The Navigator

Wealth Management

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC WEALTH MANAGEMENT SERVICES

Karim Visram Private Wealth Management Group
RBC Dominion Securities

Karim F. Visram, CFA; CPA; CGA, CFP; FMA
Vice-President & Director - Portfolio Manager
karim.visram@rbc.com
416-956-1913

Jonathan Smart, CFA
Associate Advisor
jonathan.smart@rbc.com

Herman Venegas
Associate Advisor
herman.venegas@rbc.com

Ambreen Babwani
Administrative Assistant
ambreen.babwani@rbc.com

TEAM CONTACT
Website: KarimVisram.com
Team Email: TeamKarim@rbc.com
Team Phone: 416-956-8888

200 Bay Street, Suite 3900
Royal Bank Plaza, South Tower

Principal residence

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 surrounding the principal residence exemption such as what qualifies as a principal residence and some implications of holding the residence in joint ownership with an adult child. Any reference to a spouse in this article also includes a common-law partner.

This article outlines several strategies, not all of which will apply to your particular financial circumstances. The information in this article is not intended to provide legal or tax advice. To ensure that your own circumstances have been properly considered and that action is taken based on the latest information available, you should obtain professional advice from a qualified tax advisor before acting on any of the information in this article.

What qualifies as a principal residence?

A principal residence can include your house, apartment, condominium, cottage, mobile home, trailer, houseboat or shares in a co-operative building. In addition, the land on which your housing unit is situated is generally considered part of your 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 your principal residence unless it is necessary for the use and enjoyment of your housing unit. There are a few instances of this, including, for example, 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.

For a property to be your principal residence, you must own the property, either solely or jointly with one or more individuals.

Another requirement is that you (the owner) or your spouse, former spouse, or child must have “ordinarily

If you sell a personal-use property, you may realize a capital gain or loss. You are generally required to pay tax on a capital gain resulting from a sale of a personal-use property, unless there is a specific exemption (e.g. principal residence exemption).

inhabited" the residence during some part of the year. Whether a property is ordinarily inhabited is a question of fact which means that the facts of each particular case need to be looked at. The Canada Revenue Agency (CRA) has stated that this test may be met even where the owner lives in the property for a short period of time. For example, if you own a seasonal property, such as a cottage, it may be considered ordinarily inhabited if you stay in the property during a short vacation. Property that you purchase that is mainly used for earning income is generally not considered to be ordinarily inhabited by you in the year even if the stay in the property for some period of time. However, it is possible for you to earn incidental income (e.g. rental income) from a property and still claim it as your principal residence.

Lastly, for a property to be your principal residence, you have to designate it as your principal residence for a particular tax year. You or your family unit may designate only one property as your principal residence per year after 1981. Your family unit includes you, your spouse throughout the year (except where you and your spouse were living apart throughout the year and were separated under a court order or written separation agreement) and your unmarried minor children. If, in the year, two individuals become spouses, each person can designate a separate principal residence for that year. For each year prior to 1982, each member of the family unit may designate a separate property as their principal residence.

The following are some examples of situations in which a property may qualify as a principal residence:

- 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 a former spouse lives in the home that you own but do not occupy, that property can still qualify as your principal residence.
- A portion of your home can be rented or used as a home-based business without impairing your ability to designate the entire property as your principal residence provided the main use of the property is for residential purposes. In addition, there must be no structural change to, and no depreciation expense, known as capital cost allowance (CCA), claimed on the portion of the home that is rented or used as a home-based business. If your home has been structurally altered for the purpose of earning income or if CCA has been claimed, the portion of the home so affected will cease to qualify as part of the principal residence.
- A property that is located outside Canada can be designated as your principal residence if it meets the previously discussed criteria and you, the owner of the property, were a resident of Canada for tax purposes for each year you propose to designate the property as your principal residence.

Selling your principal residence

Personal-use property

A principal residence is an asset that you own primarily for your or your family's use or enjoyment which means that it is personal-use property. If you sell a personal-use property, you may realize a capital gain or loss. You are generally required to pay tax on a capital gain resulting from a sale of a personal-use property, unless there is a specific exemption (e.g. principal residence exemption).

