

The Principal Residence Exemption



The principal residence exemption rules under the *Income Tax Act* allow you to eliminate or reduce the capital gain from the disposition of your principal residence. There are specific rules which dictate how and when a property can be designated as a principal residence. Since these rules are complex and subject to change at any time, you should consult a professional tax advisor to address your specific situation.

What is a principal residence

A principal residence refers to a housing unit, which can be your house, apartment, condominium, cottage, mobile home, trailer or houseboat. The land on which a housing unit is situated can also qualify as part of a principal residence provided that it does not exceed one-half hectare (approximately 54,000 square feet) or is necessary for the use and enjoyment of the housing unit as a principal residence.

Generally, in order for a property to qualify as your principal residence for any year, it must meet the following conditions:

- The property includes a housing unit and land as described above;
- The property must be owned by you, either alone or jointly with another person;
- The property is ordinarily inhabited in the year by you, your current or former spouse or common-law partner or any of your children; and
- You designate the property as your principal residence.

The principal residence exemption

When you dispose of a principal residence, you may realize a taxable capital gain on the disposition. However, the resulting capital gain may be eliminated or reduced by claiming the principal residence exemption. The following is the formula generally used to calculate the exemption:

$$\frac{(1 + \text{Number of years the property is designated as your principal residence})}{\text{Number of years the property was owned}} \times \text{Capital gain}$$

The “one plus” portion in the above formula (the “One Plus Rule”) is intended to allow you to claim the principal residence exemption on two properties for the same year when you sell your current principal residence and buy a new principal residence in that year. Discussed below, the One Plus Rule may also benefit you when you own two housing units at the same time. Effective October 2, 2016, you will not be able to use the One Plus Rule if you were not a resident of Canada at the time the property was acquired.

Designating a principal residence

To benefit from the principal residence exemption, you must designate a property as your principal residence when there is an actual or deemed disposition of the property. Since 1982, a family unit can designate only one property as a principal residence for a particular year. Generally, a family unit includes you, your spouse or common-law partner, and any unmarried children under the age of 18. Children who have attained the age of majority are generally not included and can own and designate a separate property as their principal residence.

Prior to 2016, the Canada Revenue Agency’s administrative position was that you were not required to report the sale of your principal residence for income tax purposes if it was your principal residence for your entire ownership period of the property and the whole capital gain was sheltered due to the principal residence exemption.

Since 2016, you must report the sale of your principal residence on Schedule 3, Capital Gains (or Losses) of your income tax return. In addition, you must complete Form T2019 (IND), Designation of a Property as a Principal Residence by an Individual (Other Than a Personal Trust).

If you fail to report the sale and designation of your principal residence on your income tax return as described above, you can generally file an amended income tax return with the Canada Revenue Agency. However, a late filing penalty may apply equal to the lesser of:

- 8,000 or
- \$100 for each complete month from the original due date to the date your amendment request was made.

Choice of principal residence

It is possible to concurrently own more than one property that can qualify as your principal residence. For example, you may ordinarily inhabit both a home and a vacation property during the year. However, as noted above, after 1981 a family unit can designate only one property as a principal residence for a particular year. Accordingly, at the time you first dispose of one of the properties, you need

to decide which property to designate as your principal residence for the preceding years.

You should consider designating the property which has the largest average capital gain per year in order to reduce the overall tax liability among all the properties.

Additional tax savings may be available due to the One Plus Rule, as you can save the designation in the year of disposition for another property. An example will help illustrate:

The MacLeod's purchased their home for \$400,000 in 2010 and their cottage for \$250,000 in 2015. They spend quite a bit of time in both properties throughout the year. In 2019, they sold the home for \$550,000 and the cottage for \$380,000. The capital gains for the properties are:

The Home:

Total capital gain = \$150,000;
(i.e. \$550,000 - \$400,000)

Average annual capital gain = \$15,000;
(i.e. (\$550,000 - \$400,000)/10);

The Cottage:

Total capital gain = \$130,000;
(i.e. \$380,000 - \$250,000)

Average annual capital gain = \$26,000;
(i.e. \$380,000 - \$250,000)/5).

