PRENTICE YATES & CLARK
CHARTERED PROFESSIONAL ACCOUNTANTS

info@pyc

the newsletter of Prentice Yates & Clark

Fall 2021

*110 Sheppard Ave. East,
Suite 800
Toronto, Ontario
M2N 6Y8*

*(416) 366-9256
1 (800) 265-7818
Fax: (416) 366-9171
Web: www.pyc.net*

Four common questions about the CRA's principal residence exemption

CPA expertise can help clients maximize this exemption and minimize taxes when it is time to sell property.

When filing personal income tax returns, how to report a property sale can be confusing and expensive, dependent on value appreciation and the capital gains tax owed. Luckily, under Canada's *Income Tax Act* (ITA), the sale of a residence can be exempted from this tax under the Principal Residence Exemption (PRE).

CPAs will remember that in 2016 the CRA required the sale of principal residence to be reported on the seller's income tax in order to qualify for the PRE and to tighten up eligibility requirements.

With this in mind, there are several things Canadian property owners need to consider when filing for PRE, particularly if they own multiple properties. Here are four questions clients may ask you and how CPAs can adequately respond.

1. How long do I need to live in a residence to claim it as a principal residence and qualify for PRE?

The CRA does not specify an exact duration of time an individual or their family members, including a spouse, common-law partner or children, must reside in a dwelling for it to qualify as a principal residence for a given year. The tax rules refer to the residence being "ordinarily inhabited" within the calendar year, which is a relatively low bar. A more significant issue is whether a property held for a short period will produce an income gain or a capital gain when sold.

Clients should beware that the CRA will analyze evidence, such as length of time in the dwelling, sources of income and real estate buying patterns, to establish if the dwelling is indeed a principal residence or perhaps part of a business venture, such as real estate flipping.

"If the CRA challenges your claim of exemption, they're going to look at all the facts in the scenario," says CPA Michael Espinoza, senior manager, national tax office, Grant Thornton LLP. "[Such as] what was your intention of moving in and did something happen that forced you to sell [the property]?"

2. Can other properties, such as a cottage, be designated a principal residence and eligible for PRE?

Most properties (home or cottage, for example) can be designated a principal residence – even those seasonal residences located outside of Canada, such as in the U.S. or Caribbean – as long as the owner or their family ordinarily inhabit it during each calendar year being claimed.

Clients should be aware that only one property per year, per family (spouse or common-law partner and children under 18), can be designated a principal residence. Although it is becoming rare now, each spouse can designate a different property as a principal residence for years before 1982. Once sold, a property that isn't deemed a principal residence will be subject to capital gains tax for the years it was not designated. A gain may also arise if the residence is designated for some, but not all, of the years of ownership.

There is also a restriction on land size that qualifies for the PRE. Property that exceeds one-half hectare (roughly 1.2 acres) will generally not qualify for the exemption. For example, if the property is a farm, only one-half of a hectare of land plus the home would qualify for the exemption, while the remaining acreage would be subject to capital gains tax based on value appreciation. If the excess land is required for the use and enjoyment of the property, then the land that qualifies can be larger. However, CRA is very restrictive when applying this rule.

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Four common questions about the CRA's principal residence exemption - continued

When selling one of multiple properties owned, an owner can designate it as a principal residence for all or part of the years of ownership to take best advantage of the exemption and minimize the amount of capital gains tax paid.

"Generally speaking, it makes sense to designate the property that has the highest average gain per year of ownership," says Bruce Ball, FCPA, vice-president of taxation at CPA Canada. "However, there are a number of factors to consider and getting advice from a CPA may help reduce your tax."

Clients should speak to a tax professional to assess how best to calculate this, experts say.

3. Can a property that generates income be deemed a principal residence and eligible for PRE?

The mandatory income tax reporting of a principal residence sale was introduced by the CRA to limit when the exemption could be applied. Overall, it increased monitoring over foreign property ownership, "quick flips" or short holdings (on properties that may not qualify for principal residence status), properties that were not "ordinarily inhabited" every year by the owner, a well as serial builders who build and occupy a property before selling it.

Therefore, property that is used mainly to generate income or that is considered inventory does not qualify for PRE. This includes property that is solely rented out on a long- or short-term basis, or one where the owner occupies one unit and rents out the others.