On the other hand, if you sell a personal-use property that depreciates in value, you cannot deduct the resulting loss when you

calculate your income for the year. In addition, you also cannot use the loss to offset capital gains.

Calculating the capital gain or loss

The capital gain or loss on the sale of your principal residence will be equal to the difference between the proceeds of sale and the adjusted cost base (ACB) of the property. The ACB is normally the purchase price plus any expenses to acquire it, such as commissions and legal fees. The ACB of a property also includes capital expenditures, such as the cost of additions and improvements to the property. You cannot add current expenses, such as maintenance and repair costs, to the ACB of a property.

Prior to 1972, capital gains were not taxed in Canada. As a result, if you owned a home since before 1972, only the increase in value since December 31, 1971 is used to calculate the gain.

Prior to 1972, capital gains were not taxed in Canada. As a result, if you owned a home since before 1972, only the increase in value since December 31, 1971 is used to calculate the gain.

If the sale of your principal residence results in a capital gain, the gain can be reduced if you made a capital gains election with respect to the property on your 1994 tax return. As a bit of background, on February 22, 1994, the government removed the $100,000 capital gains exemption, but allowed you to file a special one-time election on your 1994 tax return to claim this exemption against capital gains accrued to that date. The election allowed you to opt to have a deemed disposition of any capital property you owned on February 22, 1994, at any amount up to its fair market value on that day. In most cases, the amount you elected as a deemed disposition became your new cost base. The election was made by filing CRA Form T664, *Election to Report a Capital Gain on Property Owned at the End of February 22, 1994 with your 1994* income tax return. If you still own the property for which a capital gains election was made, you should continue to monitor the revised cost base to ensure it is taken into consideration when you later sell the property.

The capital gain on the sale of your property can further be reduced or eliminated by claiming the principal residence exemption, which is discussed in the next section.

The principal residence exemption

If the sale of your principal residence results in a capital gain, the capital gain can be reduced or eliminated by claiming the principal residence exemption and applying the following formula:

$$\frac{1 + \text{Number of years designated as principal residence*}}{\text{Number of years the property is owned after 1971}} \times \text{Capital gain} = \text{Tax-exempt capital gain}$$

* The taxpayer must have been resident in Canada during these years to qualify for inclusion in the formula

As previously mentioned, after 1981, the principal residence exemption rules do not permit you or your family unit to designate more than one property per year as your principal residence. The purpose of this rule is to limit the tax benefit to one property per family unit. Where you own only one home, and that home can be considered your principal residence, any capital gain arising from the subsequent sale of that home may be reduced to nil based on this formula.

In the case where you disposed of a principal residence in one year and acquired a replacement residence in the same year, you are not allowed to designate both properties as a principal residence for the year. To ensure that you are not denied an exemption in respect of both properties for the year, the

For the 2016 tax year and onwards, when you sell your principal residence (or are deemed to dispose of your principal residence) you will be required to report the disposition on Schedule 3, Capital Gains (or Losses) of your income tax return for the year.

formula provides for the inclusion of one additional taxation year of exemption room (the one-plus rule).

In the case where you own more than one home concurrently for any period after 1981 and each home qualifies as a principal residence, the following should be considered in applying the principal residence exemption:

- Determine which property has the greatest average annual increase in value. Consider designating this property as the family's principal residence for the maximum number of years.
- The maximum number of years that a property needs to be designated as the principal residence is the number of years of ownership minus one (due to the one-plus rule) to fully exempt the gain.

An example

Assume Mrs. Jones acquired a home in the city 23 years ago for $50,000. She also purchased a cottage 18 years ago 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. She calculates the average annual increase in value for each home:

- The average annual increase for the city home was approximately $7,292 per year.
  - [($225,000 – $50,000) ÷ 24 years (total years of ownership including the year of sale)]
- The average annual increase for the cottage was approximately $5,789 per year.
  - [($180,000 – $70,000) ÷ 19 years (total years of ownership including the year of sale)]

Mrs. Jones should therefore designate the city home as her principal residence for 18 out of the 19 years she owned both properties. She does not need to designate it for the entire 19-year period because the one-plus rule allows her to exempt all capital gains from tax. Mrs. Jones can therefore, designate her cottage as her principal residence for one year and the one-plus rule will allow her to exempt a total of two years worth of gains.

