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COMMENT

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IMPORTANT CHANGES TO PRINCIPAL RESIDENCE EXEMPTION

Canadian residents generally enjoy tax-free growth in the capital value of their principal residence. This tax measure, referred to as the principal residence exemption, provides tremendous value as it allows many Canadians to sell their home tax-free. It allows qualifying individuals to move between homes without the worry of a tax liability arising upon the sale of one home that would otherwise affect the cash available to purchase the next. For many Canadians, the value of their property represents a substantial proportion of their personal wealth.

On October 3, 2016 Finance Minister Morneau announced new measures to address the housing market, and improve the fairness and integrity of the tax system as it relates to the principal residence exemption. The changes include new reporting requirements, modifications to the calculation of the tax-free amount for individuals based on a residency requirement, and an extension to the period in which a reassessment may occur.

I. NEW REPORTING REQUIREMENTS

While the rules require that a claim for the principal residence exemption be reported using form T2091 when a principal residence is sold in Canada, it has been the Canada Revenue Agency's (CRA) long standing administrative position not to require reporting when there is no net gain. This means most Canadian's have typically not filed any paperwork in respect of their claim for exemption on the sale of their principal residence.

This administrative leniency has now ceased. All dispositions on or after January 1, 2016, for which the principal residence exemption is claimed, will have to be reported on schedule 3 of an individual's personal income tax return along with the required filing of form T2091.

Taxpayers who fail to report the disposition of their home will not be eligible to claim the principal residence exemption to shield the gain on the sale from taxation. A taxpayer can request an amendment of a prior tax return to report the disposition and make a claim for the principal residence exemption. However, the CRA has indicated that they may enforce late filing penalties in extreme situations. The penalty would be the lesser of $8,000 and $100 for each month between the original due date and the date the request for amendment is made.

This updated reporting requires individuals to report a disposition and claim the exemption, but will not create additional taxes for most Canadians. What it will do, however, is highlight those individuals who frequently buy and sell their residences. In some of these situations, the CRA may assess the gain on such dispositions as profit from the business of trading homes. With more sales information, the CRA will be better positioned to ferret out higher risk profiles that could lead to more audits.

II. CALCULATION OF THE EXEMPTION AMOUNT

The gain realized on the disposition of a principal residence may be eligible for a reduction referred to as the exemption. This exemption amount prior to the October announcement was derived from the following formula:

$\{ (1 + A) \div B \}$ times the gain realized upon disposition

Where,

- A is the number of years the house was the principal residence and the owner was resident in Canada
- B is the number of years of ownership

A taxpayer's ownership period begins in the year of purchase and ends in the year of disposition. The numbers used in the formula above are whole years with no decimal places. For example, if the ownership was from June 1990 to April 2015, the result would be 16 years of ownership.

The "1" in the formula is used to allow individuals to buy and sell a home in the same year and is commonly referred to as the "one-plus rule." Because only one home may be designated as a principal residence in any single year, the "1" ensures individuals do not incur taxation simply because of the sale and purchase in the same year.

The October 3, 2016 proposal is to eliminate the "1" in the formula above in respect of individuals who are non-resident in the year of purchase. This change is effective for all dispositions on or after October 3, 2016 regardless of when the house was purchased. The implementation of this change necessitates the collection of facts to prove residency in the year of purchase.

Consider the example of Peter who purchased a home in Canada for $450,000 in 2010, but did not immigrate to Canada until 2011. Assume Peter sells this home in 2017 for $690,000. He will realize a gain of $240,000 and would report seven (A in the formula) as the number of years that the home was his principal residence and he was resident in Canada (2011 to 2017 inclusive). Peter's years of ownership (B in the formula) would be reported as eight.

Peter will be entitled to reduce his $240,000 capital gain by 7/8th of $240,000, which equals $210,000 [(A ÷ B x $240,000)], leaving him with a $30,000 capital gain to report on his 2017 income tax return. By removing the "1" from the formula because Peter was not resident in Canada in the year of purchase, Peter is exposed to additional personal taxes on the net $30,000 capital gain.