Exceptions include renting out property for the short term, such as a cottage for a couple of weeks in the summer or a house as an Airbnb while on vacation, which an owner occupies otherwise; and if a family member (spouse or common-law partner or child) rents out the property.

"If, for the most part, you are using [the property] for your own purposes ... then it will qualify for a principal residence, even if you use Airbnb," says Espinoza. "Which means you could have people coming in frequently, as long as you are living there [regularly, in some capacity]."

4. What penalties are incurred when the sale of a principal residence is not reported to the CRA?

If an owner fails to report the selling of a principal residence, they could be subject to a late-filing penalty of $100 per month, up to a maximum of $8,000, **according to the CRA**. In addition, if an owner doesn't report the sale, the exemption may be denied and therefore the owner would be taxed on the capital gains.

"Although the new reporting requirements have been in place for several years now, many individuals may still believe that they do not have to report the sale of the principal residence when they only own one property," Ball says. "Failing to report the sale can result in significant costs."◆

Four threats to watch out for when a hacker gets your phone number

The more personal information we supply online, the greater at risk we are of identity theft, experts say.

Passing out your digits is all it takes to put you at risk of identity theft, warn cyber-security experts.

From account profiles to online registration forms – be it for retailers, hospital records or social media platforms – we are supplying personal information digitally without hesitation or regard for the implications.

"If someone has your phone number, they are likely to have other identity elements as well, so don't be surprised," says Claudiu Popa, a certified security and privacy risk adviser and CEO of Informatica Corporation, a Canadian cybersecurity consulting firm.

In a world where our offline and digital identities are symbiotic, here are some identity theft scams, and mitigation tactics, to watch out for.

1. Spoofing to scam

You've likely received several of these spammy, or spoofing, calls. The caller poses as police, the Canada Revenue Agency, or the immigration service, demanding payment and threatening jail time, deportation, and so on. Many are falling victim to a potentially financially devastating scam, warn experts.

"If [call recipients] don't have that level of awareness, they are a sitting duck, and that's who [spoofers] are hoping to catch," says Popa.

According to the Canadian Anti-Fraud Centre, these scams have defrauded Canadians of more than $16.7 million since 2014. It has become so prevalent that the Canadian Radio-television and Telecommunications Commission recently **ramped up its efforts** to combat it. The commission will require telecom service providers to implement, by next September, a new framework called STIR/SHAKEN (Secure Telephone Identity Revisited/Signature-based Handling of Asserted Information Using Tokens) technology, which enables the recipient to determine before answering whether the call is suspicious or not. In the meantime, the commission, now requires, as of Dec. 19, that these providers block calls with numbers more than 15 digits long or that can't be dialed (such as those with a string of letters or zeros), or provide more advanced call-filtering services.

"Legislation would put the responsibility back on the organizations, and that will hit the cellphone carriers," says Matt Coveart, identity theft expert at DragonFly I.D., an identity restoration service provider. "They are going to have to do more."

Four threats to watch out for when a hacker gets your phone number - continued

Mitigate it

- Avoid answering any calls received from unknown numbers.
- If you do answer the call, immediately hang up and do not answer any questions.
- Never give out any personal information (such as social insurance numbers and banking information) without verifying the request is legitimate.
- Report any calls received to the Canadian Anti-Fraud Centre.
- Keep abreast of offerings by your mobile provider to help stop these calls

2. Porting for profit

Identities are now being compromised by phone porting, whereby the fraudster, with phone number in possession, links that phone to another SIM card, enabling access to its apps, cloud and email accounts and more.

From there, the fraudster may call the mobile service provider, impersonating the phone owner and make account changes or report the device lost or stolen. They may change passwords on accounts using the "forgot password" option, gaining access through verification codes now sent to them.

Meanwhile, victims may be locked out of their accounts, unable to call, text or use data. They may fall prey to extortion threats or have their bank accounts drained and credit cards racked up.

"It's very targeted. They find an old cellphone bill and try to leverage that information. The representatives believe the device is stolen or lost," says Coveart. "They [cyber criminals] say they would like to have the phone ported to another device. Once it's ported to that device … there are all sorts of impersonation scams from that point."