Even though there is a larger capital gain on the house, the average annual capital gain is larger for the cottage. Accordingly, there is more tax savings by designating the cottage as the principal residence rather than the home. Due to the One Plus Rule, the entire capital gain on the cottage will be eliminated if they designate the cottage as a principal residence for 4 years (2015 – 2018).

Further, since only 4 years were designated for the cottage, the home can be designated as the principal residence for 6 years (2010 – 2014, and 2019) and due to the One Plus Rule, the capital gain on the home will be eliminated for 7 years. The result of this example is that the whole capital gain on the cottage and 7/10th of the capital gain on the house is sheltered for tax

purposes, and the MacLeods' total capital gain is limited to \$45,000; (i.e. (\$150,000 x 3/10).

In the above example, if the MacLeods had instead designated their house for each of the 10 years (because it had the largest overall gain), the family would have been stuck with a total capital gain of \$104,000 (i.e. 4/5th of \$130,000; as the One Plus Rule would still shelter 1 year on the cottage) instead of \$45,000 for both properties.

Changes in the use of a principal residence

There can be tax consequences when you change how you occupy or use your property. For example, you may change the use of your property from a personal use (i.e., principal residence) to an income producing use (i.e., rental or business property), or from an income producing use to a principal residence.

When you change your principal residence to a rental property or vice versa, you are generally deemed to have sold the property at its fair market value and to have immediately reacquired the property for the same amount. Any resulting capital gain on the deemed disposition needs to be reported in your income tax return in the year the change of use occurs. However, you may be able to defer and reduce (or even eliminate) the capital gain by filing an election with the Canada Revenue Agency in your tax return for the year. Further, making this election may allow you to designate the property as your principal residence for an additional period of up to four years, either before or after the change in use (provided that you do not designate any other property as your principal residence for this additional period).

Generally, you can elect out of the deemed disposition arising on the change of use unless you (or your spouse, CLP or a trust under which you, your spouse or CLP is a beneficiary) previously claimed tax deductions for depreciation (i.e. capital cost allowance) on the property.

The deemed disposition also occurs when there is a change in use of only a part of a property (e.g., the basement is converted to a rental property). Prior to the 2019 Federal Budget, an election could not be made to

defer the recognition of the capital gain on the deemed disposition that arises on a change in use of only a part of a property. However, the 2019 Federal Budget proposes to extend the option of electing out of the deemed disposition where there is a change in use of only a part of a property.

When a principal residence is owned by a trust

Where a property is held by a personal trust, it may be possible to claim the principal residence exemption on a disposition of the property. However, since 2017, only the following types of personal trusts are eligible to designate a property as a principal residence if the specified beneficiary is a resident of Canada:

- An alter ego trust, spousal or common-law partner trust, joint spousal or common-law partner trust or certain trusts for the exclusive benefit of the settlor during the settlor's lifetime;
- A qualified disability trust; or
- A trust for minor children of deceased parents.

To claim the principal residence exemption, the trustee must file Form T1079, Designation of a Property as a Principal Residence by a Private Trust, with the trust's T3 return for the year of the disposition of the property to claim the principal residence exemption. Further, no beneficiary of the trust or member of a beneficiary's family unit can designate any other property as a principal residence for the period the trust designates a principal residence (i.e., when the personal trust claims the principal residence exemption for a particular year, the beneficiaries and their family units cannot designate any other property as a principal residence).

Prior to 2017 and subject to certain conditions, other types of personal trusts could designate a property as a principal residence. There are special transitional rules that allow a personal trust that owned a property before 2017 (and is not one of the eligible trusts listed above) to designate the property as a principal residence in order to benefit from the principal residence exemption for the capital gain accrued up to December 31, 2016.

Considerations

Speak to your TD Advisor and tax professional to understand if you can benefit from the PRE and to ensure you are aware of the filing obligations for your situation.



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