

# Principal residence exemption – what you need to know

The principal residence exemption is a powerful tool allowing you to reduce or eliminate the capital gains tax realized on a principal residence. As many people understand, your personal home is not taxable, although the mechanics of reaching this conclusion is more complex. Below is an overview of what you need to know when selling, transferring, changing the use and designating your property as your principal residence to maximize the exemption.

## What property is considered a principal residence?

A principal residence includes a house, cottage, condo, an apartment or unit in an apartment building or in a duplex. You can find additional types of properties in Canada Revenue Agency's ("CRA") income tax folio [S1-F3-C2, Principal Residence](#). The property must meet the following four conditions:

1. The property meets the criteria as a property as defined in the Income Tax Act ("ITA").
2. You own the property alone or jointly with another person.
3. You designate the property as your principal residence.
4. You or your current or former spouse or common-law partner, or any of your children lived in ("ordinarily inhabited") the property at some point in the year.

Whether a property is ordinarily inhabited by any of the above-named people is always based on the facts. However, the CRA states it may be sufficient even if a person inhabits the property for a short period of time. This rule allows properties like vacation homes, summer properties, cabins and cottages used for personal use to qualify as a principal residence. Properties that have an income producing purpose (e.g. rental properties) generally don't qualify as a principal residence even if you inhabit it for a short period of time in the year. If you receive only incidental rental income from a housing unit, you may still be able to designate the home as principal residence assuming you meet all other conditions.

In addition to the building itself, you can include the land under the building and surrounding land as part of the principal residence. However, there is a limit on the amount of surrounding land you can include. The general rule allows you to include ½ hectare (approximately 1.25 acres) of adjoining land which is used as part of the enjoyment of the home. Land more than this amount is taxable unless you can show other factors (such as average lot size in the area or subdivision restrictions) cause the surrounding lands to be larger than the allotted amount.

You may also claim the principal residence exemption on property located outside of Canada. However, it's important to determine what tax implications you are facing in a foreign jurisdiction before designating a foreign property as your principal residence.

## Designating a property as your principal residence

You designate property as your principal residence on a year-by-year basis when you sell or transfer the property. You, or your "family unit" cannot designate more than one property for the same year. A family unit generally includes you, your spouse or common-law partner, and minor children. As you can only designate one property in any given year, where you own more than one property, you may have taxes to pay on that second property. If you owned a property prior to 1982, it's possible for each spouse to designate separately owned properties if they didn't both designate the same years of the same property. In these situations, consult a tax advisor for additional assistance. We discuss the optimal use of the exemption with multiple properties below.

When you sell or transfer your principal residence, you're required to report the disposition on your tax return for that year. Starting in 2017, you report the sale on Schedule 3, Capital Gains of the T1 Income Tax and Benefit Return and complete Form T2091 (or Form T1255 for deceased individuals). The relevant form in Quebec is TP-274. You can only claim the principal residence exemption in the year where the sale has been reported in your tax return.

## Principal Residence Exemption

The principal residence exemption on sale or disposition is based on the following formula:

$$A \times \left( \frac{B}{C} \right)$$

Where:

- A is your gain on the property
- B is 1 + the number of tax years ending after you acquire the property that you designate as your principal residence while you are resident in Canada. Since you can designate only one property as a principal residence for a tax year, the rules recognize that two properties may be owned in the same year. For example, where one property is sold and another acquired in the same year. The effect of the "plus one" in variable B is to treat both properties as a principal residence in the year, even though only one of them may be designated as such for that year. However, changes to tax legislation, which applies to dispositions after October 2, 2016, excludes this "plus one" rule where the taxpayer was not resident in Canada for tax purposes in the year they acquire the property.
- C is the number of tax years ending after the property's acquisition date, during which you own the property

Example:

Todd and Tina are both residents of Canada and purchased a home in 2002 for \$300,000. They haven't owned any other real estate and choose to designate all years of ownership as their principal residence. Todd and Tina decide to sell their home in 2018 for \$400,000.

$A = \$400,000$  (proceeds) -  $\$300,000$  (cost) =  $\$100,000$  capital gain

$B = 1 + 17 = 18$  years as all years of ownership designated as a principal residence

$C = 17$  years

The principal residence exemption ( $\$100,000 \times [18/17]$ ) creates an exemption that is greater than the capital gain on sale and therefore reduces the capital gain to nil.

## Multiple Properties – Optimizing the exemption

Many families have more than one personal-use property. The second property may be a summer vacation home or a winter cottage. In many cases, these properties may increase greatly in value compared to the home in the city. At the time of sale of either property, you must decide which years and property you'd like to designate as your principal residence. If you're selling only one property, you'll have to make assumptions about the future growth of the remaining property.