Mitigate it

- **Protect your personal information.** Cautiously fill out online forms, only entering what you absolutely need to. Does this company really need your date of birth, gender or marital status? Is it even legal to request it?
- **Contact your mobile service provider** to find out what additional security measures are available if your phone is lost or stolen, or has been compromised.
- If your identity is hacked, **report it to the Canadian Anti-Fraud Centre** and your local police force, and immediately contact your financial institutions and credit bureaus.

3. Phishing for vulnerability

According to security firm Wandera, 83 per cent of phishing attacks in 2019 took place in text messages or in apps. Meanwhile, a recent IBM study reported that users are three times more vulnerable to phishing attacks on a mobile device than a desktop.

Hackers know this, and target accordingly. Similar to email phishing, these fraudulent requests may be urgent or threatening, demanding payment or personal information, and/or encouraging users to click on ransomware-infected links or attachments. They may also be simple requests, including account updates or password confirmations.

"What people don't understand about ransomware is that your data gets stolen first," says Popa. "So that [info] goes out there and it just joins the masses of personal information that is available about anyone going forward and forever."

Mitigate it

- **Never respond** to (or click on) suspicious messages, links or attachments sent via text or apps.
- **Report suspicious messages** to your mobile service provider, and anti-fraud centre.
- If the message sent looks legitimate, **contact the alleged sender** (i.e., your bank) before responding or entering any information to confirm receipt.
- **Update any passwords/log-in credentials** associated with targeted accounts.

4. Mining for identities

With access to one piece of personal information, fraudsters can mine for more data to piece together an identity, Popa says. With the amount we share online – from birthdates, to family members, to marital statuses, to employers – we make it easy for them, he adds.

A quick search of a phone number, he says, can lead to its mobile service provider. One phone call to that provider can reveal account details when the right questions are asked. One account detail can direct to a social media account. Furthermore, Popa adds, fraudsters can use data they collect from multiple individuals and combine the information to create virtual people.

"It could be a phone number. It could be a picture. It could be a home address, social media profile. Any one of these identity elements can give rise to an opportunity to gather more data about an individual," he says.

"You can mix someone's social insurance number with someone's home address and suddenly you don't have someone who really exists. That's called a synthetic identity … and you can multiply your opportunities for making money."

In an internal report completed last August, and obtained by the Canadian Press through an Access to Information request, Privacy Commissioner Daniel Therrien called out federal political parties for not adequately protecting Canadians personal information and misusing voter data without proper consent. The report states that Canadian privacy policies fall short on setting limits on how data is used, how long it is kept, whether it is accurate, and how it is safeguarded through security systems.

Mitigate it

- When possible, **create distinct digital identities** across platforms and accounts using pseudonyms or nicknames, different email addresses, fake birthdates, and so on, advises Popa. Keep track of this information for customer service. "People need to understand one thing. The person that they are in real life is different than the digital identity that they have online. Divorce these two concepts," he says. "The way they do that, is to be as pseudonymous as possible online."
- **Use an offline password manager** and database to keep track, creating new and distinct passphrases, rather than passwords (minimum of 12 characters, including spaces and punctuation), advises Popa. "Type in a sentence. It's much easier to remember and it's less likely to guess it."◆

An article in our previous newsletter contained an error. The description of the RRSP contribution deadline should have read, "The contribution for the year must be made by the 60th day of the following year – so, close to the end of February or beginning of March."

FIRE: What is it, and what can we learn from it?

Financial Independence Retire Early, also known as FIRE, is a people-driven movement to earn, save and invest aggressively. The ultimate goal? Being able to leave full-time employment at a much younger age, often in your 30s or 40s.

It may not mean retiring completely, but perhaps opting to work part-time, or transitioning to a career that provides more personal satisfaction but less financial security. The internet is full of websites and blogs where people share their **FIRE experiences and achievements**.

FIRE is not for everyone. It appeals to younger workers who have longer earning and savings potential, but the aggressive savings targets of 50 per cent or more of take home pay may not be achievable for lower income workers whose basic needs make up a greater proportion of their total expenditures.

However, **Brandon Ganch**, an avid FIRE blogger, thinks any FIRE step can be a step in the right direction. “Even if you make little money, just making your spending more conscious and efficient can be helpful to anyone,” he says.

