# Principal residence exemption – What you need to know

In general, the principal residence exemption is a powerful tool that allows you to reduce or eliminate the tax associated with a capital gain 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. This article will provide an overview of what Canadians need to know when selling, transferring, changing the use and designating your property as their 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.[1] The property has to 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 considered ordinarily inhabited by any of the above-named persons is always based on the facts. However, the CRA has stated that 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 a purpose of producing income (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.[2]

In addition to the property itself, you can include the land on which the property is situated and surrounding land as part of the principal residence. However, there is a limit on the amount of land you can include. The general rule allows you to include ½ hectare[3] of (adjoining) land which is used as part of the enjoyment of the home. Land in excess of this amount would therefore be considered taxable unless it can be shown that 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 is 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. No other property may have been designated by either the taxpayer or their "family unit"[4] for the same years. As you can only designate one property in any given year,[5] where you own more than one property, you may have taxes to pay on that second property. We will discuss the optimal use of the exemption with multiple properties below.

On sale or transfer of a principal residence, you are 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[6] (or Form T1255 for deceased individuals). 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:

$$A \times \left( B / C \right)$$

Where:

- A is your gain on the property
- B is 1 + the number of tax years[7] ending after you acquire the property that you designate as your principal residence while you are resident in Canada[8]
- C is the number of tax years ending after the property's acquisition date, during which you owned the property

*Example:*

Todd and Tina are both residents of Canada and purchased a home in 2002 for $300,000. They have not owned any other real estate while owning this property and have chosen to designate all years of ownership of this home 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 were designated a principal residence C = 17 years

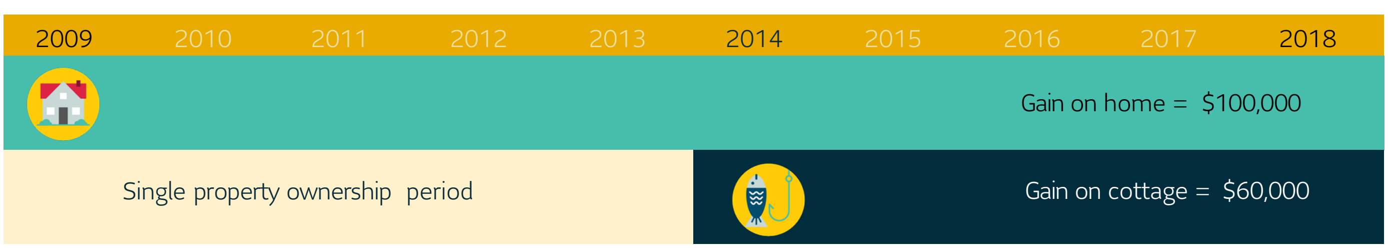
The principal residence exemption $100,000 x (18/17) creates an exemption that is greater than the capital gain on sale and therefore reduces the capital gain to nil.

## Multiple Properties – Optimizing the exemption

Many families have more than one personal-use property. That 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 of the properties, you will have to decide which property you would like to designate as your principal residence. Where you are selling only one property, assumptions are made 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. Many people will 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. 6 years later in 2014, they purchased a cottage for $100,000. Both properties were enjoyed annually until 2018 when they decided to sell both properties. The home was sold for $200,000 and the cottage was sold for $160,000.




*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.[9]

*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.[10]

In both scenarios, the principal residence exemption applies in varying degrees due to the 1+ element in the formula. This allows an exemption on the cottage even where no years were designated. 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 should review the tax effects of all situations prior to making a designation.

## Transfer of property

Transferring property to your adult children is a common estate-planning tool that many people use to avoid probate and ease administration of the estate. However, this type of planning doesn't come without tax and legal consequences.

When transferring property to an adult child (even if done by way of gift), it is a disposition for tax purposes as 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 while alive may:

- disinherit other family members from their fair share of your estate as a large asset generally bypasses the estate due to joint ownership being established;
- result in land transfer tax in some provinces which may create an unneeded upfront cost; and
- 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 are 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 have the ability to defer the recognition of the gain to a later year by filing a tax election.[11]

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

## Summary

The principal residence exemption is not only used when there is a sale of a 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. Further, you should review it when you transfer the home or cottage to children even if done as a gift. Please make sure to consult your tax advisor when dealing with principal residence issues to ensure you are aware of the tax and legal consequences.



Published and revised by: Estate & Financial Planning Services

Last revised: January 2023

[1] Principal residence is defined in Section 54 of the Income Tax Act ("ITA"). You can find additional types of properties in Canada Revenue Agency's ("CRA") income tax folio S1-F3-C2, Principal Residence.

[2] A taxpayer receiving only incidental rental income from a housing unit is not considered to own the property mainly for the purpose of gaining or producing income and therefore, would still be able to designate the home as principal residence assuming all other conditions are met.

[3] ½ hectare is approximately 1.25 acres

[4] A family unit generally includes the taxpayer itself, the spouse or common-law partner, and minor children. Where the taxpayer is under 18 years of age or is not married or is not in a common-law partnership, the family unit extends to the parents and siblings under the age of 18.

[5] Where a property has been owned prior to 1982, it was possible for each spouse to separately designate owned properties as their principal residence (as long as they did not both designate the same years of the same property). In these situations, consult a tax advisor for additional assistance.

[6] The relevant form in Quebec is TP-274.

[7] A tax year for the purposes of this formula includes partial tax years where a property is bought or purchased part way through the year.

[8] Given only one property can be designated 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 residence is sold and another acquired in the same year. The effect of the one plus in variable B in the formula 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 one plus rule where the taxpayer was not resident in Canada for tax purposes in the year the property was acquired.

[9] $60,000 gain ($160,000 proceeds - $100,000 adjusted cost base) x (1 + 0 years designated / 5 years of ownership) = $12,000 exemption. Net gain of $48,000 taxed a 24% capital gains tax = $11,520 taxes payable.

[10] $100,000 gain ($200,000 proceeds - $100,000 adjusted cost base) x (1 + 6 years designated / 10 years of ownership) = $70,000 exemption. Net gain of $30,000 taxed a 24% capital gains tax = $7,200 taxes payable.

[11] A tax election under subsection 45(2) of the ITA deems there to be no change in use/status when changing from principal residence to income producing. No depreciation is allowed to be claimed as an expense on the income property, and the change in use/status can typically be deferred for only 4 years. Similarly, a tax election under subsection 45(3) of the ITA allows a taxpayer to defer the gain on the change is use/status on a rental property where no depreciation was claimed on the property. When making a change of use, discuss these elections with your tax professional.