The general rule of thumb to optimize the exemption is to choose the property with the greatest increase in value. However, many factors go into this decision if there are unknown variables with the second property. You may choose to exempt the current sale from taxes even though it may not be the most efficient use of the exemption. This decision may come from the need for current cash flow and the desire to delay taxes until death.

Example:

John and Sally purchased their home in 2009 for \$100,000. Six years later in 2014, they purchased a cottage for \$100,000. Both properties were enjoyed annually until 2018 when they decided to sell both. They sold the home for \$200,000 and the cottage for \$160,000. In both scenarios, the principal residence exemption applies in varying degrees due to the "plus one" element in the formula. This allows them to claim some exemption on both properties even if they don't designate any years to one property.

2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
									Gain on home = \$100,000
									Gain on cottage = \$60,000

**Scenario 1:** Use the exemption on the home (cottage is taxable)

The capital gain on the cottage is \$60,000 and will result in taxes of \$11,520.

$(\$160,000 \text{ proceeds} - \$100,000 \text{ adjusted cost base}) \times (1 + 0 \text{ years designated} / 5 \text{ years of ownership}) = \$12,000 \text{ exemption}$ . Net gain of \$48,000 taxed at an assumed 24% capital gains tax = \$11,520 taxes payable.

**Scenario 2:** Use the exemption on the cottage (home is taxable)

The capital gain on the home is \$100,000 and will result in taxes of \$7,200.

$(\$200,000 \text{ proceeds} - \$100,000 \text{ adjusted cost base}) \times (1 + 6 \text{ years designated} / 10 \text{ years of ownership}) = \$70,000 \text{ exemption}$ . Net gain of \$30,000 taxed at an assumed 24% capital gains tax = \$7,200 taxes payable.

In this case, the years of ownership of the home is greater than the cottage. This allows John and Sally to use all years of cottage ownership to exempt the sale of the cottage. It still allows them to use some years of the home for a partial exemption on the sale of the home. In the end, you will want to review the tax effects of all situations prior to making a designation.

## Transfer of property

Transferring property to your adult child is a common estate-planning tool that many people use to avoid probate and ease administration of the estate. However, this type of planning has tax and legal consequences.

When transferring property to an adult child (even if done by way of gift), it's a disposition for tax purposes because you give up a portion of your interest to establish joint ownership. You can possibly use the principal residence exemption on this disposition to avoid a tax bill. However, your child will likely face tax on any future growth of the property for their proportionate interest, assuming they already have their own principal residence.

In addition to the tax consequences, transferring property early may:

- disinherit other family members from their fair share of your estate since a large asset generally bypasses the estate when jointly owned with rights of survivorship.
- result in land transfer tax in some provinces which may create an unneeded upfront cost.
- expose the property to creditors and marital claims of your adult child as the property is now an asset in their name.

We recommend you review any transfer of property to your adult child with your professional advisors prior to implementation.

## Change of Use

A change of use from personal use property to an income producing rental property or vice versa is typically considered a taxable disposition. When changing the ownership/use of a principal residence, you can use the principal residence exemption to mitigate the tax cost of converting a property to a rental property. However, future growth on this property will now become taxable. When you change the use from rental property to personal use, you include any gain or loss on the property in income in the year of change. You may also have to report recapture if you claimed depreciation on the rental property. You're also allowed to make a partial change of use of their property when you convert a portion of your home to a rental.

In all instances, whether changing to personal use or to rental, you may be able to defer the recognition of the gain to a later year by filing a tax election. You can elect under subsection 45(2) of the ITA to have no change in use when changing from principal residence to income producing. You cannot claim depreciation as an expense on the income property if you make this election. Similarly, you can elect under subsection 45(3) of the ITA to defer the gain on the change in use on a rental property. You cannot have claimed depreciation on the property when it was income-producing. In both cases, you recognize the gain when you later transfer or dispose of the property or rescind the election. In addition, you may be able to claim up to four years of ownership as your principal residence even if you didn't ordinarily inhabit the property. When making a change of use, discuss these elections with your tax professional.

Generally, the CRA doesn't apply the deemed disposition rule when the rental portion is small in relation to the property's size, no major structural changes were made, and you aren't deducting capital cost allowance when calculating the rental income.

### The bottom line

The principal residence exemption is not only used when there is a sale of a primary home. It can impact you if you own multiple personal use properties and need to decide how to maximize the exemption. It also impacts you if you change the use of your property from personal use to income producing and vice versa. We recommend you review it when you transfer the home or cottage to children even if done as a gift. Consult your tax advisor when dealing with principal residence issues to ensure you are aware of the tax and legal consequences.

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