RBC Wealth Management

the Navigator

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC FAMILY OFFICE SERVICES

Aaron Fennell, MBA, CFA
Portfolio Manager & Investment Advisor
Tel: 416-313-6397
aaron.fennell@rbc.com

RBC Dominion Securities
181 Bay Street, Suite 2350
Toronto, ON M5J 2T3
www.aaronwfennell.com

Principal residence

A home is often the single largest purchase made by Canadians and an asset that can appreciate significantly over time. On the sale of a property, there can be a considerable tax liability on the increase in the value of the home since the date of purchase, 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.

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's 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 inhabited" the residence during some part of the year. Whether a property is considered ordinarily inhabited depends on various facts, so each particular case needs to be looked at. The Canada Revenue Agency (CRA) has stated this test may be met even

when 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 you purchase that's mainly used for earning income is generally not considered to be ordinarily inhabited by you in the year, even if you 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.

Here 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 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's 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, that portion of the home won't qualify as part of the principal residence.
- A property that's located outside of 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.

A principal residence is a property you own primarily for your or your family's use or enjoyment, which means it's a "personal-use property." If you sell a personal-use property, you may realize a capital gain or loss.

Selling your principal residence

Personal-use property

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

On the other hand, if you sell a personal-use property that depreciates in value, you can't deduct the resulting loss when you calculate your income for the year. In addition, you also can't 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. Keep in mind, you can't add current expenses, such as maintenance and repair costs, to the ACB of a property.

Did you know?

Prior to 1972

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 from December 31, 1971, onward, is used to calculate the gain.

The importance of 1994

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. On February 22, 1994, the government removed the $100,000 capital gains exemption but allowed you to file a special one-time election with your 1994 tax return to claim any remaining unused exemption against capital gains accrued on your property 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 (FMV) on that day. In most cases, the amount you elected as a deemed disposition became your new cost base. As such, if you still own the property for which a capital gains election was made, you'll want to take this into consideration in calculating your capital gain 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.

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:

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

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

As mentioned, after 1981, the principal residence exemption rules don't 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're not allowed to designate both properties as a principal residence for the year. To ensure you're not denied an exemption in respect of both properties for the year, the formula provides for the inclusion of one additional taxation year of exemption room (known as the "one-plus" rule).

If 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 FMVs today for the home and the cottage are $225,000 and $180,000, respectively. Mrs. Jones is thinking of selling both properties this year. Since the city home was the only residence owned by Mrs. Jones for the five years prior to purchasing the cottage, she can only designate the city home as her principal residence for those 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 of the 19 years she owned both properties. She doesn't 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 also 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

When you sell your principal residence (or are deemed to dispose of your principal residence), you're 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 the address of the property. In addition, you have to complete the relevant sections of a separate CRA prescribed form in order to designate the property as your principal residence.

If you don't 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. The CRA may be able to accept a late-filed principal residence designation in certain cases, but a penalty may apply. The penalty is equal to whichever amount is less:

- $8,000, 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've changed the use of the property and may be affected by the change in use rules. Where these rules apply, you're considered to have disposed the property at its FMV and to have immediately reacquired it for the same amount. You may realize a gain or loss in the year the change of use takes place.

Converting to a rental property

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're 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'll still have to report the net rental or business income you earn from the property and can't claim CCA on the property. Even if you're 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 don't use the property as your principal residence. However, you can only do this if you don't designate any other property as your principal residence for this time. This election should be made and filed with your tax return for the tax year in which the change of use occurred.

Converting to a principal residence

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. Keep in mind that you can't 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. This election must be made and filed with your tax return for the year in which you sell the property, or 90 days after the date the CRA asks you to make the election, whichever is earlier.

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've changed the use of the property and may be affected by the change in use rules.

Partial change in use

The deemed disposition rules also apply where there's a partial change in use of a property. For example, a partial change in use can occur where you own a multi-unit residential property, such as a duplex, and either start renting or move into one of the units. However, for changes in use of a multi-unit residential property that occur after March 18, 2019, you may elect that a deemed disposition not apply where a change in use involves only part of a property.

Non-residents

The principal residence exemption is generally only available if you're a Canadian resident for tax purposes. If you cease to be a Canadian resident, you can't 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.

Previously, the one-plus rule accommodated and assisted in situations where a non-resident, who later became a Canadian resident, acquired a principal residence during their non-resident period. For dispositions of property after October 2, 2016, the one-plus rule is only available if you're a resident during the tax year in which you acquired the property.

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, including a principal residence, 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.

Before January 1, 2017

In tax years prior to 2017, if a trustee disposed of a property that formed part of the trust's assets and there was at least one "specified beneficiary" of the trust, it may have been 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's beneficially interested in the trust and either ordinarily inhabited the property in the particular year, or who had a spouse, former spouse or child who ordinarily inhabited the property. For every year a trustee designated a property as the trust's principal residence, all specified beneficiaries of the trust and members of their family unit (e.g. spouse or minor child) were unable to designate another property as their principal residence for the same tax year.

