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Edwin C. Harris*

A Case Study in Tax Reform: The Principal Residence

I. *The Tax Reform Process*

For most Canadians, "tax reform", in the abstract, is almost a motherhood issue: of course we're in favor of it, particularly if we are referring to that most obtrusive and resented of taxes, the income tax. In fact, as of the end of 1983, we shall have lived twelve years under an income tax régime that the federal government was pleased to call "tax reform". Why, then, should there be at least as much clamor for changes to the income tax now as there was in the early 1960s, when the federal government of the day felt impelled to appoint a Royal Commission on Taxation (the Carter Commission) to make a thorough study of the much criticized income tax law and to recommend major reforms? *Plus ça change*.

While the intention to achieve "tax reform" was genuine, that term seems most inappropriate to describe the turmoil that has resulted in our income tax system, which is becoming less manageable with each year's massive set of new amendments. In retrospect, it was probably naive to expect any other result from this prolonged process, which began over twenty years ago. Nevertheless, it is ironic that we should be hearing a growing demand for the reform of tax reform.

After long deliberation, the Royal Commission on Taxation, in its imposing report made public in early 1967, made sweeping recommendations which, if implemented, would undoubtedly have represented tax reform. Among the most important recommendations was a substantial extension of the tax base to include in income such hitherto untaxed receipts as capital gains and gifts. These recommendations, however, contained fatal weaknesses. Some of these weaknesses were avoided in the white paper ("Proposals for Tax Reform") that the federal government issued in November 1969 in response to the Royal Commission's report. The white paper was much less ambitious in scope; thus, it proposed to omit gifts from the tax base. But it, too, contained serious

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weaknesses. After receiving reports on the white paper from committees of both the House of Commons and the Senate (the latter report, in particular, being quite critical of the white paper), the government unveiled its tax reform bill in June 1971.

The bill gave effect to many of the criticisms and further narrowed the scope of the proposed changes to the existing income tax system. Thus, only half of a taxpayer's net capital gains would be included in his income. Even so, the massiveness of the bill, its verbose and aesthetically unpleasing style of draftsmanship, and its confusing new terminology and concepts (for example, "eligible capital property" is *not* one kind of "capital property") created many uncertainties of interpretation that took years to correct — at least in part. The new act came into effect at the beginning of 1972, after several amendments had been made to the bill in late 1971; but that was just the beginning of the correction process, which eventually continued in tandem with new "reforms", new complexities, and new uncertainties of interpretation. These objectionable developments were aggravated, on several occasions, by unconscionably long delays, significant changes in the substance of the provisions, budgets and income tax amending bills, and delays in the issuance of necessary regulations that, when issued, often had retroactive effect. Throughout this process, significant changes in the administrative interpretation of the Income Tax Act (the "act") by Revenue Canada, Taxation (the "department") handed taxpayers and their advisers many unpleasant surprises. So much for that major goal of tax reform — certainty.[1]

One area of particular vulnerability to uncertainty and change in the proposals relating to the taxation of capital gains has been the proper special treatment, if any, to be given to an individual's "principal residence". Because it illustrates so well the process that I have just described in general terms and because of its importance with regard to both the value of property and the number of taxpayers affected, I have chosen to describe in this article the evolution of the special rules in our income tax law relating to principal residences.

1. I have traced this process in two articles and (briefly) in a book. See Harris, *What Should Canada Do with the Carter Report?*, 21 Bull. Int'l Fiscal Documentation 531 (1967); Harris, *Tax Reform in Canada — Stage II*, 24, *ibid*, 179 (1970); E. C. Harris, Canadian Income Taxation, chapter 1, s. 1.02 (2d ed. 1981; 3d ed. 1983).

II. *The Principal Residence in the Tax Reform Proposals*

The Royal Commission recommended that "gains on all forms of property should be included in computing income, subject to a limited exception for certain residential, including farm, properties."[2] The recommended exemption could accumulate up to a lifetime total of $25,000 for each family unit or individual. "Although the reasons for this exclusion are largely administrative, there are also social implications. The complexities in maintaining adequate cost records over the periods involved if gains on residential properties were taxed would be considerably greater than would be involved for other types of property."[3] Unfortunately, the commission did not elaborate on the "social implications" that apparently influenced its recommendations. It was concerned, however, about possible claims for losses if gains on sales of principal residences were taxed, and about pressures that would likely develop, if such gains were taxed (as had occurred in the United States), to allow "rollover" provisions — that is, provisions postponing the recognition of a taxable gain on the sale of a principal residence in certain cases, such as where the sold residence is replaced within a limited period by a new principal residence.

The commission proposed that, subject to the lifetime dollar limit, gains on the sale of a building, and on the supporting or surrounding land, used by the owner for residential purposes, as well as on farm residential property, should be exempt. It suggested that an individual who owns a principal residence should be permitted, in lieu of keeping track of capital expenditures representing improvements to his property so as to add them to the cost of the property in order to compute its tax basis when it is sold, to elect to add to his tax basis one percent of the cost of the building for each year that the property is held. As well, farmers should be permitted to add to the tax basis of their farm residences any related interest and property taxes. The tax basis of a property that is used for both business and residential purposes would need to be apportioned between the two uses.[4] Losses on the disposition of a principal residence would not be recognized for tax purposes.[5]

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2. 3 Report of Royal Commission on Taxation 353 (1967).
3. *Id.*, at 358.
4. *Id.*, at 358-59.
5. *Id.*, at 360.

