit from the exemption on its gain accrued up to the end of 2016 to the extent that the trust otherwise qualified for the exemption in respect of that gain. A trust that is not, at any time in or after its first taxation year that begins after 2016, a trust described in that subparagraph, is not eligible to claim the exemption in respect of the portion of its gain that accrues after 2016.

In the case that a trust to which subsection 40(6.1) applies would otherwise have qualified for transitional relief under subsection 40(6) in respect of a property owned by the trust at the end of 1981 and not disposed of until after 2016, a special rule in element A of the formula in subsection 40(6.1) provides that the trust's gain under its first notional disposition under that subsection is computed as though subsection 40(6) applied.

These amendments apply on Royal Assent.

Definitions

ITA
54

Section 54 of the Act defines various terms for the purposes of Subdivision C – Taxable Capital Gains and Allowable Capital Losses.

"principal residence"

The principal residence definition sets out the requirements that apply in order for a property (typically a housing unit, but also including certain leasehold interests, and shares of a cooperative housing corporation, in respect of a housing unit) to be a taxpayer's principal residence for a taxation year. Only taxpayers who are individuals or personal trusts are eligible to have a principal residence. A property must be a taxpayer's principal residence for a taxation year in order for that taxation year to apply in reducing, under the formula in paragraph 40(2)(b) of the Act, the taxpayer's gain from a disposition of the property in that year or a later year. These rules are commonly referred to as the "principal residence exemption rules".

In the case where the taxpayer is a personal trust, a property does not qualify as the trust's principal residence for a taxation year unless the requirements in paragraph (c.1) of the definition are met. That paragraph includes the requirements that the trust designate, in prescribed form, the property as the trust's principal residence for the taxation year and that the designation identify each individual who in the taxation year is a specified beneficiary of the trust for the year. For this purpose, a specified beneficiary of a trust for a taxation year is an individual who in the taxation year is beneficially interested in the trust and who (or whose spouse or common-law

partner, former spouse or common-law partner or child) ordinarily inhabits the housing unit in the taxation year.

Paragraph (c.1) is amended to introduce additional requirements in order for a property to qualify as a trust's principal residence for a taxation year that begins after 2016. In general terms, these requirements are that the trust be an eligible trust one of whose beneficiaries (the "eligible beneficiary") is resident in Canada in the year and a specified beneficiary of the trust for the year. In addition, where the trust acquires the property on or after Announcement Date, the trust's terms must provide the eligible beneficiary with a right to use and enjoy the housing unit as a residence throughout the period in the year that the trust owns the property. Eligible trusts fall into three categories, although a trust may qualify as an eligible trust under more than one of the categories:

- In the first case, an eligible trust is an *alter ego* trust, spousal or common-law partner trust, joint spousal or common-law partner trust, or certain trusts for the exclusive benefit of the settlor during the settlor's lifetime. In this case, the eligible beneficiary is the individual whose death (at any time after the start of the year) determines a day for the trust under subsection 104(4). In effect, the eligible beneficiary must be, depending upon the type of trust, the trust's settlor, or the spouse or common-law partner or former spouse or common-law partner of the settlor. A joint spousal or common-law partner trust may have more than one eligible beneficiary for a taxation year.

- In the second case, an eligible trust is a testamentary trust that is a qualified disability trust for the taxation year. In this case, the trust's eligible beneficiary must be an electing beneficiary under the trust for the year who is a spouse or common-law partner, former spouse or common-law partner or a child of the trust's settlor. The trust may have more than one eligible beneficiary for a taxation year.

- In the final case, an eligible trust is a trust (*inter vivos* or testamentary) the settlor of which died before the start of the year. In this case, the eligible beneficiary must be a minor child of the settlor whose parents (i.e., the settlor and the other parent) are deceased before the start of the year. The trust may have more than one eligible beneficiary for a taxation year.

This amendment applies in determining whether a trust that disposes of property, in (or after) the trust's first taxation year that begins after 2016, may designate the property as its principal residence for the year of disposition and any earlier taxation years of the trust. In this regard:

- For the trust to be eligible to designate the property as its principal residence for any earlier taxation years of the trust that begin after 2016, the trust must meet for the year the requirements introduced by new subparagraph (c.1)(iii.1). This is the case whether the trust acquired the property before 2017 or after 2016.

- However, if the trust owned the property before 2017, new subparagraph (c.1)(iii.1) does not apply in determining whether the property may be designated as a principal residence of the trust for a taxation year that begins before 2017. In addition, in this case, the trust's gain from the disposition may be determined using the special transitional rule in new subsection 40(6.1) of the Act if the requirements in that subsection are met.

This amendment does not apply in determining whether a trust that disposes of property in the trust's 2016 taxation year (or, in the case of a graduated rate estate that has a 2017 taxation year that began in 2016) may designate the property for that year and any earlier taxation years of the trust.

This amendment comes into force on Royal Assent.

Distributions from a trust

ITA
107(4.1)

Subsection 107(2) of the Act allows certain trusts to distribute property to a capital beneficiary under the trust on a tax-deferred (i.e., rollover) basis. Subsection 107(4.1) prevents subsection 107(2) from applying to a distribution of trust property to a beneficiary under the trust where, generally, the trust attribution rule in subsection 75(2) was at any time applicable in respect of property of the trust.

