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Your Guide to Tax-Saving Strategies

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Thinking of selling your house? It pays to understand the principal residence exemption

Home sweet home

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Your “home sweet home” is always that much sweeter when you sell it and realize that you can shelter the capital gains from the sale with the principal residence exemption.

The concept is simple – you don’t have to pay tax when you sell your home. Sounds easy, right? But many people don’t realize the complexity involved in the rules that allow you to sell your house tax-free.

Here’s a summary of some of the key rules and requirements that may throw you off-side with the principal residence exemption:

✎ The home must be ordinarily occupied for personal use by you, your spouse (or former spouse) or a child at some time during the year.

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✎ To claim the principal residence exemption on a large lot (over 1/2 hectare, or about 1 1/4 acres), you must be in a position to establish that the land is necessary for the “use and enjoyment” of your home.

✎ Restrictions will also apply if part or all of your home is rented out, is not used by a family member, or if you have not been resident in Canada throughout the period of ownership.

✎ As a general rule, a family can claim the principal residence exemption on only one home at a time.

Most people think of the principal residence exemption as a black and white matter – either you qualify to sell your home tax free or you don’t. Actually, that’s not the case.

When you sell your home, you must calculate the gain on your residence just like any other capital gain. Then the principal residence exemp-

tion itself reduces your gain.

Moreover, eligibility for the exemption is on a year-by-year basis, which might come as a surprise to many. And the more years you qualify relative to your total period of ownership, the more your gain gets reduced.

Basically, the principal residence exemption calculation is usually:

As you can see, to get the tax reduction you must designate the home as the principal residence on a year-by-year basis. (Note: If your gain is completely covered by the principal residence exemption, it is not necessary to file the designation form.)

Large lots

And what if your home sits on a large piece of property? As noted above, the CRA may make it difficult for you to claim the exemption on your property if the land is over 1/2 hectare.

That said, the Federal Court of Appeal (FCA) did focus on this very issue. The general rule is that in order for any excess land to qualify for the exemption, it is necessary to use that land for enjoyment of the home.

In the *Cassidy* case, the home sat on 2.43 hectares of land and was owned by the taxpayer from 1994 to its sale in November 2003.

The taxpayer argued that since he was legally unable to

$$\frac{(\# \text{ of years home is principal residence} + 1) \times \text{capital gain}}{\# \text{ of years home is owned}}$$

subdivide the land (up until May 2003), the entire 2.43 hectares was necessary for his use and enjoyment since he could not put a home on a smaller piece of land.

The Tax Court of Canada agreed with the CRA in denying the principal residence exemption on the basis that the 1/2 hectare rule applied only on the date of sale. And since the sale was in November 2003, the restriction on the subdivision was no longer in place.

However, the FCA rejected that argument and sided with the taxpayer in holding that the principal residence exemption determination is made each year and not just at the time of sale. Therefore the principal residence exemption applied to the entire 2.43 hectares.

Non-personal use

One dangerous trap that you may find yourself stumbling into is a situation where part or all of the residence becomes non-personal use.

Specifically, when part of the property is rented out, the value of the residence itself must be pro-rated between personal and non-personal use, and only the personal portion will qualify for the principal residence exemption. But on what basis is this decided?

And what if your home sits on a large piece of property?

The appreciation on a residence is composed of a land and a building component. In many areas of Canada, most of the gain is attributable to land value rather than building value, especially since buildings tend to depreciate as they get older.

The standard advice is to pro-rate the land gain in the

same ratio as building use. But in the right circumstances, you might be able to make an argument that a greater proportion of land is eligible for the personal residence exemption.

And this is where things get a bit tricky.

If the property itself changes from being a home to being a rental property (from personal use to income-producing use), then you will be deemed to have disposed of the property (both land and building) at fair market value and reacquired it immediately thereafter at the same amount.

Any gain otherwise determined on this deemed disposition may be eliminated or reduced by the principal residence exemption.

You are, however, entitled to declare that no change in use should be considered to have taken place if you elect to treat the property as a principal residence.

This election can be made by means of a letter, signed by you and filed with your income tax return for the year in which the change in use occurred.

Be aware, however, that if capital cost allowance (CCA) is claimed on the property, the election is considered to be rescinded on the first day of the year in which that claim is made.

If you make this election, the property can qualify as your principal residence for up to four taxation years during which the election remains in force, even if the residence is not ordinarily inhabited during those years by you, your spouse or a child.

You must remain a Canadian resident during these years for the full benefit of the principal residence exemption to apply.

This election is beneficial if you move back into the resi-

dence, as any change from income-producing back to personal use will also result in a second deemed disposition.

If you had made the election that no change in use applied to the residence when it first changed from personal to income-producing use (i.e. it remains a principal residence for when you move back into it at a later date) the property will have always been deemed to be personal use.

And you can designate four of those years that you were away as being part of the principal residence exemption to shelter a portion of the gain.

There are ways to get around this four-year limitation in certain situations.

For example, if you are renting your residence because you (or your spouse) are required to move by your employer, then none of the years you are away from the residence and renting it will be included. This can be extended indefinitely. It applies only if the employer is not related to you or your spouse and you subsequently satisfy one of the following three conditions:

(1) You resume living in the home during the term of your (or your spouse's) employment with that employer;

(2) If you (or your spouse's) employment with that employer is terminated and you resume living in the home before the end of the next taxation year; or

(3) If you (or your spouse) pass away during the term of you (or your spouse's) employment with that employer.

There is also a condition that the original residence be at least 40 kilometers further from the new place of employment.

Conversely, as noted above, if a property which you have been using to earn income becomes your principal residence, there

will be a deemed disposition based on the change-of-use rules.

Again, however, you can defer the recognition of any gain or loss on the deemed disposition arising from the change in use by making the necessary election which operates in the same way as the one discussed above.

Note that this election does not defer the recapture of CCA on the change in use and, in fact, the election will not be allowed if any CCA has been claimed on the property after 1984 and before the property becomes the principal residence of the taxpayer.

And, lastly, there will also be a deemed disposition if you partially convert your principal residence to income-producing use, and the partial change is substantial and of a more permanent nature i.e., where there is a

structural change.

The CRA cites several examples of this, including the conversion of the front half of a house into a store, a portion of a house into a self-contained apartment or alterations to a house to accommodate separate business premises.

And you might think that, if there is going to be a deemed disposition, the CRA would also give you a break and allow you to make an election, as in the case where there's a total change in use. Right? Wrong.

There is no election available when there is a partial change in use. Instead, the CRA has stated that they will not apply the deemed disposition rule (and hence, the property will retain its nature as a principal residence) if all of the following conditions are met:

- ✓ 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 CCA is claimed on the property.

Examples of the circumstances under which these conditions can be met include: carrying on a business of caring for children in your home; renting one or more rooms in the home; or you have an office or other work space in the home which is used in connection with your business or employment.

Even though you may claim expenses pertaining to that portion of the property used for income-producing purposes, the CRA will jump in to apply the deemed disposition rule if you claim CCA on that portion of the residence. □