Like the Royal Commission, the authors of the white paper would have taxed in full, when realized, capital gains that accrued after the commencement of the new tax system; but they added certain exceptions to this general rule. Thus, a capital gain on the sale of a principal residence, including a farm house, would not be taxed except to the extent that it exceeded $1,000 multiplied by the number of years during which the property was occupied as the taxpayer's principal residence. Losses on the disposition of such a property would not be deductible. If records of capital improvements to the property were not kept, the taxpayer would be granted a "home improvement allowance" of $150 per year of occupancy.[6] Rollovers would be allowed on the sale of a home and the purchase of another when the taxpayer moved to another part of Canada on a change of employment. Only one principal residence would be recognized per unattached taxpayer or per married couple, except in the case of a formal separation.[7]

Interestingly, the white paper offered some explanation of the "social implications" to which the Royal Commission had referred. In what must rank as one of the most fatuous rationalizations ever offered by a Canadian government for a tax measure, the white paper said that ". . . the government does not feel that it would be appropriate to treat the homeowner's gain as ordinary income. Home ownership is part of the Canadian way of life, and within reasonable limits the profits on the sale of a personal residence would be treated as a recovery of the personal expenses of the homeowner."[8] In a devastating criticism of the white paper proposals relating to principal residences,[9] Horst G. Wolff pointed out that "the taking of employment and the conduct of business for gain are part of the Canadian way of life as well." Yet gains from these activities have long been taxed in Canada. Wolff concluded that "the exemption of gains would result in inequity in the tax treatment of renters as compared to home-owners; and the fixed dollar limitation on the exemption would result in inequity among

6. Proposals for Tax Reform, s. 3.19 (1969).
7. *Id.*, s. 3.20.
8. *Id.*, s. 3.6. My translation is: the government judges that the taxation of gains on principal residences is simply politically unsaleable. This, in my view, was undoubtedly a correct conclusion.
9. Wolff, *The White Paper: Tax Treatment of Principal Residences*, 18 Can. Tax J. 263, 268 (1970).

home-owners."[10] The exemption would aggravate the inequity that would result from not taxing homeowners on "imputed rent" — that is, the advantage of not having to pay rent for accommodation out of after-tax earnings. Even the Royal Commission did not recommend that imputed rent be taxed. I agree with the commission (notwithstanding Wolff's doubts) that the effective taxation of imputed rent involves formidable administrative difficulties. More importantly, it was and is, in my view, politically unfeasible to attempt to tax imputed rent in Canada.[11] Once, however, it was conceded that imputed rent is not to be taxed, the basic goals of equity and neutrality by which the "comprehensive tax base" proposed by the commission was justified were seriously compromised.

If it is decided that gains on principal residences should be given preferential tax treatment, Wolff suggested that we adopt the United Kingdom's approach in preference to the proposals of the Royal Commission and the white paper. If the United Kingdom's approach was followed, any gain on the sale of a residential property would be reduced (or eliminated) by the proportion of the total time during which it was owned by the taxpayer and it qualified as his principal residence. Up to one acre of land associated with a principal residence would be exempt on the same basis, but in certain cases a larger piece of land could qualify.[12] As we shall see, this approach, in essence, was adopted in the amending bill.

The House of Commons Standing Committee on Finance, Trade and Economic Affairs, in its report on the white paper,[13] recommended that, in general, only half of net capital gains be taxable. It proposed the adoption of the United Kingdom's rule with respect to one acre of land associated with a principal residence, it would have substituted an annual allowance for growth in value of $1,500 for the $1,000 proposed in the white paper, and it would not have granted a rollover where a principal residence was sold and replaced because of the owner's change of employment.[14]

In its report on the white paper,[15] the Standing Senate Committee

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10. *Id.*, at 263.
11. *Id.*, see the discussion at 265-67.
12. *Id.*, see the discussion at 271-74.
13. Report dated October 1970.
14. *Id.*, at s. 3.21B.
15. Report dated September 1970.

on Banking, Trade and Commerce recommended a $50,000 lifetime principal-residence exemption for an individual and his or her spouse and a rollover for any gain on a principal residence that is sold and replaced within a year. It also proposed a $75,000 lifetime exemption for the sale of farms.[16] With respect to capital gains in general, it proposed full taxation of gains on properties held for less than one year and half-rate taxation (or a twenty-five percent tax, if less) on most longer-term gains.

In June 1971, the federal government unveiled its ponderous Bill C-259 to amend the Income Tax Act. In general, the bill provided that half of net realized capital gains, to the extent that they accrued after the end of 1971, would be included in income, but an exemption was provided for gains on principal residences, following the pattern set by the United Kingdom. In an accompanying explanatory booklet,[17] the Department of Finance explained these provisions as follows:

> Many who commented on the [white paper] provisions felt that substantial tax liabilities would still occur in areas where pressure on the housing market pushed prices up strongly and that homeowners would continue to face uncertainty about their tax position. It was also argued that the economic use of our housing stock might be inhibited if families could not 'move up' to larger houses as they grew and established themselves.
>
> The Government has decided that these arguments can best be met by a complete exemption. This will save homeowners from valuation problems and meet the very strong views of Canadian homeowners and many other Canadians who aspire to home ownership.[18]

Subject to some amendments that were added by the government in late 1971, the principal-residence provisions contained in Bill C-259 became part of the new Income Tax Act at the beginning of 1972.

III. *Legislative History*

It should be helpful to begin with the text of the present relevant provisions of the act, including those enacted in 1983 at the conclusion of the distressingly protracted budgetary and amendment

16. *Id.*, at 58-59.
17. Summary of 1971 Tax Reform Legislation (June 18, 1971).
18. *Id.*, at 31. Actually, because of the apportionment formula provided for in the bill, valuation problems might not be avoided where a home did not always qualify as a principal residence while it was held by a taxpayer.

process that commenced with the ill-conceived budget of November 12, 1981. Then the more significant changes that have been made in those provisions since the beginning of 1972 will be traced. The order in which these provisions will be considered here departs somewhat from their sequence in the act in an effort to achieve a more logical approach, but the interdependency of the provisions prevents any sequence from being totally logical. Some critical analysis will accompany the legislative history, but most of the criticism will be reserved for the next section. Our procedure will be to quote the text of each relevant provision of the act, followed immediately by a reference to its legislative history and, where it seems appropriate, some explanatory comment.

