The Navigator

RBC WEALTH MANAGEMENT SERVICES

Principal Residence – The Basics

A home is often the single largest purchase made by Canadians and an asset that can appreciate significantly over time. In many cases, a family may own more than one home. On the sale of any of these properties, there can be a significant tax liability on the increase in the value of the home, unless the principal residence exemption can be applied to eliminate or reduce the tax liability.

This article addresses a number of tax and estate planning questions, including "What is a principal residence?" and "Who qualifies to claim the principal residence exemption?"

What qualifies as a principal residence?

A principal residence can include a house, condominium, cottage, mobile home, trailer, houseboat or shares in a co-operative building. In addition, the land on which the housing unit is situated is generally considered part of the principal residence, provided that this land is less than half a hectare (approximately 1.24 acres). In the case of farm property, the residential unit situated on the farm property along with the surrounding half hectare may be considered a principal residence.

Land in excess of half a hectare is generally not considered part of the principal residence unless it is necessary for the use and enjoyment of the housing unit. There are a few instances where the land in excess of half a hectare is considered necessary for the use and enjoyment of the housing unit. Examples of this include residential lots where local municipal zoning bylaws require that minimum residential lot sizes exceed half a hectare, or where the excess land is required to provide access to and from public roads.

To designate a property as a principal residence, an individual must own the property, either solely or jointly with one or more individuals. In addition, the owner, their spouse or common-law partner, their former spouse or common law partner, or their children must also ordinarily inhabit the residence during some part of the year. The definition of spouse under the Income Tax Act includes a common-law partner (same or opposite sex partner) who has cohabited with the owner in a conjugal relationship for a continuous period of no less than 12 months.

Other points of note regarding principal residence

- A cottage property used by the family during the summer can qualify as a principal residence, unless the main reason for owning the property is to gain or produce income. In that case there may be some exceptions.
- If an elderly surviving parent moves into a retirement residence and their home is subsequently occupied by

one of their children, that home will continue to be the principal residence of the parent.

- Where an ex-spouse lives in the home owned by the other ex-spouse, such property qualifies as the principal residence of the ex-spouse who owns the property. For example, if former Spouse A lives in the home owned by former Spouse B, former Spouse B can continue to designate that home as their principal residence even though they do not live there.
- Vacant land on which a home is subsequently built does not qualify as a principal residence until such time as the home is inhabited.
- A portion of a home can be rented or used as a home-based business without impairing the owner's ability to designate the entire property as their principal residence provided the main use of the property is for residential purposes. In addition, there must be no structural change to, and no capital cost allowance (depreciation expense) claimed on, the portion of the home that is rented or used as a home-based business. If the home has been structurally altered for the purpose of earning income or if a capital cost allowance has been claimed, the portion of the home so affected will cease to qualify as part of the principal residence.
- A principal residence that is converted to a rental or other income-producing property can still be designated a principal residence for a period of up to four years after the conversion, provided that no capital cost allowance is claimed on the property during this period. The owner must also file an election with Canada Revenue Agency (CRA). The four-year period can be extended indefinitely if the owner or the owner's spouse is required to relocate due to changes in their employment location. When such employment ceases, the owner and/or the owner's spouse must resume ordinary habitation of he home.
- If a property is initially acquired to earn income and the owner later personally inhabits the property, the owner can treat the property as a principal residence for the period during which the property was owned and used as an income-producing property for a maximum period of four years. Again, an election must be filed with CRA, and there must not have been a capital cost allowance claimed on the property during that period.
- A property that is located outside Canada can be designated as a principal residence if it qualifies under the criteria set out above and

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the owner of the property was a resident of Canada for tax purposes for each year for which they propose to designate the property as their principal residence.

Each family unit may designate only one residence as their principal residence per year after 1981. A family unit includes the owner, their spouse (except where the spouse was living apart from the taxpayer throughout the year and was separated from the taxpayer under a court order or written separation agreement) and their unmarried minor children. If in the year two individuals become spouses, each person can still designate a separate principal residence for that year. For each year prior to 1982, each member of the family unit may designate a separate home as their principal residence.

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Principal residence exemption

The capital gain arising from the sale of a home is the difference between the proceeds of sale and the adjusted cost base. The adjusted cost base is normally the purchase price plus the cost of any capital additions. This capital gain can be reduced if a capital gains election was applied to the home as of February 22, 1994 as part of the elimination of the $100,000 general capital gains exemption. Note that the time period to make a late capital gains election has now expired.