Designating your principal residence

Previously, you were not required to report anything to the CRA with respect to the sale of your principal residence if the property was designated as your principal residence for every year you owned it and there was no capital gain on the disposition of the property after using the principal residence exemption. If the property was not your principal residence for every year that you owned it (e.g. a different property, such as a cottage, was designated as your principal residence for one or more of the years during the same period of ownership), CRA Form T2091(IND), *Designation of a Property as a Principal Residence by an Individual (Other than a Personal Trust)* would have to be filed with your tax return for that year. If you were deceased, your executor/liquidator would have to file CRA Form T1255, *Designation of a property as principal residence by the legal representative of a deceased.*

On October 3, 2016, the government announced an administrative change to the CRA's reporting requirements when you sell your principal residence. For the 2016 tax year

Where you own a principal residence and decide to start using the property as a rental property, you should be aware of the change in use rules. Similarly, where you own a rental property and decide to start using it as your principal residence, you have changed the use of the property and may be affected by the change in use rules.

and onwards, when you sell your principal residence (or are deemed to dispose of your principal residence) you will be required to report the disposition on Schedule 3, *Capital Gains (or Losses)* of your income tax return for the year. You must report the date of acquisition, the proceeds of disposition and a description of the property. As well, if the property was your principal residence for every year that you owned it, you will need to make the principal residence designation on Schedule 3. Form T2091(IND) (or Form T1255) will still be required for the designation in the case the property was not your principal residence for all of the years that you owned it. Form T2091(IND) should also be used if CRA Form T664 was filed previously to report a capital gain on property owned at the end of February 22, 1994. This reporting will be required for dispositions that occur on or after January 1, 2016.

If you do not report the disposition or fail to make the principal residence designation in the year of the sale, you can ask the CRA to amend your tax return. Under the changes, the CRA can accept a late principal residence designation in certain cases, but a penalty may apply equal to the lesser of:

- $8,0 00; or
- $100 for each complete month from the original due date to the date your amendment request was made.

Tax implications of a change in use

Where you own a principal residence and decide to start using the property as a rental property, you should be aware of the change in use rules. Similarly, where you own a rental property and decide to start using it as your principal residence, you have changed the use of the property and may be affected by the change in use rules. Where these rules apply, you are considered to have disposed the property at its fair market value and to have immediately reacquired it for the same amount. You may realize a gain or loss in the year the change of use occurs.

Where you convert your principal residence to a rental property, any resulting capital gain on the deemed disposition can usually be eliminated or reduced by the principal residence exemption. If you are unable to eliminate the gain, you can make an election to not recognize the deemed disposition. This allows you to defer the recognition of any gain until you sell the property. If you make this election, you will still have to report the net rental or business income you earn from the property and cannot claim Capital Cost Allowance (CCA) on the property. Even if you are able to eliminate the gain using the principal residence exemption, you may still want to file this election. In addition to deferring the gain, the election allows you to designate the property as your principal residence for up to four years, even if you do not use the property as your principal residence. However, you can only do this if you do not designate any other property as your principal residence for this time. To make this election, attach a letter signed by you to your income tax return for the year in which the change of use occurred.

Where you convert your rental property to a principal residence, you may also elect to not recognize the deemed disposition and defer the recognition of any capital gain until you actually sell it. You cannot make this election if you claimed CCA on the property for any tax year ending after 1984. If you make this election, you can designate the property as your principal residence for up to four years before you actually occupy it as your principal residence. To make this election, attach a letter signed by you to your income tax return for the year in which you sell the property,

If you cease to be a Canadian resident, you cannot claim the principal residence exemption when you dispose of a property for any year after the year in which you became a non-resident.

or 90 days after the date the CRA asks you to make the election, whichever is earlier.

Non-residents

The principal residence exemption is generally only available if you are a Canadian resident for tax purposes. If you cease to be a Canadian resident, you cannot claim the principal residence exemption when you dispose of a property for any year after the year in which you became a non-resident. Due to the one-plus rule, a portion of the gain from the sale of your principal residence will be taxable if you were a non-resident of Canada for two or more calendar years during your period of ownership.