Paragraph 54(g)

(g) ''principal residence'' of a taxpayer for a taxation year means a housing unit, a leasehold interest therein, or a share of the capital stock of a co-operative housing corporation, owned, whether jointly with another person or otherwise, in the year by the taxpayer, if the housing unit was, or if the share was acquired for the sole purpose of acquiring the right to inhabit a housing unit owned by the corporation that was,

(i) ordinarily inhabited in the year by the taxpayer, his spouse or former spouse, or a child of the taxpayer who, during the year, was wholly dependent upon him for support and was a person described in subparagraph 109(1)(d)(i), (ii) or (iii), or

(ii) property in respect of which the taxpayer has made an election for the year in accordance with subsection 45(2),

except that, subject to section 54.1, in no case shall any such housing unit, interest or share, as the case may be, be considered to be a taxpayer's principal residence for a year

(iii) unless it has been designated by him in prescribed form and manner to be his principal residence for that year and no other such housing unit, leasehold interest or share has been so designated for that year by him, by a person who was throughout the year his spouse (other than a spouse who was throughout the year living apart from, and was separated pursuant to a judicial separation or written separation agreement from, the taxpayer), by a person who was his child (other than a child who was during the year a married person or 18 years of age or over) or, where the taxpayer was not during the year a married person or a person 18 years of age or over, by a person who was

(A) his mother or father, or

(B) his brother or sister and who was not during the year a married person or a person 18 years of age or over, or

(iv) by virtue of subparagraph (ii), if by virtue of that subparagraph the property would, but for this subparagraph, have been his principal residence for four or more previous taxation years,

and for the purposes of this paragraph the "principal residence" of a taxpayer for a taxation year shall be deemed to include, except where the property consists of a share of the capital stock of a co-operative housing corporation, the land subjacent to the housing unit and such portion of any immediately contiguous land as may reasonably be regarded as contributing to the taxpayer's use and enjoyment of the housing unit as a residence, except that where the total area of the subjacent land and of that portion exceeds 1/2 hectare, the excess shall be deemed not to have contributed to the individual's use and enjoyment of the housing unit as a residence unless the taxpayer establishes that it was necessary to such use and enjoyment;

Several amendments to this definition in 1973-74, 1974-75-76, and 1976-77 changed portions preceding subparagraph (iii) and were made retroactive to the commencement of the application of the principal-residence rules at the beginning of 1972. Thus, the reference to "a leasehold interest therein" in the early part of the definition was added to expand the exemption to cover circumstances where the taxpayer did not own the residence property but had a relatively long-term leasehold interest in it that might be sold for a gain. Subparagraph (i) originally referred only to the taxpayer and not to the other members of his family; the amendments permitted the exemption to be claimed where, for whatever reason, the taxpayer himself did not reside in the property but one or more members of his immediate family did — providing that the other requirements, including his not designating any other property as his principal residence for the same year, were met. In the part of the definition immediately following subparagraph (ii), the addition of the reference to a leasehold interest paralleled the change referred to earlier. The reference to section 54.1 accompanied the addition of that section in 1974-75-76, retroactive to 1972, as will be discussed presently.

Having regard to the strong recommendations of the Royal Commission and the concurrence of almost all subsequent reports and commentators that only one property should be eligible to qualify as the principal residence of the members of a family unit at

any one time, many practitioners were surprised to find, in the early 1970s, that the department interpreted paragraph 54(g) as authorizing each spouse to have a separate principal residence. Each spouse is a separate taxpayer under the act, and the phrase "ordinarily inhabited in the year" appearing in subparagraph (i) was not interpreted as requiring continuous occupation throughout the year or for any substantial period of the year; customarily recurring occupation for limited periods, as in the case of a vacation home, would suffice.[19] Thus, if a husband and wife held both a city home and a country home, which they regularly occupied for a period of each year, in common or joint ownership, each could designate his or her half interest in one or the other property as a principal residence, but his or her half interest in the other property would then not be exempt. Practitioners resolved this problem by recommending that the common or joint ownerships be severed and that, instead, one spouse totally own one of the properties and the other spouse totally own the other property. Then, both properties could be totally sheltered from tax on any capital gain by being designated their respective principal residences. The transfer of an interest in a home from one spouse to the other would qualify for a rollover, even with respect to an interest that was not the transferer's principal residence.[20] The transferee spouse could then designate the entire property that he or she now solely owned as his or her principal residence for the full period during which he or she ordinarily inhabited it — that is, for as long as it had been a family residence after 1971.[21]

It took the government a surprisingly long time to recognize that allowing a family to have two principal residences was not originally intended and was not appropriate by any stretch of the equity criterion. Horror stories were emerging that wealthy families were expanding their exemptions even further by putting occasional residences of theirs in the names of dependent children, each of whom was also entitled to designate a principal residence. The inevitable correction is contained in the most recent amendments to

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19. See Interpretation Bulletin IT-120R2, "Principal Residence", paras. 6, 8 (February 23, 1981). See also *Schlamp* v. *The Queen*, 82 DTC 6274, [1982] C.T.C. 304 (Fed.Ct.T.D.); and McGregor, *Principal Residence: Some Problems*, 21 Can. Tax J. 116 (1973).

20. Act subs. 73(1). Subsequent statutory references are to the act, except where otherwise indicated.

21. See Interpretation Bulletin IT-366, "Principal Residence — Transfer to Spouse or Spouse Trust", paras. 7, 8 (March 28, 1977).

subparagraph (iii), effective for 1982 and following years. In addition to some relatively minor wording changes in the early part of this subparagraph, the entire reference to the spouse and minor children was added. Transitional relief was provided in the new subsection 40(6), to be discussed later, for the situation where a family had, under the previous rules, more than one principal residence at the end of 1981.

