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HollisWealth®

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TAX AND THE PRINCIPAL RESIDENCE

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Article by Keith Masterman

Generally in Canada there is no tax paid on the capital gain realized from the sale of a home owned by the taxpayer, provided it qualifies as a principal residence under the Income Tax Act. This means that a person may sell a principal residence without incurring a capital gain tax. Similarly, if a principal residence is owned when a taxpayer dies, the residence will not attract a tax liability realized from the deemed disposition of assets.

The rules surrounding a principal residence

A property does not have to be the place where the taxpayer normally lives. The property will qualify as a principal residence if the taxpayer, the taxpayer's spouse or common-law partner, or any of the taxpayer's children live in it at some point in time during the year. In many situations, depending on the increase in value of the family home and the family cottage, it is advisable to claim a cottage as a principal residence rather than the family home.

Further, the property does not necessarily need to be located in Canada. Depending on the facts, a Canadian may designate a foreign vacation property as a principal residence and qualify for the principal residence exemption.

However, there are some restrictions. For instance, after 1981 a taxpayer and their spouse may only have one principal residence at any particular time. Prior to 1982, each individual could designate one principal residence. Therefore, if a couple owned both a primary home and a cottage, the principal residence exemption is available for both properties for the period the properties were owned prior to 1982. For each year after 1981 the couple would be required to designate one of the properties a principal residence, claimable at the time a property is sold or deemed sold at death.

Also, if the residence is situated on a large lot, over 1/2 hectare, the taxpayer must be able to establish that any land over the 1/2 hectare is necessary for the "use and enjoyment" of the home.

Although the rules appear straightforward, certain situations present specific challenges. These include the ownership of properties greater in size than a 1/2 hectare, some rental properties, and properties that are purchased to be resold, such as condominiums.

Properties in excess of 1/2 hectare

In 2011 the tax court heard Cassidy v. the Queen. A taxpayer sold a home which was situated on 2.43 hectares of land. The taxpayer argued that since he was unable to legally subdivide the land, the entire property was necessary for his "use and enjoyment." The court held that the election to treat a home as a principal residence is made on a year by year basis. During most of the period of ownership the property could not be subdivided, and the court agreed with the taxpayer that the entire property was a principal residence. However, in the final year of ownership the zoning had changed to allow for land subdivision, so for that year only a half hectare of the property could be claimed as a principal residence. The remaining property was subject to tax on the gain in its value during that one-year period.

Rental property

A property must be ordinarily occupied for personal use, as opposed to business or commercial use, to be considered a principal residence. This may mean that where a taxpayer uses a portion of their residence as an income-generating apartment, the taxpayer may lose the principal residence exemption on the portion of the building constituting the apartment from that point forward depending on the circumstances. An exception to this rule normally applies if the income-producing use is ancillary to the main use of the property as a residence, there is no structural change to the property, and no capital cost allowance (CCA or depreciation) is claimed on the property. Also, where a residence is rented to a taxpayer's child who occupies the home as his/her residence, the taxpayer can still normally designate the home as the taxpayer's principal residence.

Canada Revenue Agency (CRA) recently issued an interpretation bulletin where a taxpayer had moved to a long term seniors' centre but allowed his child to live in his previous residence at a rental rate below fair market value. An elderly citizen wishing to retain their family home after moving to an extended care living facility is becoming increasingly common. CRA confirmed the taxpayer could designate the property a principal residence for the entire period of time the child live in it, pointing out that the definition of principal residence requires the taxpayer, his or her current or former spouse or common-law partner, or his or her child to ordinarily live in the house during the year. Nothing in the definition of principal residence stops the owner from charging rent, below, at, or above the market to his or her child.

Properties purchased for resale and condominium units

Increasingly, Canadians are purchasing properties as a short-term investment. In an effort to take advantage of the strong real estate market in parts of Canada individuals are purchasing properties to "flip" in a relatively short time frame with the goal of realizing a profit. Often these individuals are claiming the property as a principal residence and not claiming a capital gain for tax purposes.

From CRA's perspective these properties are purchased for resale and the proceeds constitute income from a business or from, "an adventure in the nature of a trade" and not a capital gain from the sale of a capital property. Where there is a short holding period, CRA's position is reinforced and the gain may be taxed as income and not as a capital gain.

Where the home is held on account of capital and is otherwise subject to capital gains tax on sale, in order for the property to qualify as a principal residence it must be "owned" by the taxpayer. Condominium sales often have three time periods associated with ownership: the period when the building is being constructed, an interim occupancy period, and finally the period after title to the unit is actually registered. Although the taxpayer has an ownership interest in the unit during all three periods, it is only from the last period—actual registration of title—that CRA considers it to be owned by the taxpayer for purposes of claiming the principal residence exemption.

Conclusion

The principal residence exemption is an important planning tool for Canadians owning property. However, it is important to understand the rules surrounding the exemption in order to ensure the property meets the definition.

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Hope you find this information resourceful. If you have any questions and would like to discuss the contents, please don't hesitate to contact me.