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The principal residence exemption

Canada's capital gains exemption on a family's principal residence offers advisors a powerful way to help improve the financial wealth of clients. But the rules have changed in recent years, so it's important for advisors to have a clear understanding of the numerous rules that apply. The terminology can also be confusing. The concepts behind the terms can impact inheritance planning and are especially important for clients who own more than one property.

Definition and designation of a principal residence

In order for an individual to claim a capital gains exemption on the sale of a residence, it must qualify as a "principal residence".[1] A principal residence is defined as a housing unit (house, apartment or unit in a duplex, apartment building or condominium, cottage, mobile home, trailer or houseboat).[2]

In addition, the housing unit must be ordinarily inhabited in the year by the taxpayer (who is an individual other than a personal trust[3]), by his or her spouse or common-law partner, former spouse or former common-law partner, or child (not a parent). Whether a housing unit is "ordinarily inhabited" is a question of fact. As there are no requirements with regard to minimum time periods or continuous occupancy, it is possible to designate a seasonal residence that is occupied only during vacations or for only part of the year. A residence must be designated by an individual other than a personal trust as his or her principal residence for the year.

[1] Section 54 ITA *Income Tax Act (Canada)*, R.S.C. 1985, c.1, (5th Supp.) (ITA).
[2] CRA Income Tax Folio S1-F3-C2, "Principal Residence" (July 25, 2019), par. 2.7.
[3] There are special rules that apply to personal trusts.

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A family unit can designate only one principal residence for a particular year.[4] A family unit consists of the following persons:[5]

- the individual
- the individual's spouse or common-law partner (unless the spouse or common-law partner was living apart from the individual under a judicial separation or written separation agreement)
- the individual's child (unless the child was married, in a common-law partnership or 18 years of age or older during the year)

If the individual was not married, in a common-law partnership, or 18 years of age or older during the year, his or her family unit includes the following persons:[6]

- the individual
- the individual's parents
- the individual's brother or sister (unless married, in a common-law partnership or 18 years of age or older during the year)

If an individual disposes of a principal residence to his or her spouse and a tax-free rollover takes place,[7] ownership of the residence by the spouse is deemed to have started when the individual became the owner.[8] For example, an individual who has owned a home since 1998 passes away in 2019 and leaves the home to his spouse. She sells the house in 2020. For purposes of calculating the capital gains exemption, the spouse is deemed to have owned the home since 1998.

[4] Section 54 ITA, paragraph *(c)* of the definition of "principal residence", and section 274, paragraph 2*(b)* TA.
[5] Section 54 ITA, subparagraph *(c)*(ii) of the definition of "principal residence", and section 274, paragraph 2*(b)* TA.
[6] Section 54 ITA, clause *(c)*(ii)(D) of the definition of "principal residence", and section 274, subparagraph 2*(b)*(iv) TA.
[7] Subsection 70(6) or 73(1) ITA.
[8] Subsection 40(4) ITA and section 272 TA.

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Changes to the principal residence tax rules

In 2016, the gouvernment made changes to the principal residence rules. These amendments are summarized below.

Trusts

For taxation years commencing after December 31, 2016, trusts (other than qualified trusts) that own a principal residence will no longer be allowed to designate the property as a principal residence. Qualified trusts that will still be allowed to make this designation include:

- An alter ego trust (no age limit);
- A trust for the exclusive benefit of the settlor during the settlor's lifetime (alter ego – age 65 or over);
- A spousal or common-law partner trust;
- A joint spousal or common-law partner trust;
- A testamentary trust that is a "qualified disability trust";
- A trust for a minor child where the settlor and his or her spouse (the child's parents) have passed away before the start of the year.

For other trusts, transitional rules will allow capital gains accrued up to December 31, 2016 to qualify for the principal residence exemption on the basis of a notional disposition. Other, more complex, rules were incorporated into these amendments.

Clients to whom this situation applies should obtain an appraisal of the fair market value of the residence as at December 31, 2016, and consult a tax specialist to review their trust structure.

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Non-residents

For dispositions after October 2, 2016, the "1 +" rule will not be available upon disposition of a property for any individual who was not resident in Canada during the year that included the date the property was acquired.

Reporting a disposition

For taxation years ending after October 2, 2016, i.e., for 2016 and subsequent years, the actual or deemed disposition (for example, as a result of a change in use) of a property that is designated as a principal residence must be reported to the CRA on Schedule 3 of the T1 general return, even if the designation covers all years of ownership and the capital gain is fully exempt. Taxpayers who do not file this designation or report the disposition of real property could be liable for a penalty of $8,000 at the federal level and $5,000 at the provincial level in the event of a late-filed election. In addition, failure to report the disposition will mean that the taxation year in question will not be subject to the limitation period. However, checking off the box that says "I designate the property described below to have been my principal residence for all years owned" in order to avoid completing the prescribed form will result in the taxpayer losing the opportunity to designate the residence for one less year (the year of disposition). This simplified declaration is appropriate only where the taxpayer is not the owner of another residence during the year; this would include the purchase of a new residence to replace the first residence. While purchasing another residence in the same year should not cause any issues, it is possible that a second residence might be purchased in future. For this reason it's preferable to keep one year of exemption room.