The gain can be further reduced or eliminated through the application of the principal residence exemption, which is discussed below. If the sale of a principal residence results in a loss, such loss cannot be claimed as a personal residence is considered personal-use property.

A capital gain realized on the sale of a property can be reduced through the principal residence exemption by applying the following formula:

$$\frac{1 + \text{Number of years designated as principal residence}^{*}}{\text{Number of years the property is owned}}$$

$$\times \text{ capital gain} = \text{tax-exempt capital gain}$$

* The taxpayer must have been resident in Canada during the years designated to qualify for inclusion in the principal residence exemption.

Where a family owns only one home, that home is the family's principal residence, and any gain arising from the subsequent sale of the home will be reduced to nil based on this formula. If more than one home is owned concurrently for any period after 1981 and each home qualifies as a principal residence, then the following should be considered in applying the principal residence exemption:

- The home with the greatest average annual increase in value should be designated as the family's principal residence for the maximum number of years.
- The maximum number of years that a property should be designated as the principal residence is the number of years of ownership minus one (due to the bonus year in the numerator of the formula).

For example, Mrs. Jones acquired a home in the city 23 years ago for $50,000. 18 years ago, she purchased a cottage for $70,000, which her family uses during the summer. The fair market values today for the home and the cottage are $225,000 and $180,000 respectively. Mrs. Jones is thinking of selling both properties this year. As the city home was the only residence owned by Mrs. Jones for the 5 years prior to purchasing the cottage, she can only designate the city home as her principal residence for these five years. For the 18-year period since purchasing the cottage property, Mrs. Jones can designate either the city home or the cottage as her principal residence each year.

The average annual increases are approximately $7,292 per year [($225,000 – $50,000) ÷ 24 years (total years of ownership including the year of sale)] for the city home and approximately $5,789 per year [($180,000 – $70,000) ÷ 19 years (total years of ownership including the year of sale)] for the cottage. Mrs. Jones should therefore designate the city home as her principal residence for 18 out of the 19 years she owned both properties. She need not designate it for the entire 19-year period as the principal residence exemption formula requires the city home be designated principal residence for only 23 out of the 24 years to exempt all gains (due to the additional one year in the numerator of the formula). Mrs. Jones can therefore designate her cottage as her principal residence for the remaining year.

The taxpayer must have been resident in Canada during the years designated to qualify for inclusion in the principal residence exemption.

In this example, not only will the gain on the sale of the city home be exempt from tax, the principal residence exemption could reduce the taxes payable when she sells her cottage.

How is a home designated a principal residence?

A home is designated a principal residence using form *T2091(IND) — Designation of a Property as a Principal Residence by an Individual (Other than a Personal Trust).* This form is completed and filed with the tax return for the year in which the property was disposed. However, the seller does not need to complete this form unless there is still a capital gain on the disposition of the property after using the principal residence exemption.

Form T2091(IND) should also be used if Form 664 was filed previously to report a capital gain on property owned at the end of February 22, 1994. If the principal residence exemption is applied to eliminate the capital gain on the disposition of a property without filing the T2091 form, that property will be considered the principal residence for the years in question. This means that another property that was owned during the same period and had a higher average annual price appreciation may not be able to be designated as the principal residence for the same period. It also means that the additional one year in the numerator of the formula may not be available for the next property. It is therefore advisable to file a T2091 whenever a property is disposed of if more than one property is owned at the same time.

Non-residents

The principal residence exemption is generally only available to individuals who are Canadian residents for tax purposes. An individual who ceases to be a Canadian resident cannot claim the principal residence exemption when they dispose of a property for any year after the year in which they became a non-resident. Thus, because of the bonus year in the formula (the "1+" component), a portion of the gain from the sale of the principal residence will be taxable if the individual is not a resident of Canada for two or more calendar years during their period of ownership.