III. REASSESSMENT PERIOD

The October 3rd announcement also proposes to allow the CRA to reassess beyond the normal reassessment period, which is generally three years for individuals from the date of the initial notice of assessment. This means individual taxpayers who dispose of real or immovable property, but do not report the disposition, will be subject to reassessments that extend beyond the normal reassessment period.

These changes to the principal residence exemption will affect every home owner in Canada. The impact for the majority of Canadian residents should be minimal – reporting a disposition when selling a home. However, there is a higher probability of catching those who may be misusing the principal residence exemption, and the new exemption formula will limit its availability to those years in which the owner is resident in Canada.

CHANGES TO THE CAPITAL DIVIDEND ACCOUNT

The March 22, 2016 federal budget has resulted in significant changes to the credit to the capital dividend account arising upon the receipt of life insurance proceeds. While these proposals are not yet final, it is expected they will be enacted before the end of 2016 with certain retroactive effect.

The credit to the capital dividend account for the receipt of life insurance proceeds is found at paragraph (d) of the definition of "capital dividend account" in subsection 89(1) of the Income Tax Act (ITA).

In general terms, paragraph (d) of the definition of the "capital dividend account" is comprised of a series of components (subparagraphs i through vi) as follows:

- Subparagraph (i) is the proceeds of a life insurance policy of which the corporation was a beneficiary on or before June 28, 1982 received by the corporation in the period and after 1971 in consequence of the death of any person.
- Subparagraph (ii) is the proceeds of a life insurance policy (other than a "LIA policy" – leveraged insurance annuity policy) of which the corporation was not a beneficiary on or before June 28, 1982 received by the corporation in the period and after May 23, 1985 in consequence of the death of any person.

The June 28, 1982 and May 23, 1985 dates referenced above are to recognize that for a period of time there was the "life insurance capital dividend account" that tracked life insurance proceeds received by a corporation. This account ceased to track life insurance proceeds received by a corporation after May 23, 1985.

It is important to note that if a life insurance policy meets the definition of a LIA policy (as defined in subsection 148(1)), then the proceeds are not added to the capital dividend account.

Subparagraphs (i) and (ii) work together to add life insurance proceeds received by a corporation to its capital dividend account. This combined amount is then reduced by four amounts, three of which were amended by or introduced by the March 22, 2016 federal budget.

- Subparagraph (iii), which in general terms reduces the CDA credit, has been amended to reflect the "adjusted cost basis of a policyholder's interest in the policy immediately before death." Previously this subparagraph reflected the adjusted cost basis of the policy to the corporation that was a beneficiary of the policy. Therefore, prior to this change, if the corporation receiving the proceeds was not the policy owner, there was no reduction to the credit arising from this component.

The new wording means that the policy's adjusted cost basis will be used in the capital dividend account calculation even where the corporate beneficiary is not the owner of the policy.

The change to this provision creates some uncertainty in situations where there are multiple corporate beneficiaries of the same policy (i.e., such as a split dollar arrangement, shared ownership or split beneficiary designation). This now creates the question - does each beneficiary reduce their capital dividend account calculation by the entire policy's adjusted cost basis, or a proportional amount based on the amount of life insurance proceeds received?

- Subparagraph (iv) applies if the policy is a 10/8 policy (as defined in subsection 248(1)) and death occurs after 2013. It reduces the CDA credit by the amount of debt outstanding before death under the 10/8 policy arrangement. This paragraph was introduced in the 2013 budget designed to reduce the tax benefits associated with 10/8 policies.
- Subparagraph (v) is new and will apply to life insurance proceeds received after March 21, 2016 where a policy was disposed of after 1999 and before March 22, 2016 by a policyholder (other than a taxable Canadian corporation) and subsection 148(7) applied to the transaction. In this situation, the amount by which the fair market value of the consideration, given in respect of the disposition, exceeds the greater of cash surrender value and adjusted cost basis of the policy interest immediately before the disposition will be used to reduce the credit to the capital dividend account.

Consider the example of Stan who transferred his life insurance policy to his company in 2005. At the time of the transfer, the policy had a cash surrender value of $50,000 and an adjusted cost basis of $75,000. Stan took back consideration of $200,000 from his corporation based on a fair market valuation from an independent actuary. At the time of transfer, subsection 148(7) of the ITA deemed Stan's proceeds of disposition to be the policy's cash surrender value, so Stan did not declare any income on the transaction because his adjusted cost basis was higher than the deemed proceeds.