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The principal residence exemption

Principal residence is a federal income tax concept that applies uniformly across Canada. Qualifying principal residences are exempt from Canada's capital gains tax. The taxpayer doesn't claim this exemption until he or she disposes of the property. A disposition includes a sale or deemed disposition arising from a gift or death.

The tax-free status doesn't depend on whether there are any actual proceeds received, i.e., the exemption can also eliminate capital gains tax triggered by a deemed disposition of the principal residence.

In order for a property to be designated as a taxpayer's principal residence for a given year, there must be ownership of the property by the taxpayer at some point during the year. This includes joint ownership – whether it is joint tenants in common, joint tenancy with rights of survivorship, or some other form of co-ownership.

A taxpayer can use the exemption only for periods when he or she owned a property. The exemption can even be allocated to different properties in different years.

Calculating the exemption

The principal residence exemption[9] is calculated according to the following formula:

$$A - \frac{(A \times B)}{C} - D$$

where

[9] Paragraph 40(2)*(b)* ITA and section 271 TA.

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A = Capital gain otherwise determined

B = (i) if the taxpayer was resident in Canada during the year that includes the acquisition date, one plus the number of taxation years that end after the acquisition date for which the property was the taxpayer's principal residence and during which the taxpayer was resident in Canada; or

(ii) if the taxpayer was not resident in Canada during the year that includes the acquisition date, the number of taxation years that end after the acquisition date for which the property was the taxpayer's principal residence and during which the taxpayer was resident in Canada.

The "1 +" is needed to prevent the loss of a year of exemption in respect of a residence when a person sells his or her principal residence and acquires another in the same year. As only one residence per year can qualify for the exemption, the "1 +" ensures that the exemption on the other home is not lost.

C = the number of taxation years that end after 1971 during which the taxpayer owned the property.

D = if the acquisition date is before February 23, 1994 and the taxpayer or the taxpayer's spouse or common-law partner made an election to be taxed on a capital gain that was exempt:[10]

- 4/3 of the lesser of:
  - the taxable capital gain designated in the election after deduction of the principal residence exemption;
  - the maximum capital gain that would have been reported and exempt if the amount designated in the election had been the fair market value of the residence as at February 22, 1994.

[10] Subsection 110.6(19) ITA and section 726.9.2 TA. This election allowed individuals to crystallize their accrued capital gain as at February 22, 1994 by means of a $100,000 capital gains exemption. The election had to be filed with the 1994 income tax return.

If the conditions for applying variable D are not met, the reduction (D) = 0.

1982 rules

From January 1, 1972 to December 31, 1981, both spouses could claim a capital gains exemption on a principal residence and, in some circumstances, taxpayers may still benefit from owning property dating back that far.

Since 1982, the rules on the principal residence exemption limit the election to one residence per couple. This tax rule applies to couples who meet the definition of "spouse" under the ITA. The definition includes not only those who are married, but also couples of opposite or same sex who have cohabited in a conjugal relationship for one year (or less if a child is born or adopted by the couple).

The residence can be located anywhere, even outside of Canada. Assuming all other requirements are met, an owner can sell a property abroad and still take advantage of the capital gains exemption here in Canada. However, there may be country-specific taxes or fees, or both, that apply when the property is sold.

Special opportunities for property owners between 1972 and 1981

As mentioned above, from January 1, 1972 to December 31, 1981, the capital gains exemption on a principal residence was available to each family member.

Two spouses could each own a residence and elect it as their respective principal residence to claim the capital gains exemption. This could have been used, for example, in situations where one spouse owned the house and the other owned the cottage.

Clients who own property dating back that far must complete the election formula in the ITA to determine whether they are subject to any taxable gain on the second property.

Tax optimization and principal residence

In cases where there is more than one residence, the question of which should be designated as the principal residence requires careful thought. Every situation is unique, especially where the ownership periods are very different.

Here is a good rule of thumb:

Step 1: Calculate the capital gain on each of the residences.

Step 2: Divide the capital gain on each of the residences by the number of years of ownership.

The residence with the highest capital gain per year should generally be designated as the principal residence. However, consideration should also be given to the time that is expected to elapse before a second disposition takes place. Where the second property will be owned for a long period of time, it may in some cases be preferable to reduce taxation on the capital gain as much as possible right away, despite a potentially larger gain a number of years down the road.

It is also important not to lose the "1 +" in the calculation formula and to use it on each residence.

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Illustration

Below is an example to illustrate how this works.

In 2006 a couple purchases a house for \$250,000. In 2013 they acquire a cottage for \$200,000 and spend the majority of their vacations there. In 2020 they sell their house for \$400,000; their cottage is worth \$250,000 at the time. Expenses for the sale of the house amount to \$5,000. The couple then purchases a new property the same year.

To determine the amount of the capital gains exemption on the house, we need to know whether the house should be designated as the principal residence from 2006 to 2019. As the value of the house has increased by around \$10,700 for each year of ownership (\$150,000 increase in value / 14 years), while the value of the cottage has increased by around \$7,000 for each year of ownership (\$50,000 increase in value / 7 years), it's more advantageous for this family to designate the house as its principal residence from 2006 to 2019. The new property will be designated as a principal residence for 2020. The couple has been resident in Canada at all times.