The department has administratively eased the strict statutory requirements regarding the designation of a principal residence.[22] In an interpretation bulletin, the department states that "although it is provided that an otherwise eligible residence is not a principal residence for a taxation year unless it is designated as such in the taxpayer's income tax return for the year in which the disposition or the granting of an option to acquire the property occurs, the Department's administrative position is that this designation need not be filed with the taxpayer's income tax return unless a taxable capital gain on the disposition of a principal residence occurs after deducting the exempt portion of the gain or unless the taxpayer wishes to file the designation in respect of property disposed of to his spouse or a 'spouse trust'."[23] Here, as in many other areas, the harsh requirements of the act have had to be mitigated by administrative concession.

The final amendment to the definition in paragraph 54(g) was enacted in 1983 as part of the government's metrication program, substituting "1/2 hectare" for the previous "one acre" — and, incidentally, thereby expanding somewhat the allowed area of related land to the approximate equivalent of 1.235 acres. In this way, the government chooses to convince us of the merits of metrication!

Subparagraphs 109(1)(d)(i)-(iii), referred to in subparagraph 54(g)(i), list categories of dependent children in respect of whom a taxpayer may deduct a child's "personal exemption" in computing his taxable income. The references to subsection 45(2) in subparagraphs 54(g)(ii) and (iv) will be explained later when subsection 45(2) is discussed.

22. See also Income Tax Regulations s. 2301; Forms T2090, T2091.
23. Interpretation Bulletin IT-120R2, n. 19, *supra*, para. 9. See also Interpretation Bulletin IT-366, n. 21, *supra*, para. 11.

Section 54.1

(1) A taxation year in which a taxpayer does not ordinarily inhabit his property as a consequence of the relocation of his or his spouse's place of employment while he or his spouse, as the case may be, is employed by an employer who is not a person to whom he or his spouse is related shall be deemed not to be a previous taxation year referred to in subpararaph 54(g)(iv) if

(a) the property subsequently becomes ordinarily inhabited by him during the term of his or his spouse's employment by that employer or before the end of the taxation year immediately following the taxation year in which his or his spouse's employment by that employer terminates, or

(b) he dies during the term of his or his spouse's employment by that employer.

(2) In this section, ''property'', in relation to a taxpayer, means a housing unit

(a) owned by him,

(b) in respect of which he has a leasehold interest, or

(c) in respect of which he owned a share of the capital stock of a co-operative housing corporation if the share was acquired for the sole purpose of acquiring the right to inhabit a housing unit owned by the corporation

whether jointly with another person or otherwise in the year and that at all times was at least 40 kilometres farther from his or his spouse's new place of employment than was his subsequent place or places of residence.

As indicated earlier, section 54.1 was added in 1974-75-76, retroactive to the beginning of 1972, to expand the scope of the definition of ''principal residence'' in paragraph 54(g). Section 54.1 was amended in 1976-77, retroactive in effect to the beginning of 1972. The most recent amendment was enacted in 1983, applicable after 1981, to substitute ''40 kilometres'' for the previous ''25 miles'' in subsection 54.1(2). The significance of section 54.1 will become apparent when we consider subsection 45(2).

Paragraphs 40(2)(b) and (c)

(b) where the taxpayer is an individual, his gain for a taxation year from the disposition of a property that was his principal residence at any time after the date, (in this section referred to as the ''acquisition date'') that is the later of December 31, 1971 and the day on which he last acquired or reacquired it, as the case

may be, is his gain therefrom for the year otherwise determined minus that proportion thereof that

(i) one plus the number of taxation years ending after the acquisition date for which the property was his principal residence and during which he was resident in Canada,

is of

(ii) the number of taxation years ending after the acquisition date during which he owned the property whether jointly with another person or otherwise;

(c) where the taxpayer is an individual, his gain for a taxation year from the disposition of land used in a farming business carried on by him that includes property that was at any time his principal residence is

(i) his gain for the year, otherwise determined, from the disposition of the portion of the land that does not include the property that was his principal residence, plus his gain for the year, if any, determined under paragraph (b) from the disposition of the property that was his principal residence, or

(ii) if the taxpayer so elects in prescribed manner in respect of the land, his gain for the year from the disposition of the land including the property that was his principal residence, determined without regard to paragraph (b) or subparagraph (i) of this paragraph, less the aggregate of

(A) $1,000, and

(B) $1,000 for each taxation year ending after the acquisition date for which the property was his principal residence and during which he was resident in Canada;

These provisions contain the exemption formula for individual taxpayers. As can be seen, the exemption is only available to individuals, thereby excluding corporations. As well, only years during which the taxpayer is resident in Canada will count toward his exemption.[24]

The significance of "one plus" or "$1,000, and" in the formulas is that, in a year in which one residence is disposed of and another is acquired, both residences cannot qualify as the taxpayer's principal residence since, under subparagraph 54(g)(iii), he can have only one principal residence in a year. To compensate, the formula in effect allows a "free" year — even where a principal residence that is disposed of is not replaced.

24. See also para. 49(1)(a); Income Tax Application Rules, 1971, cl. 26(5)(c)(i)(D), para. 26(7)(c), s. 26.1; Income Tax Regulations s. 2300.

The references in paragraphs 40(2)(b) and (c) to an "acquisition date" and its definition in paragraph 40(2)(b) were added in 1977-78 to eliminate an unintended result from the apportionment formula, particularly where the property was deemed to have been disposed of after 1971 (as on a change of use) and was subsequently deemed to have been reacquired. Where, in the case of farm property, an election is made to use subparagraph 40(2)(c)(ii), the need to separate the total property and its cost and proceeds into farming and residential portions is avoided. It should be noticed that the formulas do not grant a "home improvement allowance" to relieve a taxpayer, for whom a particular property has not always qualified as a principal residence, from the need to keep records of capital improvements.