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When the home is owned by a trust

A trust is a relationship between the trustee and the beneficiary. The trustee holds legal ownership of the property for the benefit of the beneficiary. The beneficiary is the beneficial owner of the property. If a trustee disposes of a property that forms part of the trust's assets and the property was inhabited by a beneficiary of the trust, a beneficiary's spouse or common-law partner, former spouse or common-law partner or a beneficiary's children, then the trustee may be able to use the personal residence exemption to exempt or reduce any resulting capital gains. The trust would file form *T1079 — Designation of a Property as a Principal Residence by a Personal Trust* with the trust's return for the year in which the disposition of the principal residence occurs. For every year that the trustee designates such property as the trust's principal residence, the beneficiary who ordinarily inhabited the property or whose spouse, common-law partner, former spouse or common-law partner, or child ordinarily inhabited the property and members of their family unit are unable to designate another property as their principal residence

If a trustee distributes a property to a beneficiary in satisfaction of the beneficiary's capital interest, the trustee is deemed, subject to certain exceptions, to distribute the property at the trust's cost base, and the receiving beneficiary acquires the property at the same cost. In this case the trustee should not claim the principal residence exemption since there is no benefit in doing so. When the property is subsequently sold, the beneficiary may claim the principal residence exemption for those years that the trustee owned the property if the beneficiary, the beneficiary's spouse or common-law partner, former spouse or common-law partner or the beneficiary's children lived on the property while the trustee owned the property.

Deduction of mortgage interest

Individuals often borrow to invest by mortgaging their principal residence. If the borrowed money is used directly to earn business or investment income, the interest paid on the mortgage may be deductible. An individual who comes into a large sum of money and wishes to invest may first want to consider paying down their mortgage. They can then remortgage the home and use the borrowed funds to invest. This way, interest paid on the mortgage may be deductible. The mortgage interest will not be deductible if the individual invests the sum directly without first paying down the mortgage. The reason is that the actual and direct use of the borrowed money will determine whether the interest paid may be deductible.

Please note, using borrowed money to purchase investments involves greater risk than a purchase using your own money. Individuals have a continuing obligation to repay principal and interest even if the value of the investment goes down. Leverage strategies could result in far greater losses than an investment strategy that does not involve leverage.

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Inheritance issues

Provincial family law legislation generally provides for a division of family assets between spouses on the breakdown of their marriage. However certain items such as gifts and inheritances received during marriage generally do not form part of the family assets and may therefore not be subject to division upon a subsequent marriage breakdown. This exclusion from family assets may be lost if monies received from a gift or inheritance are used to pay down the mortgage on a matrimonial home. If you are a spouse receiving an inheritance and this is a concern, you should obtain independent legal advice from a qualified family law lawyer as every province has its own unique rules.

Estate planning considerations — Joint ownership with a non-spouse

A question frequently asked by surviving spouses who wish to avoid probate fees or simplify the administration of an estate is whether or not they should register title to their principal residence in joint names with their children. While it may be possible to avoid probate fees in some circumstances by adding an adult child as a joint tenant with the right of survivorship, there can be other unintended consequences.

As a result of two decisions in the Supreme Court of Canada in 2007, when an individual transfers assets such as a principal residence into joint ownership with adult children, there may be a number of potential outcomes from a legal and tax perspective.

The homeowner may wish to transfer a percentage of the legal and beneficial ownership of the home into joint names with adult children. This would result in a taxable disposition of the portion of the home transferred at the time of transfer (though it would be exempt from tax due to its principal residence status). On the death of the parent, their remaining share would pass to the surviving joint tenant(s) by right of survivorship without attracting probate fees.

While it may be possible to avoid probate fees in some circumstances by adding an adult child as a joint tenant with the right of survivorship, there can be other unintended consequences.

If however the parent only wishes to transfer the right of survivorship and not the beneficial ownership of the proportionate share to their adult children, then there would be no disposition at the time of transfer, but the property would be transferred to the surviving joint tenant(s) by right of survivorship on the parent's death without attracting probate fees. There would be a disposition for tax purposes at the date of death, but again, the principal residence exemption would apply.

It is therefore important that a parent who transfers title to joint names makes their intentions clear and documents these intentions to avoid confusion as to the nature of the transfer that has occurred. In the event that the parent wishes to gift a share in the beneficial ownership at the time they add the joint tenant, the adult child will be deemed to have acquired an interest in the parent's principal residence, to the extent of the portion transferred. On a subsequent sale, the child may be liable to pay tax on their share of any resulting gains since the principal residence exemption will not be available to the child unless they lived in the home. The child's interest in the home may also be exposed to marital or creditor claims. It may be possible to avoid such adverse consequences by merely transferring a right of survivorship in their principal residence and not the beneficial title to their children. Furthermore, there could be legal and other costs (such as land transfer fees) involved in changing legal ownership of a property.

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