New subparagraph (v) will reduce the capital dividend account credit by $125,000 when Stan's company eventually receives the life insurance proceeds. This represents the amount by which Stan's consideration of $200,000 exceeds the greater of cash surrender value ($50,000) and adjusted cost basis ($75,000) immediately before the transfer.

The reduction caused by new paragraph (v) will be a fixed amount and will not vary over time. The information necessary to make this calculation will likely be available from the original transfer documents. This necessitates that information be preserved and made available to the tax professional, who will be calculating the company's capital dividend account credit after the insurance proceeds are received.

- Subparagraph (vi) is also new and applies to life insurance proceeds received after March 21, 2016, where the policy was disposed of after 1999 and before March 22, 2016 by a policyholder (other than a taxable Canadian corporation) and subsection 148(7) applied to the transaction. If this criterion applies, the credit to the company's capital dividend account will be reduced by the amount by which the lesser of adjusted cost basis of the policy immediately before the transfer and fair market value of consideration received on the transfer exceeds the cash surrender value at the time of disposition of the policy, less the absolute value of the negative ACB at the time of death.

Continuing the example of Stan from above, this paragraph would result in an initial reduction in the credit to the capital dividend account of $25,000. This is the amount by which the lesser of adjusted cost basis ($75,000) and fair market value of consideration ($200,000) exceeds the cash surrender value ($50,000) at the time of transfer.

This $25,000 amount can be reduced and possibly eliminated if the policy's adjusted cost basis immediately before death has been reduced below zero because of the annual deduction of the net cost of pure insurance in the formula of the policy's adjusted cost basis.

These proposed changes create an essential need for accurate and long-term corporate record retention with respect to transactions over the policy's lifetime. It would be prudent for the corporate policyholder to retain these records, as such information will be required to properly determine the credit to the capital dividend account upon the receipt of the insurance proceeds. Such record keeping can certainly span many decades over the life of the policy.

CANADA/QUEBEC PENSION PLAN AND EMPLOYMENT INSURANCE 2017

Contributions under the Canada/Quebec Pension Plan (C/QPP) and Employment Insurance (EI) change annually. The following table presents the 2017 C/QPP and EI contributions amounts based on the new maximum earning amounts and the 2017 rates, with comparable figures for each of the three prior years.

		2017	2016	2015	2014
C/QPP	Maximum Pensionable Earnings	$55,300	$54,900	$53,600	$52,500
CPP	CPP Rate	4.95%	4.95%	4.95%	4.95%
	Basic Exemption Amount	$3,500	$3,500	$3,500	$3,500
	Maximum Employee Contribution	$2,564.10	$2,544.30	$2,479.95	$2,425.50
QPP	QPP Rate	5.40%	5.325%	5.25%	5.175%
	Maximum Employee Contribution	$2,797.20	$2,737.05	$2,630.25	$2,535.75

Federal		2017	2016	2015	2014
EI	Maximum Insurable Earnings	$51,300	$50,800	$49,500	$48,600
	Employee Rate	1.63%	1.88%	1.88%	1.88%
	Maximum Employee Contribution	$836.19	$955.04	$930.60	$913.68
Quebec		**2017**	**2016**	**2015**	**2014**
EI	Maximum Insurable Earnings	$51,300	$50,800	$49,500	$48,600
	Employee Rate	1.27%	1.52%	1.54%	1.53%
	Maximum Employee Contribution	$651.51	$772.16	$762.30	$743.58

For CPP and EI, an employer will withhold amounts, based on the schedule above, from the employee's periodic pay and remit the amounts withheld to the Receiver General. In addition to the employee's contribution to each of these plans, there is an employer required contribution as well. Employers are required to match the employee's contribution to CPP and to contribute 1.4 times the employee's contribution for EI.

A self-employed individual is responsible for their own CPP contributions and must submit an amount equal to twice the employee contribution amount. Generally, a self-employed person is not responsible for EI contributions nor eligible for an EI benefit unless registered for the EI Special Benefits for Self-Employed People.

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