New paragraph 107(4.1)(a.1) provides that the subsection does not apply to a distribution of property made by a trust if

- the trust owned the property at the end of 2016,
- in the trust's first taxation year that begins after 2016 it is not a trust described in subparagraph (c.1)(iii.1) of the definition "principal residence" in section 54, and
- the property would be eligible to be designated by the trust as its principal residence for its taxation year in which the distribution occurs if that subparagraph did not apply to the trust for that year.

This amendment is intended to ensure that a personal trust and the beneficiary to whom it distributes property are not precluded from applying subsection 40(7) of the Act in respect of the distributed property only because subsection 75(2) may have applied in respect of the trust.

For cases where the effect of the amendment is to restore the application of subsection 107(2) to a distribution by a trust of property (because subsection 107(4.1) does not apply), a trust not wanting the application of subsection 40(7) may make an election under subsection 107(2.001) in respect of the distribution, so that subsection 107(2) does not, and subsection 107(2.1) does, apply to the distribution. Where subsection 107(2.1) applies to the distribution, the trust may be eligible to apply subsection 40(6.1) in computing any gain arising from the disposition of the property on the distribution.

Subsection 107(2.002) does not apply in respect of the distribution of such a property, and subsection 107(2.01) does not apply to the distribution if the trust is not described in (c.1)(iii.1) for the year of distribution.

This amendment comes into force on Royal Assent.

Trust not disqualified

ITA
108(4)

Subsection 108(4) of the Act provides that the payment of estate, income or similar taxes will not alone disqualify a trust from qualifying, for certain purposes, as an *alter ego* trust, spousal or common-law partner trust, joint spousal or common-law partner trust, or a trust for the exclusive benefit of the settlor during the settlor's lifetime.

Subsection 108(4) is amended so that a trust also will not cease to qualify as one of the trusts listed above only because a child, spouse or common-law partner, or former spouse or common-law partner of the individual – whose death determines a day for the trust under subsection 104(4) – ordinarily inhabits a housing unit that is property (or is in respect of a leasehold interest or share of a cooperative housing corporation) owned by the trust.

This amendment applies to taxation years that begin after 2016.

Assessment and reassessment

ITA
152(4)

Subsection 152(4) of the Act generally provides that the Minister of National Revenue may at any time assess tax and other amounts payable by a taxpayer for a taxation year, but may not assess after the normal reassessment period for the year. The normal reassessment period for a year is for corporations (other than Canadian-controlled private corporations) and mutual fund trusts, in general, four years from the date of the initial notice of assessment. For other taxpayers, it is, in general, three years from the date of the initial notice of assessment. Subsection 152(4) includes exceptions that apply in certain circumstances.

New paragraph 152(4)(b.3) is added to permit the assessment of a taxpayer for a taxation year outside of the normal reassessment period for the year, if the taxpayer does not report in the taxpayer's return of income under Part I of the Act for the year a disposition in the year by the taxpayer of real or immovable property. The paragraph also applies in the case where the taxpayer owned the property indirectly through a partnership, the partnership disposes of the property and the partnership did not report the disposition in the partnership return required by section 229 of the *Income Tax Regulations*. Finally, the paragraph also applies in the case where a taxpayer does not file a return of income under Part I of the Act for the year, but is assessed tax under Part I by operation of subsection 152(7). However, if the disposition is by a corporation or partnership, the paragraph only applies if the property is capital property of the corporation or partnership.

In the case where the taxpayer or partnership does file a return for a taxation year that does not report the disposition and the return is subsequently amended (i.e., by filing an adjustment request in prescribed form, or in a manner otherwise permitted) to report the disposition, paragraph (b.3) applies to an assessment in respect of the disposition only if the assessment is made within three years after the date that the amendment is filed. This three-year limit does not preclude an assessment, in respect of the disposition, from being made after the normal

reassessment period for a taxation year under another exception to the normal reassessment period limit, such as under paragraph 152(4)(a).

In the case where the disposition is not reported by the taxpayer or partnership in the relevant return and an assessment is made in respect of the disposition, the three-year limit does not apply.

This amendment applies to taxation years that end on or after Announcement Date.

Limits on extended period assessments and reassessments

ITA
152(4.01)

Subsection 152(4.01) of the Act limits the matters in respect of which the Minister of National Revenue can assess when an assessment to which paragraph 152(4)(a), (b), (b.1) or (c) applies is made beyond the normal reassessment period for a taxpayer in respect of a taxation year.

Subsection 152(4.01) is amended to add a reference to new paragraph 152(4)(b.3), which allows for the assessment of a taxpayer for a taxation year outside of the normal reassessment period for the year, if the taxpayer or a partnership of which the taxpayer is a member does not report a disposition in the year by the taxpayer or partnership, as the case may be, of real property.

As such, the assessment of a liability for a taxation year, authorized to be made after the normal reassessment period by new paragraph 152(4)(b.3), is limited by new paragraph 152(4.01)(c) to that which can reasonably be regarded as relating to the unreported or previously unreported disposition.

This amendment applies to taxation years that end on or after Announcement Date.

Designations and allocations

ITA
220(3.21)

Subsections 220(3.2) to (3.7) of the Act allow for the late filing, amendment and revocation of certain elections made by taxpayers. Subsection 220(3.21) extends those rules to certain designations, by treating the designations as though they were elections for the purposes of those rules.

New paragraph 220(3.21)(a.1) provides that the designation provided for under the definition principal residence in section 54 is also treated as though it were an election for the purposes of those rules.

This amendment applies to taxation years that end on or after Announcement Date.