Subsection 40(4) and (5)

(4) Where a taxpayer has, after 1971, disposed of property to an individual who is deemed by subsection 70(6) or 73(1) to have acquired it for an amount equal to its adjusted cost base to the taxpayer immediately before the disposition, for the purposes of computing the individual's gain from the disposition of the property under paragraph (2)(b) or (c), as the case may be,

(a) the individual shall be deemed to have owned the property throughout the period during which the taxpayer owned it;

(b) the property shall be deemed to have been the individual's principal residence

(i) in any case where subsection 70(6) is applicable, for any taxation year for which it would, if the taxpayer had designated it in prescribed manner to have been his principal residence for that year, have been the taxpayer's principal residence, and

(ii) in any case where subsection 73(1) is applicable, for any taxation year for which it was the taxpayer's principal residence; and

(c) where the individual is a trust, the trust shall be deemed to have been resident in Canada during each taxation year during which the taxpayer was resident in Canada.

(5) For the purposes of determining whether any property of a trust described in subsection 70(6) or 73(1) was its principal residence for any taxation year, paragraph 54(g) shall be read as if

(a) the reference in subparagraph (i) of that paragraph to "the taxpayer" were read as a reference to the spouse referred to in

subparagraph 70(6)(b)(i) or 73(1)(c)(i), as the case may be, and

(b) the references in subparagraph (iii) of that paragraph to "him" were read as references to the trust and the spouse mentioned in paragraph (a).[25]

The references to subsections 70(6) and 73(1) are to provisions that permit a rollover, upon death and during the lifetime of the transferer, respectively, of capital property from one spouse to the other or from one spouse to a qualifying trust established for the other spouse. A minor technical amendment was made to paragraph 40(5)(a) in 1977-78 to change the cross-reference to subsection 73(1) as a result of simultaneous amendments to that subsection.

Subsection 40(6)

(6) Where a property was owned by a taxpayer, whether jointly with another person or otherwise, at the end of 1981 and continuously thereafter until disposed of by him, the amount of the gain determined under paragraph (2)(b) in respect of the disposition shall not exceed the amount, if any, by which the aggregate of

(a) his gain calculated in accordance with paragraph (2)(b) on the assumption that he had disposed of the property on December 31, 1981 for proceeds of disposition equal to its fair market value on that date, and

(b) his gain calculated in accordance with paragraph (2)(b) on the assumption that paragraph (2)(b) applies and that

(i) he acquired the property on January 1, 1982 at a cost equal to its proceeds of disposition as determined under paragraph (a), and

(ii) subparagraph (2)(b)(i) is read without reference to "one plus"

exceeds

(c) the amount, if any, by which the fair market value of the property on December 31, 1981 exceeds the proceeds of disposition of the property determined without reference to this subsection.

As indicated earlier, this subsection, enacted in 1983, was intended to provide transitional relief where a family held more than

25. See also Tax Ruling TR-69, "Designation of Principal Residence" (July 11, 1977); Interpretation Bulletin IT-366, n. 21, *supra; Smellie Estate* v. *M.N.R.*, 77 DTC 308, [1977] C.T.C. 2435 (Tax Rev. Bd.).

one principal residence at the end of 1981. A deemed disposition at the end of 1981 would have benefited from the former rules allowing a family to have more than one principal residence. Any such property that is not designated as the family's principal residence after 1981, because of the more restrictive rules then applicable under the amendments to subparagraph 54(g)(iii), is not sheltered from tax on any growth in value after 1981. Paragraph (c) provides for the possibility that such a property may have declined in value after 1981.

Subsection 45(2)

> *(2)* For the purposes of this subdivision and section 13, where subparagraph (1)(a)(i) and paragraph 13(7)(b) would otherwise be applicable in respect of any property of a taxpayer for a taxation year and the taxpayer so elects in his return of income for the year under this Part, the taxpayer shall be deemed not to have commenced to use the property for the purpose of gaining or producing income therefrom or for the purpose of gaining or producing income from a business except that, if in his return of income for a subsequent year and under this Part he rescinds his election in respect of the property, he shall be deemed to have commenced so to use the property on the first day of that subsequent year.

Subsection 45(1) provides, in general, for a deemed disposition and deemed reacquisition, at fair market value, of capital property owned by a taxpayer, the use of which has been changed from an income earning purpose to another purpose, or vice versa. An important exception is provided in subsection 45(2), which was substituted for the original version of that subsection in 1974-75-76 but with retroactive effect to the beginning of 1972.

Subsection 13(7) provides similar rules to those in subsection 45(1) on a change of use of depreciable property, providing, in effect, for a deemed disposition or acquisition of depreciable property. Specifically, paragraph 13(7)(b) provides that, for purposes of the depreciable property rules, where a taxpayer who has acquired property for another purpose commences to use it to earn income, he is deemed to have acquired it at the time of change of use at its then fair market value. Therefore, if the property otherwise qualifies as depreciable, he is entitled thereafter to claim capital cost allowance (that is, depreciation deductions) on it based on that deemed capital cost. Subparagraph 45(1)(a)(i) provides that, for purposes of the rules for determining capital gains or capital

losses (rules which can apply to depreciable property — for capital gains only — and to nondepreciable property, such as land, that qualifies under the act as capital property), where a taxpayer who has acquired property for another purpose commences to use it to earn income, he is deemed to have disposed of it at the time of change of use, and immediately thereafter to have reacquired it at its then fair market value. This might give rise to an immediate capital gain if the value of the property at that time exceeds its adjusted cost base (that is, its basis for tax purposes), and could be very painful for the taxpayer who has not in fact disposed of the property and has received no actual proceeds. At the same time it will establish that value as the new adjusted cost base of the property, so that any gain that is taxed on its change of use will not be taxed again on its subsequent disposition by the taxpayer.[26]