The capital gains exemption is calculated as follows:

$$A - \frac{(A \times B)}{C} - D$$

Where

A corresponds to \$145,000

Proceeds of disposition	$400,000
(Adjusted cost basis)	($250,000)
(Selling cost)	($5,000)
Capital gain	**$ 145,000**

B corresponds to 1 + 14 (taxation years 2006 to 2019)
C corresponds to 15 (taxation years 2006 to 2020)
D corresponds to 0

$$= \$145{,}000 - \left(\frac{\$145{,}000 \times 15}{15}\right) - 0$$

= $145,000 – $145,000
= 0

With the house as principal residence, the capital gain is fully exempt.

Required forms

To designate a property as a principal residence, a taxpayer must file form T2091(IND) with the CRA and form TP-274-V with Revenu Québec.

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Converting a principal residence to an income property

If a taxpayer converts a principal residence to an income property, he or she is deemed to have disposed of the property at fair market value and reacquired it immediately after at the same price. This can trigger a capital gain. However, the taxpayer may instead defer recognition of the gain to a later year and continue to own the property as a principal residence.

The converted property continues to qualify as a principal residence for up to four additional taxation years, provided the taxpayer has no other principal residence elected during this time, and provided he or she remains a Canadian resident. This election may be very valuable in situations where the taxpayer moves out of a property temporarily, converts it to an income property, but then moves back in at a later date. Deductions of capital cost allowances for the income property are not permitted during that time.

Principal residence and family law

The concept of family property (or family patrimony in Quebec) is a family law concept, and has nothing to do with income tax. The precise name and corresponding legislation vary from province to province. The matrimonial home is part of the assets that make up the "matrimonial property" or "family assets". In Quebec, for married or civil union spouses, there's a similar concept called "family patrimony" that includes, among other assets, the family residence and movable property intended for use by the family and owned by either spouse.

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In the event of a separation, where a couple owns two residences (for example, a home and a cottage) that might both qualify as a principal residence, it's important to determine who will use the principal residence exemption and for which years.

When spouses or their children use a residence, their use can create a "matrimonial home" status for the residence. The effect of this status is to limit the owner's right to deal with the property. The owner of a matrimonial home cannot sell or mortgage it without the other spouse's consent. This protection also exists in Quebec, where it is referred to as "protection of family residence". Some provinces permit multiple homes, and even rented premises, to qualify.

Matrimonial home status also affects who has rights to occupy the home. If a spouse with sole title dies, the surviving spouse may have special rights to remain in the home, regardless of who the title passes to. These are important limitations when it comes to estate planning for the owner with sole title. The non-titled spouse may also have special rights to a portion of the proceeds on marriage breakdown if the property is sold.

Spouses can usually agree by contract to alter or give up their rights attached to any particular property. The contract may be a pre-nuptial agreement, a marriage contract, or a separation agreement. In Quebec, a spouse may not execute in advance a renunciation (release) of interest and partition of the property making up the family patrimony. A spouse may, however, execute a renunciation upon death or upon the initiation of proceedings for dissolving the marriage or civil union.

Other considerations

- If the main reason for owning a housing unit is to gain or produce income, then that housing unit will generally not be considered to be ordinarily inhabited in the year by the taxpayer where it is inhabited for only a short period of time in the year. However, if the housing unit is rented to the taxpayer's child and the child ordinarily inhabits the housing unit in that year, the taxpayer could still designate the housing unit as the taxpayer's principal residence provided the other conditions are met.

- Special rules apply in situations where a principal residence starts being used for the purpose of producing rental income (change in use). In such a case, the taxpayer will be deemed to have disposed of the property at a price equivalent to its fair market value at the time he or she started using it for income-producing purposes.

- If a taxpayer acquires land in one taxation year, and constructs a housing unit on it in a subsequent year, the property may not be designated as the taxpayer's principal residence for the years that are prior to the year in which the taxpayer starts to ordinarily inhabit the housing unit. Such prior years (when the taxpayer owned only the vacant land or the land with a housing unit under construction) would not be included in variable B in the formula. Where the total area of the land upon which a housing unit is situated exceeds ½ hectare, the excess land is deemed not to have contributed to the use and enjoyment of the housing unit as a residence and thus will not qualify as part of a principal residence, except to the extent that the taxpayer establishes that it was necessary for such use and enjoyment. The excess land must clearly be necessary for the housing unit to properly fulfill its function as a residence and not simply be desirable.

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- Further details about the principal residence tax rules can be found in CRA Income Tax Folio S1-F3-C2, Principal Residence.

What advisors can do

As part of your fact-finding efforts with clients, property ownership and the timing of these purchases are important considerations in developing plans, both during the client's lifetime and for periods following death.

All examples presented in this article are for illustration purposes only. No one should act upon these examples or information without a thorough examination of their tax and legal situation with their own professional advisors after the facts of the specific case are considered.

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