A more conscious financial outlook

There are some valuable takeaway lessons in FIRE for all of us. Perhaps the most important is that FIRE focuses our attention on assessing our current financial health and thinking about our future financial needs. How much do you actually spend each month? How much of that is on "needs" and how much is on "wants"? What will your ideal retirement look like? How much will that cost?

Many Canadians of all ages cannot answer those questions. A **2018 study** by the Aegon Centre for Longevity and Retirement reported that 72 per cent of Canadians were somewhat aware or very aware of the need to plan financially for retirement, while only 44 per cent have a well-developed financial plan for their retirement and 13 per cent don't have a plan at all.

The same study also found that 51 per cent of Canadians are retiring earlier than they had planned to, but only 22 per cent of those were doing so for “positive” reasons, such as an unexpected financial windfall, like an inheritance, or realizing that they had saved enough for retirement and could therefore stop working. The remaining 78 per cent retired earlier than planned because of their own ill health, a job loss, family responsibilities or other reasons.

Smart spending and saving

Tracking your spending carefully is the first step in answering those questions, especially to determine how much is spent on your needs versus discretionary spending. This process may seem straightforward, but in practice the lines can be blurry sometimes. You may feel that you need your morning cup of coffee to function but the non-fat pistachio latte version may fall more into the wants category. When you track your spending, it becomes very clear how much some of those wants are eating into your cash flow. Cutting out spending that does not support your short-term or long-term goals will boost your savings.

The other side of the savings equation to consider is increasing your income. This can be achieved by changing your job or negotiating an increase in pay, taking on a side hustle, or even purchasing a rental property. In fact, some of those popular FIRE websites and blogs often turn into a successful side hustle for their creators – transforming them into FIRE influencers!

Values-based budgeting and credit

Many people think of budgeting as an unpleasant, punitive experience, to be avoided at all costs, yet the principles of FIRE can help you understand that budgeting is really about evaluating and aligning your spending with your values and priorities, once your needs have been covered. You can decide whether to spend money now on a hobby that brings you pleasure, or you can save and invest that money to fund your retirement. Either way, the key is making a conscious, well-informed decision.

“Once you find the true meaning of enough, buying yourself more than enough doesn’t really make you any happier,” says Pete Adney, also known as **Mr. Money Moustache**, a father figure in the FIRE community.

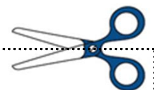
One concern that has been raised about FIRE is that some advocates argue that it is better to use your credit card to pay for everything, since this makes tracking your expenditures easier and you can earn rewards for your spending. There are even many active online forums to help you determine which is the best credit card for rewards. Yet studies consistently show that **people spend more** when using a credit card rather than cash, so this option does require more self-discipline. That said, the negative impact should be minimal for most following FIRE principles since the movement advocates for more mindful spending.

Happiness is an investment

If you are following the FIRE path, you may think it makes sense to stay at a job you hate that is financially rewarding, just so that you can retire early and find something that you love to do – but this is hardly a recipe for a happy life. Plus identifying what you want to do in your retirement can be challenging, especially if your spouse or friends are not also retiring at the same time.

We are often defined by our professions, what we do, who we work for. Even if retirement is something we plan for and look forward to, this can be a significant adjustment.

The essence of FIRE isn’t really all that new – live within your means and save money for the future. As Charles Dickens wrote in *David Copperfield*, first published in 1849, “Annual income twenty pounds, annual expenditure nineteen nineteen and six, result happiness. Annual income twenty pounds, annual expenditure twenty pounds ought and six, result misery.” FIRE just brings this into the twenty-first century. ◆



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Prentice Yates & Clark,
Chartered Professional Accountants

Phone: 416-366-9256 / Toll Free: 1-800-265-7818

Fax: 416-366-9171

CONTACT	EXT.	E-MAIL
Partners		
Tom McGivney	233	tom.mcgivney@pyc.net
J.J. Pauze	230	jj.pauze@pyc.net
Paul Jaroszko	227	paul.jaroszko@pyc.net
Dionne Reid	232	dionne.reid@pyc.net

visit our website

www.pyc.net

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