Subsection 45(2) therefore appears to say that where a taxpayer who owned an asset that was not being used to earn income commences to use it to earn income in circumstances that would qualify it as depreciable property, he can elect that the change-of-use rules will not apply to that asset, in which case there will be no deemed disposition and no deemed reacquisition for purposes of the capital-gain rules and no deemed acquisition for purposes of the depreciable-property rules. Consequently, the taxpayer can avoid recognizing, at least for now, any accrued capital gain on the asset. There will be no increase, however, in his adjusted cost base of the asset, so that any accrued gain at that time will continue to be potentially taxable (to the extent that it is not eligible for exemption as a gain on a principal residence); and since he is deemed not to have commenced to use the asset to earn income, it does not qualify as depreciable property and is not eligible for capital cost allowance while the election continues in effect.[27] There is no time limit on the effect of the election once it has been made, so that if it continues in force until the taxpayer, while still owning the asset, ceases to use the asset to earn income, there will be deemed to be no change of use at that later time either. It is possible, however, for the taxpayer to revoke his election for any year subsequent to the year for which the election was made, in

26. A deemed disposition is provided only for capital-gains purposes and not for purposes of the depreciable-property rules because the latter rules do not apply to an asset until it is acquired for the purpose of earning income. See Income Tax Regulations, para. 1102(1)(c).
27. *Id.*

which case the change-of-use rules would apply as of that subsequent year.

The most important application of subsection 45(2) is where an individual who has held a property as his principal residence commences to rent it to someone else. If he makes the election, subparagraph 54(g)(ii) provides (quite generously) that the property can continue to qualify as his principal residence while it is being rented, even though it is not then "ordinarily inhabited" by him or his family, if the other requirements of principal-residence status are met. For such an election to help the taxpayer to shelter a gain on the ultimate realization of the property, the formula in paragraph 40(2)(b) or (c) requires that he continue to be resident in Canada in those years.

Subparagraph 54(g)(iv), however, limits the benefit of the rule in subparagraph 54(g)(ii) to a maximum of four years after the last year in which the taxpayer or his family "ordinarily inhabited" the property — except where the relieving provisions of section 54.1 apply. The termination of the principal-residence exemption, in these circumstances, after four years does not affect the continuing validity of the election for purposes of subsection 45(2), unless and until that election is revoked; nor does it remove the taxpayer's inability, while the election remains in effect, to claim capital cost allowance on the building. Rather, he continues to be taxable on the rents received and may deduct against them all proper expenses relating to the property other than capital cost allowance. Unless section 54.1 applies, however, any years after the fourth full year that the election is in effect will not count, for purposes of paragraph 40(2)(b) or (c), as years during which the property was his principal residence, but will count, of course, as years during which he owned the property.[28] It takes some crystal-ball gazing for a taxpayer to decide whether it is desirable to revoke his election with respect to a property that has been his principal residence, effective in the fifth year.[29]

28. See also Interpretation Bulletin IT-399, "Principal Residence — Rental by Non-Resident Owner" (November 14, 1977).

29. If he does and if the property until then has qualified each year as his principal residence under either subparagraph 54(g)(i) or (ii), then the entire gain on a deemed disposition at fair market value at that time could be exempt under para. 40(2)(b), but there would be no exemption for any subsequent growth in value. If he leaves his election in effect until the property is sold, then the entire gain will be apportioned equally, in effect, to each of the years when the property was held, and

A principal residence also falls within the meaning of "personal-use property", as defined in paragraph 54(f) of the act, but it does not qualify as the kind of personal-use property that is defined in paragraph 54(e) to be "listed personal property". This means that losses on the disposition of a property that accrued while it qualified as the taxpayer's principal residence will not be recognized for tax purposes, since they are regarded as consumption losses.[30]

IV. *Analysis*

Some of the myriad uncertainties and interpretation problems raised by the foregoing relatively brief provisions of the act have already been referred to. In this section, we shall consider several more, but by no means all, of these problems. Throughout the discussion it is well to keep in mind that assets having a very substantial aggregate value are being sheltered from tax by these rules.

In the definition of "principal residence" in paragraph 54(g), it is obviously necessary to exclude related land where the principal residence is a share of a cooperative housing corporation. The result, however, appears to be that there is no limitation on the size of the land, either per housing unit or in the aggregate, that the corporation may hold as part of its residential property, unless the land area is so substantial as to call into question the purpose for which the taxpayer acquired a share of the corporation. At the same time, the corporation itself is not exempt from tax on any gain that it makes on disposing of part or all of a residential building or associated land owned by it.

The half-hectare limitation seems arbitrary when one regards the vastly different needs for land of different types of housing and the substantial differences that one might expect in land areas between urban and rural residences.[31] Regardless of the area of land, certain burdens of proof rest on the taxpayer if the qualification of any part of his land as part of his principal residence is challenged by the

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a proportionate amount of the gain (subject to the "one plus" in the formula) will be allocated to the nonexempt years.

30. See subpara. 40(2)(g)(iii). This restriction may not apply, however, to a former principal residence that is not being personally used at the time that it is disposed of at a loss.

31. If, in the case of farming property, the taxpayer ultimately elects to use subpara. 40(2)(c)(ii), the area of the land associated with the principal residence becomes irrelevant.

department, but the nature of the burdens differs: if the land does not exceed half a hectare, the taxpayer, if challenged, must show that the land reasonably *contributes* to his use and enjoyment[32] of the housing unit as a residence; if the land exceeds half a hectare, he must show that the excess was *necessary* to that use and that enjoyment. Normally, however, the department will not question the qualification of the related land if its area does not exceed half a hectare.[33]

No guidance is offered, either in the act or in departmental pronouncements, as to how the lines are to be drawn on the ground if the land exceeds half a hectare and the taxpayer cannot meet his heavy burden of proof. As well, if some but not all of the excess over half a hectare is proved to be necessary, it appears that no part of the excess will qualify.

