The TaxLetter®

Vol. 30, No. 2 | Your Guide to Tax-Saving Strategies | February 2012

*TAX*MATTERS

Don't stumble into a tax trap when selling your…

Home sweet home

Samantha Prasad LL.B.

Q: What's the one thing most people don't bother considering when selling their home? Hint: it's not ensuring that the newspaper delivery is cancelled. A: the tax implications.

Actually, that's only a partial answer. Nothing is simple when it comes to taxes, but there are clear ways to avoid the tax traps that lie ahead for unprepared home sellers.

When selling a house, we often assure ourselves that the principal residence exemption will spare us from having to pay capital gains tax. But this exemption is not as simple as you may think. Here is a summary of some of the more important rules that can throw you off-side of the principal residence exemption:

Samantha Prasad, LL.B., is a tax partner with the Toronto-based law firm Minden Gross LLP, a member of Meritas Law Firms Worldwide, and a Contributing Editor of The TaxLetter, published by MPL Communications.
sprasad@mindengross.com

In order to take advantage of the exemption, certain requirements must be met:

✓ 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.

✓ To claim the principal residence exemption on a large lot (over ½ hectare - about 1 ¼ acres), you must be in a position to establish that any land over half a hectare is necessary for the "use and enjoyment" of your home.

✓ Restrictions will also apply if part (or all) of your home is rented out or 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.

The second home is more of a problem; to stop you from trying to claim a separate exemption by putting it in the name of a child, rules are put in place that restrict children from claiming that exemption unless they have reached the age of eighteen in the year, or are married.

Most people think of the principal residence exemption as a black and white matter - either you qualify to sell tax free or you don't.

Actually, this is not the case. When you sell your home, you must calculate the gain on your residence just like you would any other capital gain. Then the principal residence exemption itself reduces your gain.

Moreover, eligibility for the exemption is on a year-by-year basis, which might come as a surprise to many. The more years you qualify relative to your total period of ownership, the more your gain gets reduced. To be more precise, the box below is the basic formula that normally applies:

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

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

Cassidy v. The Queen

A recent case by the Federal Court of Appeal focused on whether a taxpayer was entitled to the principal residence exemption for a property that was more than a half-hectare. As noted above, in order for any excess land to qualify, it must be necessary for the use and enjoyment of the home.

In Cassidy, 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 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 half-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 CRA 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 important trap that you may find yourself stumbling into relates to a situation where part or all of the residence is for non-personal use – particularly where part of the property is rented out – in which case 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 personal residence exemption.

But on what basis, you may ask?The appreciation on a residence is composed of a land and building components.

In many areas of Canada, most of the gain is attributable to land values rather than building values, 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.

Sounds easy enough? Well, here is where the rules get a bit trickier. If the property itself changes from being a home for you or your family to being a rental property (i.e. 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.

However, you are entitled to having no change in use being considered to have taken place if you make an election to treat the property as a principal residence.

This election can be made by means of a letter signed by you and filed with the income tax return for the year in which the change in use occurred. But, 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 time the election remains in force – even if the residence is not ordinarily inhabited during those years by you, your spouse or a child.

However, you must remain a Canadian resident during these years for the full benefit of the principal residence exemption to apply. This election is advantageous if you move back into the residence – since 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 was to apply to the residence when it first changed from personal use to income-producing use – so that it remained, in effect, a principal residence for when you move back at a later date – there will be no change of use since the property will have always been deemed to be personal use.

And you can designate four of those years you were away as 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. If you are renting out your residence because you (or your spouse) are required to move by your employer, none of the years you are away from the residence will be included in the four year limitation period ordinarily imposed by the election (i.e., it can be extended indefinitely).

This applies only if the employer is not related to you or your spouse and you subsequently satisfy one of these three conditions:

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

✓ 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

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

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

It is also conditional that the original residence be at least 40 kilometres in distance from the new place of employment than your new place of residence.

Conversely, if a property which you have used 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 I have 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, to make the story complete, there will also be a deemed disposition if you partially convert your principal residence for 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 certain examples of this occurrence as including the conversion of the front half of a house into a store, a portion of a house into a self-contained apartment (i.e. a duplex, or triplex) or alterations to a house to accommodate separate business premises.

And you would 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. However, there is no election available where 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 when 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 operating an office or other work space in the home which is used in connection with your business or employment.

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