After December 31, 2016

Since 2017, only certain types of trusts are 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. The beneficiary of these trusts must be a resident of Canada during the year and a specified beneficiary of the trust.
- A "qualified disability trust" (QDT). A QDT is a testamentary trust that jointly elects together with one or more beneficiaries who are eligible for the Disability Tax Credit (DTC) in its tax return for the year to be a QDT. The trust must also meet other conditions to be a QDT. Ask your RBC advisor for an article on Henson Trusts for more information about a QDT. For purposes of claiming the principal residence exemption, the beneficiary with a disability who jointly elects with the trust to be a QDT must be a resident of Canada during the year, as well as a specified beneficiary of the trust for the year. The beneficiary with a disability must also be a spouse, former spouse or child of the settlor.
- An inter vivos or testamentary trust for a minor child where both parents have passed away before the start of the year or a testamentary trust for a minor child that arose before the start of the year where one of the child's parents has passed away. The minor child must be a resident of Canada during the year and a specified beneficiary of the trust. In all cases, one of the child's parents must be the settlor of the trust.
- A trust (including an inter vivos trust) for the benefit of an individual who's eligible for the DTC, provided certain other conditions are met. The beneficiary of the trust must be a resident of Canada during the year, eligible for the DTC and a specified beneficiary of the trust, who is also a "qualifying individual." A "qualifying individual" includes the settlor of the trust; the child, grandchild, greatgrandchild, parent, grandparent, great-grandparent, brother, sister, uncle, aunt, niece or nephew of the settlor, or of the spouse or former spouse of the settlor; or the spouse of any of those individuals. In addition, no person other than the beneficiary may, during the beneficiary's lifetime, receive or use the income or capital of the trust. The trustee(s) also must be required to consider the needs of the beneficiary, including their comfort, care and maintenance.

If your property is held by a trust that's no longer eligible to claim the principal residence exemption after 2016, you may want to consider whether it's possible to transfer the property to a beneficiary of the trust prior to selling the property.

For every year a trustee of one of these trusts designates a property as the trust's principal residence, all specified beneficiaries of the trust and certain members of their family (e.g. spouse, minor child and, in certain cases, a parent or a minor sibling) are unable to designate another property as their principal residence for the same tax year.

Many trusts established prior to 2017 that hold a principal residence are no longer eligible to claim the principal residence exemption after 2016. A special transitional rule allows these trusts to use the principal residence exemption 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.

If your property is held by a trust that's no longer eligible to claim the principal residence exemption after 2016, you may want to consider whether it's 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 Canadian resident beneficiary in satisfaction of their capital interest in the trust, the trustee is deemed to distribute the property at the trust's ACB, 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 the purposes of the principal residence exemption. When the property is subsequently sold by the beneficiary, the beneficiary may claim the principal residence exemption for the years the trust owned the property, provided the beneficiary, or 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.

Residential property flipping rule

If you own a residential property (including a rental property) for fewer than 365 consecutive days, and you sell or dispose of it on or after January 1, 2023, the profits arising from the sale will be deemed as business income. The purpose of this deeming rule is to ensure profits from flipping residential real estate (purchasing real estate with the intention of reselling the property in a short period of time to realize gains) are always subject to full taxation and are not eligible for the 50% capital gains inclusion rate or the principal residence exemption.

This deeming rule would not apply if you sell or dispose of your home due to a certain life event, such as death, separation, household addition, personal safety, disability or illness, employment change, insolvency or involuntary separation.

If this deeming rule applies to you, the principal residence exemption would not be available. If the deeming rule doesn't apply to you because you fall within one of the exemptions or you've owned the property for 12 months or more, it will remain a question of fact as to whether the profits from the sale are taxed as business income.

The application of the property flipping rules may impact a trust beneficiary's ability to claim the principal residence exemption on the sale of a residential property that was rolled out of the trust to them on a tax-deferred basis, as described in the previous section. While the principal residence exemption rules allow for a deemed continuity of ownership between the trust and the beneficiary, the property flipping rules don't benefit from those same continuity rules. Therefore, a beneficiary who receives a residential property rolled out of a trust must personally hold that property for 365 consecutive days prior to disposing of the property in order to avoid the application of the property flipping rules and be able to claim the principal residence exemption.

Estate planning considerations

Joint ownership with an adult child

A question frequently asked by surviving spouses who want to avoid probate fees or to 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, transfer 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.

Keep in mind that 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 documentation relating to the sale or refinancing of the property. As well, there may be legal and other costs (such as land transfer fees) involved in changing ownership of the property. Given these factors, it's important to consult with a qualified 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. When that's the case, it's natural to want to make sure you deal with it in the most tax-efficient manner possible. Ensuring that your principal residence qualifies for the principal residence exemption can help you financially protect this asset.

This article may contain strategies, not all of which will apply to your particular financial circumstances. The information in this article is not intended to provide legal, tax or insurance 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, legal and/or insurance advisor before acting on any of the information in this article.



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