A principal residence, then, might consist of:

1. a house, or portion of a house (or a condominium), and the related land or a portion of the related land — part or all of which might be held jointly or (by Departmental interpretation) in common with another person, who may, but need not, be the taxpayer's spouse, or (probably) jointly or in common with two or more other persons; or
2. a leasehold interest in a housing unit, whether or not owned jointly or in common with another person. It is not clear whether a leasehold interest in land relating to the housing unit also qualifies, but if it does, the land relating to the housing unit would prima facie be confined to half a hectare, unless the taxpayer can meet the heavy burden of showing that, because of the size and location of the building and the number of its tenants, or for some other good reason, a larger piece of land was necessary for *his* use and enjoyment of the housing unit as a residence. If he cannot sustain this burden of proof, some interesting questions will arise concerning the appropriate apportionment of his cost and his ultimate proceeds of the leasehold interest between housing unit and qualifying land, on the one hand, and nonqualifying land, on the other (a similar problem can arise where the housing unit is a condominium apartment in a large apartment building); or

32. Obviously, the draftsman has failed to recognize that, where the property is not occupied by the taxpayer but is occupied by one or more members of his immediate family, the relevant use and enjoyment should be that of the family members who occupy the property.

33. See generally, Interpretation Bulletin IT-120R2, n. 19, *supra*, paras. 10-13; *Madsen* v. *M.N.R.*, 81 DTC 1, [1980] C.T.C. 3022 (Tax Rev. Bd. — under appeal); *The Queen* v. *Yates*, 83 DTC 5158, [1983] C.T.C. 105 (Fed. Ct. T.D.).

3. a share of a cooperative housing corporation, whether or not owned jointly or in common with another person.

While only an individual taxpayer, and not a corporation, can own a principal residence, we have seen that, in certain circumstances provided for in subsections 40(4) and (5), a trust (which for most purposes of the act is considered to be an individual)[34] may own a principal residence. If the taxpayer has one or more co-owners, it appears, despite some weaknesses in the wording of paragraph 54(g), that only the taxpayer's proportionate interest in the property can represent his principal residence.[35]

It is implicit in paragraph 54(g) and explicit or implicit elsewhere in the act and in its regulations[36] that a building and the related land are two distinct properties, even if they both qualify as a taxpayer's principal residence. Yet the implications of two distinct properties qualifying as a single principal residence have not been properly addressed either in the legislation or in departmental interpretations of it.[37] Consider, for example, the careless wording of paragraph 40(2)(c), which refers only to "land" in a context where this term was presumably intended to include one or more buildings.

The requirement, for an election to be available under subsection 45(2) on a change of use of what has been a principal residence, that both subparagraph 45(1)(a)(i) and paragraph 13(7)(b) apply can only relate to the building component of the taxpayer's principal residence and not to its land component, which is not depreciable property and is not subject to section 13.[38] Consequently, it should follow that, even if an election is made, the land ceases to qualify as

34. See subs. 104(2).
35. See also *The Queen* v. *Mitosinka*, 78 DTC 6432, [1978] C.T.C. 664 (Fed. Ct.T.D.); Interpretation Bulletin IT-437, "Ownership of Dwelling Property" (September 10, 1979).
36. See, for example, s. 68 and the related case law; Income Tax Regulations subs. 1102(2) and Schedule II, Class 8, subpara. (*i*)(i).
37. See, for example, Interpretation Bulletin IT-120R2, n. 19, *supra*, para., 14. Compare the confusion created by the definition of "former business property" in subs. 248(1), which seems to refer to two properties, and subs. 44(6), which treats the land and the building as a single property: the depreciable and the nondepreciable elements — that is, the building and the land, respectively — must still be segregated in order to apply subss. 13(4) and 44(1). Somewhat similar confusion is created by Income Tax Regulations subs. 1100(14), which refers to a rental building but ignores the related land, which is appropriate for purposes of Income Tax Regulations subs. 1101(1ac) but not for purposes of paras. 1100(11)(a) and (b) in those regulations.
38. See Income Tax Regulations subs. 1102(2).

a principal residence on the change of use. Obviously, this result was not intended by the draftsman and is being ignored by the department.

The confusion in interpretation becomes particularly relevant where the taxpayer holds vacant land for one or more years before constructing his residence on it. The department says that:

> Where a taxpayer acquires land in one year and constructs a residence on it in another year, he may not designate the property as his principal residence until the taxation year in which he commences to ordinarily inhabit the residence. The prior years, when he owned only the vacant lot (or the lot with a residence under construction) would not be included in the numerator of the formula in paragraph 40(2)(b). However, in determining the number of years during which the taxpayer owned the "property" referred to in the denominator of the formula, all years commencing with the year during which he acquired the vacant land would be included. Therefore, it is possible that when the principal residence is later disposed of only part of the gain may be exempted under paragraph 40(2)(b). For example, where a taxpayer acquired vacant land for $15,000 in 1972, constructed a residence on it costing $45,000, which he started to ordinarily inhabit in October 1975, and disposed of his principal residence for $90,000 during 1977, the taxpayer would realize a capital gain of $30,000 of which $20,000 ($\frac{1+3}{6}$ × 30,000) would be exempt.[39]

Apart from creating a trap for the unwary, this interpretation is at least arguably incorrect. Instead, the land and the building could be treated as separate properties, which ultimately come together to form a single principal residence, and the formula in paragraph 40(2)(b) could apply separately to each. Thus, using the department's example and assuming that one-third of the total proceeds of $90,000 (that is, $30,000) represented proceeds of the land and that construction of the residence had started in 1974 or 1975, the gain on the land would be $15,000, of which $\frac{1+3}{6}$ × $15,000, that is, $10,000, would be exempt. The gain on the building would be $15,000, all of which would be exempt. By this approach, the total capital gain to be recognized on the land and building would be $5,000 (land only), as compared with $10,000 under the department's interpretation.

