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Tax…shelter: the principal residence exemption

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With the real estate market booming (or contracting, as the case may be) in your home town, you have decided to cash in on the one income tax break that has remained relatively unchanged for individuals since its inception in 1972: the principal residence exemption (PRE). The concept seems simple enough. Generally, any gain on the sale of a home that has been ordinarily inhabited as a place of residence by you, your spouse, your common-law partner or your child will be exempt from income tax. However, the details of the rules do not reflect this simplicity.

Though many Canadians consider reporting the sale of their home for income tax purposes to be a relatively straightforward process, traps lurk for the unwary. In addition, legislative and administrative amendments announced by the Department of Finance on October 3, 2016 (the new rules) further complicate matters. (Note that property held through certain personal trusts may also qualify for the PRE. A detailed consideration of those rules falls outside the scope of this article.)

My house, my home?

Have you normally resided in the home the entire time you have owned it? If you haven't, the PRE may not exempt the entire gain from tax. The PRE works by calculating an exempt portion of the gain based on the number of years you designate as having "ordinarily inhabited" the property, plus one, divided by the number of years you have owned the property. Bare land generally will not qualify for the PRE. The new rules remove the "plus one" from the calculation for taxpayers who are non-residents of Canada at the time the property is purchased.

Have you or your spouse owned the home the entire time you have lived in it? If you haven't, a portion of the gain could be taxable to whoever else owned/owns the home. To ease succession or avoid probate fees, elderly taxpayers will sometimes transfer title on their home to their children while continuing to live in the property. This may limit the PRE claim for the period after the transfer up to the date of sale.

If you still have no reporting issues, there remains the matter of how much land qualifies. The Canada Revenue Agency (CRA) generally will limit the land area qualifying for the PRE to one-half hectare (1.236 acres). If you can demonstrate that a larger area was necessary for the use and enjoyment of the home, a larger land component may qualify. For example, if local zoning laws require a minimum lot size in excess of one-half hectare, you may be able to claim the PRE on a larger land component.

Have you ever rented out the home, perhaps while away for a period or while living elsewhere? A change in use from income-producing to personal, or the other way around, generally triggers a deemed sale under The Income Tax Act of Canada. Though elections to defer the deemed sale may be available, the change in use often complicates access to the PRE, sometimes drastically.

Prior to 1982, it was not uncommon for one spouse to claim the PRE on a home in the city while the other spouse claimed a home in the country. Since 1982, taxpayers who own two homes at once have been able to claim only one PRE per family. You must apportion the PRE to one property or another for post-1981 ownership. Further, pre-1972 capital gains are not taxed at all.

Additional caution is warranted if you attempt the calculation of the PRE having claimed all or a portion of the 1994 capital gains exemption on your home.

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If you have used the home and/or adjacent land for some other use (such as a bed and breakfast, a farm or a rental suite), the PRE could be reduced, particularly where you have claimed any capital cost allowance on the property. Special rules apply to farmers who dispose of land that was used in a farming business that includes the principal residence.

It can always get worse

Don't see any problems yet? If you have demonstrated a tendency to own homes for a relatively short time period, the CRA may take the view that, not only does the PRE not apply, but you are engaged in the business of property development and the entire gain is taxable as income. Furthermore, GST/HST may apply to business-use portions of the property upon sale.

It's worse

The PRE is claimed on form T2091, Designation of a Property as a Principal Residence by an Individual. A longstanding CRA administrative policy suggested that, if the application of the PRE eliminates the taxable capital gain on the property, you need not file the T2091 with your personal tax return for the year in which the sale of your principal residence occurred.

The October 3, 2016 announcement requires that the disposition be reported on schedule 3 and form T2091 for all PRE dispositions after December 31, 2015. Failure to report may result in penalties and may even be fatal to the PRE claim. Further, the new rules will extend the normal reassessment period from three to four years in cases where a sale was not reported.

A gain on the sale of one's home can be substantial. Accordingly, the income tax and GST/HST costs of improper planning or blundering into an unforeseen trap can be significant. Claiming the PRE is a complex matter, and this article summarizes only some of the common issues. Before you sell or buy, contact your Collins Barrow advisor for help in minimizing the tax on your shelter.

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