The one-plus rule has also accommodated and assisted in situations where a non-resident, who later became a Canadian resident, acquired a principal residence during their non-resident period. Under proposed changes, the one-plus rule will only be available if you were a resident throughout the tax year in which you acquired the property. These changes will apply to dispositions of property that occur after October 2, 2016.

When the home is owned by a trust

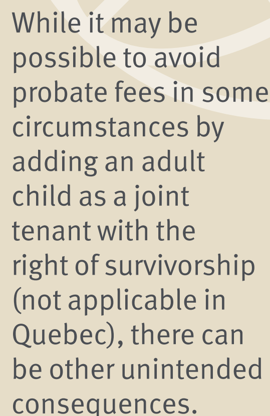
A trust is a relationship between the trustee and the beneficiary. The trustee holds legal ownership of the property for the benefit of the beneficiary. The beneficiary is the beneficial owner of the property. Properties may be transferred to or held in a trust for a number of reasons, including minimizing your exposure to probate fees and/or U.S. estate tax on death, or ensuring the smooth transition of a property between generations.

Currently, if a trustee disposes of a property that forms part of the trust's assets and there is at least one "specified beneficiary" of the trust, it may be possible for the trust to designate the property as a principal residence of the trust and shelter some or all of the resulting capital gains from tax. A "specified beneficiary" is any person who is beneficially interested in the trust and either ordinarily inhabited the property in the particular year, or who had a spouse, former spouse, or minor child who ordinarily inhabited the property. To designate the property as a principal residence, the trustee would file CRA Form T1079 — *Designation of a Property as a Principal Residence by a Personal Trust* with the trust's tax 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, all specified beneficiaries of the trust and members of their family unit (e.g. spouse or child) are unable to designate another property as their principal residence for the same tax year.

Under proposed changes, beginning in 2017, only certain types of trusts will be able to designate a property as a principal residence. Eligible trusts must fall into one of the following categories:

- An alter ego trust, spousal trust, joint spousal trust or certain trusts for the exclusive benefit of the settlor during the settlor's lifetime;
- a testamentary trust that is a "qualified disability trust"; or
- an inter vivos or testamentary trust for minor children of parents who have passed away before the start of the year. One of the parents must be the settlor of the trust.

In all cases, the beneficiary in respect of which the principal residence exemption is being claimed must be a resident of Canada during the year for which the exemption is claimed and must be the settlor or family member (spouse or child) of the settlor of the trust. As well, where the trust acquires the property after October 2, 2016, the



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 (not applicable in Quebec), there can be other unintended consequences.

terms of the trust must provide that beneficiary with a right to use and enjoy the residence throughout the period in the year in which the trust owns the property.

As a result of these proposed changes, many existing trusts established as "principal residence trusts" will no longer be eligible to claim the principal residence exemption after 2016. A special transitional rule will allow these trusts to use the existing principal residence rules to shelter gains accrued up to the end of 2016. Under this rule, the calculation of such a trust's gain on the disposition of the property will be separated into two periods: one for those years prior to 2017, for which such a trust could claim the principal residence exemption, and one for those years after 2016, for which it could not.

In light of these proposed changes, if your principal residence is held by a trust, or if you are contemplating transferring your principal residence to a trust, you may want to review this structure with your tax and legal advisor.

If your property is held by a trust that will no longer be eligible to claim the principal residence exemption after 2016, you may want to consider whether it is possible to transfer the property to a beneficiary of the trust prior to selling the property. In general, if a trust is properly structured and the trustee distributes a property to a beneficiary in satisfaction of their capital interest in the trust, the trustee is deemed to distribute the property at the trust's cost base and the receiving beneficiary acquires the property at the same cost. Where property is distributed to a beneficiary on a tax-deferred basis, the beneficiary is deemed to have owned the property continuously since the trust last acquired it for purposes of the principal residence exemption. When the property is subsequently sold by the beneficiary, the beneficiary may claim the principal residence exemption for those years that the trust owned the property provided that the beneficiary, the beneficiary's spouse, former spouse or children lived in the property while the trust owned the property.