For a property to qualify as a principal residence under paragraph 54(g), it is not necessary that it be situated in Canada. For example,

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39. Interpretation Bulletin IT-120R2, n. 19, *supra*, para. 19.

a condominium in Florida will qualify if it meets the requirements of that paragraph. As we have seen, however, if the taxpayer himself is not resident in Canada at any time in a particular year, that year will not count in the numerator of the formula in paragraph 40(2)(b) or under clause 40(2)(c)(ii)(B).[40]

The recent amendments to subparagraph 54(g)(iii) may set the stage for acrimonious family disputes. Where, in one or more years after 1981, two or more members of the same immediate family own separate properties that, were it not for that subparagraph as amended, would qualify as their respective principal residences, the first of them to dispose of his or her property and to designate it as a principal residence for that year or those years will preclude the other or others of them from making such a designation with respect to his or their property or properties. If this situation is not foreseen and provided for in a separation agreement, it could apply, after the separation of spouses, in respect of years before the separation. As well, the nuisance of having a second "valuation day" imposed by subsection 40(6) for one or more of two or more residences which were owned by members of the same immediate family at the end of 1981 is not likely to be popular with them, though it may affect only a relatively small number of families.

The provisions of section 54.1, while welcome in a limited number of cases, will create a state of continuing uncertainty concerning the tax status of the rented residence after the fourth year following the making of an election under subsection 45(2) with respect to a former principal residence. That status for all intervening years will not be clarified until the taxpayer returns to occupy the property within the time limits provided for by paragraph 54.1(1)(a) or dies while the employment in question continues — in which case the clarification is positive — or he sooner disposes of the property, or designates another principal residence for those years, or the new place of employment or place of residence shifts to within the prohibited distance, or the taxpayer or his spouse commences to work for another employer (even if that other employer is a member of the same corporate group and a successor to the business of the former employer) — in which case the clarification is negative. This uncertainty may continue for many years. No provision is made for relief if the building is destroyed, or the property is expropriated, before one of the events

40. *Id.;* see also paras. 2, 39-42.

referred to in paragraphs 54.1(1)(a) and (b) occurs, even if it is replaced by an equivalent property; nor is there any relief if the taxpayer or his spouse must retire from the employment in question because of serious illness or injury and he or she dies after the employment terminates, and, because of the illness or injury, he or she was not able to reoccupy the original residence.

If the taxpayer is moving because he or his spouse changed employers, there is a danger that section 54.1 will not apply, since the relocation must occur while he or his spouse is currently employed by a qualifying employer. Consequently, it would be wise in that situation to attempt to arrange to have the new contract of employment commence before the move takes place. It is not clear why these restrictions are necessary: the equity seems to be the same where the taxpayer moves to look for work and whether the gainful activity takes the form of carrying on a business (which does not qualify under section 54.1) or being employed by someone else (which does).

It is not clear whether subsection 40(5) can apply to a trust which was created before 1972, but which meets all the requirements of subparagraph 70(6)(b)(i) or 73(1)(c)(i) to be a qualifying spousal trust. If so, the occupation of the property by the beneficiary spouse in years after 1971 would potentially qualify the property to be designated as the principal residence of the trust for those years. In the department's view, where a residence owned by a qualifying spousal trust is designated by both the trust and the beneficiary spouse as the principal residence of the trust for a particular year, the spouse may not designate another property as his or her principal residence for that year.[41] But this conclusion seems doubtful, given the strict language of subsection 40(5) and subparagraph 54(g)(iii), and this question is not affected by the recent amendments to subparagraph 54(g)(iii). If, in fact, the spouse in that situation can designate a simultaneous principal residence for himself or herself, there is obviously an unintended "loophole" in the relevant provisions.

It appears that subsection 40(6) may have inadvertently reduced what otherwise would be the tax burden, in some cases, on the sale of a property that has been a family's sole principal residence since before 1982. For example, assume that the property was bought in 1979 at a cost of $80,000 and that it qualified as a principal

41. Interpretation Bulletin IT-366, n. 21, *supra*, para. 10.

residence for one of the three calendar years ending before 1982; assume also that its fair market value at the end of 1981 was $110,000, that it qualified as a principal residence for three of the next four years, and that it is sold in 1985 for $170,000. If subsection 40(6) were not in the act, an application of the formula in paragraph 40(2)(b) would result in a capital gain in 1985 of $25,714. Applying subsection 40(6), the gain cannot exceed the sum of the gain that would have resulted on a disposition at fair market value at the end of 1981 ($10,000) and the gain that would have resulted if the property had been acquired at its fair market value at the beginning of 1982, and the taxpayer could not claim a second benefit from the "one plus" in the formula ($15,000), or a total of $25,000. The gain that must be recognized would, thus, be reduced from $25,714 to $25,000.

V. *Conclusions*

What began as a relatively simple proposal to exempt a homeowner from tax on capital gains made on the disposition of his principal residence has become a morass of complexity, uncertainties, and anomalies, and some of the original objectives of both the tax on capital gains and the principal-residence exemption from that tax have become obscured in that process. The result is not atypical of many other aspects of "tax reform" in Canada.

What, then, is the price of tax reform? We can include legislative complexity, instability, and uncertainty; inequity among taxpayers who are affected differently by the rules without any justification for the differences; administrative headaches for the department; and compliance problems for taxpayers, at least some of which entail a monetary cost. Is it tax reform at all? Some have suggested that the process should have been called "tax deform".

Were these results inevitable? In precise terms, of course they were not, but it can be asked whether they were in general. Furthermore, there is every indication that the objectionable features of the present rules relating to principal residences will multiply, rather than diminish, as time goes on — perhaps in part in an effort to deal with some of the remaining difficulties referred to in this article, and thereby creating a whole new set of uncertainties and interpretation problems. The "refinement" process appears to have become a monster that feeds on itself.

Perhaps a different approach to legislative drafting and a different administrative philosophy could have made tax reform work with

respect to principal residences and with respect to other aspects of Canadian income tax law. This possibility, however, remains to be demonstrated. Are there any politicians, bureaucrats, or potential royal commissioners who are brave enough to try again?