Note that there are circumstances where it may not be appropriate to transfer the property to a beneficiary. This may be the case, for example, where the beneficiary has creditor issues or other problems managing funds.

Estate planning considerations

Joint ownership with an adult child

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 (not applicable in Quebec), there can be other unintended consequences. For example, when you, a homeowner, transfers your principal residence into joint ownership with your child, a taxable disposition may result with respect to the portion of the home transferred (though it may be possible to shelter any capital gains realized as a result of this disposition using the principal residence exemption). As well, on a subsequent sale, your child may be liable to pay tax on their share of any gains that have accrued on the property since the principal residence exemption will not be available to your child unless they lived in the home.

Transferring a principal residence into joint ownership with an adult child may expose the home to your child's marital and creditor claims. It may also result in a loss of control over the property, as your child's signature will be required on

Please contact us for more information about the topics discussed in this article.

documentation relating to the sale or refinancing of property. As well, there may be legal and other costs (such as land transfer fees) involved in changing ownership of the property. It is therefore important that you consult with your legal advisor prior to transferring the property into joint ownership with an adult child.

Conclusion

Often, your family home is your most valuable and significant asset. As such, you would want to ensure that you deal with it in the most tax-efficient manner possible. Ensuring that you principal residence qualifies for the principal residence exemption can help you financially protect this asset.

Wealth Management

This document has been prepared for use by the RBC Wealth Management member companies, RBC Dominion Securities Inc. (RBC DS)*, RBC Phillips, Hager & North Investment Counsel Inc. (RBC PH&N IC), RBC Global Asset Management Inc. (RBC GAM), Royal Trust Corporation of Canada and The Royal Trust Company (collectively, the "Companies") and their affiliates, RBC Direct Investing Inc. (RBC DI) *, RBC Wealth Management Financial Services Inc. (RBC WMFS) and Royal Mutual Funds Inc. (RMFI). *Member-Canadian Investor Protection Fund. Each of the Companies, their affiliates and the Royal Bank of Canada are separate corporate entities which are affiliated. "RBC advisor" refers to Private Bankers who are employees of Royal Bank of Canada and mutual fund representatives of RMFI, Investment Counsellors who are employees of RBC PH&N IC, Senior Trust Advisors and Trust Officers who are employees of The Royal Trust Company or Royal Trust Corporation of Canada, or Investment Advisors who are employees of RBC DS. In Quebec, financial planning services are provided by RMFI or RBC WMFS and each is licensed as a financial services firm in that province. In the rest of Canada, financial planning services are available through RMFI, Royal Trust Corporation of Canada, The Royal Trust Company, or RBC DS. Estate & Trust Services are provided by Royal Trust Corporation of Canada and The Royal Trust Company. If specific products or services are not offered by one of the Companies or RMFI, clients may request a referral to another RBC partner. Insurance products are offered through RBC Wealth Management Financial Services Inc., a subsidiary of RBC Dominion Securities Inc. When providing life insurance products in all provinces except Quebec, Investment Advisors are acting as Insurance Representatives of RBC Wealth Management Financial Services Inc. In Quebec, Investment Advisors are acting as Financial Security Advisors of RBC Wealth Management Financial Services Inc. RBC Wealth Management Financial Services Inc. is licensed as a financial services firm in the province of Quebec. The strategies, advice and technical content in this publication are provided for the general guidance and benefit of our clients, based on information believed to be accurate and complete, but we cannot guarantee its accuracy or completeness. This publication is not intended as nor does it constitute tax or legal advice. Readers should consult a qualified legal, tax or other professional advisor when planning to implement a strategy. This will ensure that their individual circumstances have been considered properly and that action is taken on the latest available information. Interest rates, market conditions, tax rules, and other investment factors are subject to change. This information is not investment advice and should only be used in conjunction with a discussion with your RBC advisor. None of the Companies, RMFI, RBC WMFS, RBC DI, Royal Bank of Canada or any of its affiliates or any other person accepts any liability whatsoever for any direct or consequential loss arising from any use of this report or the information contained herein. ® Registered trademarks of Royal Bank of Canada. Used under licence. © 2017 Royal Bank of Canada. All rights reserved. NAV0058 (06/17)