Manulife

Personal Home and Vacation Properties -Using the Principal Residence Exemption

Introduction

Your family's home is generally known to be exempt from capital gains taxation, but what about the family cottage or vacation property? Generally, those additional properties are not thought to be exempt. Cottages and other vacation properties have presumably increased in value and consequently, a capital gains tax liability may be triggered when the property is sold or on the death of the owner. Understanding the principal residence exemption may provide an opportunity to reduce the total tax liability on these properties. This Tax Topic discusses the tax rules relating to principal residences.

Subsection 40(2)(b) of the Income Tax Act (the "Act") provides the tax exemption for gains on a principal residence. It contains a formula to determine the exemption and its allocation among various properties. The exemption applies to a principal residence that is capital property for each year of ownership since 1971. There are numerous conditions that must be met to qualify for the exemption including type of property, ownership, whether the taxpayer "ordinarily inhabited" the premises and residency of the taxpayer. These topics will be dealt with in detail below.

What is a "Principal Residence"?

Capital Property

The term "principal residence" is defined in subsection 54 of the Act for purposes of calculating taxable capital gains and allowable capital losses. The first question is whether the property is a capital property so that a gain on the disposition is treated as a capital gain. Whether the property is capital property depends on the nature of the property and the manner in which the owner deals with the property. Where a property is considered to be on account of income, that is, used for the purpose of earning income from a business, the related gain is taxed as ordinary income. Gains resulting from the disposition of a residence are generally capital gains.

Section 2.7 of Income Tax Folio, S1-F3-C2: *Principal Residence* specifies the types of capital property that can qualify as a principal residence. A principal residence can include a housing unit, including, an apartment or unit in a duplex, apartment building or condominium, a cottage, a mobile home, a trailer, or a houseboat, a leasehold interest in a housing unit or a share of capital stock of a co-operative housing corporation that allows the owner to live there.

Related Land & Vacant Land

In the definition of "principal residence" subsection 54(e) of the Act includes the land upon which the housing unit stands and any portion of the adjoining land that can reasonably be considered to be contributing to the use and enjoyment of the housing unit as a residence. However, where the total area of the subjacent land exceeds half a hectare (about 1.2 acres), the excess is deemed not to have contributed to the use and enjoyment of the housing unit as a residence unless the taxpayer can provide evidence that the excess land is necessary for such use and enjoyment. The use of land in excess of ½ hectare in connection with a particular recreation or lifestyle (such as for keeping pets or for country living) does not mean that the excess land is necessary for the use and enjoyment of the housing unit as a residence. Some examples of where the land may be necessary for the use of the housing unit are lot size requirements for a particular area, severance restrictions imposed by municipal bylaws or where excess land is required to provide road access to the home. In all cases however, it is a question of fact as to how much, if any, of the excess land is necessary for the use and enjoyment of the housing unit as a residence.

The portion of land that is used to earn income from business or property will generally not be considered to contribute to the use and enjoyment of the housing unit as a residence.

As the definition of principal residence includes only land subjacent and immediately contiguous to a housing unit, vacant land is not generally considered to be a principal residence. Where a taxpayer acquires vacant land for the construction of a housing unit, only the years in which there is a housing unit on the land and the taxpayer or other specified individuals ordinarily inhabits the dwelling can be applied toward the exemption. The total years of ownership include the period while the land was vacant. This means that, on the sale of the property, part of the gain may not be covered by the principal residence exemption.

Ownership, Ordinarily Inhabited and Residency

In order for a taxpayer to designate a property as a principal residence, the taxpayer must own the property. The ownership can be "jointly with another person or otherwise" per the definition of "principal residence" in the Act. Ownership includes sole ownership, joint tenancy or tenancy in common and co-ownership[1]. The Act does not define the term "owned"; however, for the purposes of claiming the principal residence exemption, the ownership requirement in section 54 of the Act is met where the taxpayer is the legal or beneficial owner of the property. These terms are discussed in greater detail in Income Tax Folio, S1-F3-C2: *Principal Residence*. A personal trust may also own a home and claim the principal residence exemption. See the "Personal Trust" section below.

An important test for principal residence eligibility is that the housing unit must be "ordinarily inhabited" by the taxpayer, or by the taxpayer's spouse or common-law partner, former spouse or common-law partner or child. "Ordinarily inhabited" is not defined in the Act and is based on the facts of each particular case. A person may inhabit a housing unit only for a short period of time in the year to satisfy the ordinarily inhabited rule (Income Tax Folio, S1-F3-C2: *Principal Residence*, sections 2.10 – 2.12). For example, a seasonal residence like a cottage can be considered to be ordinarily inhabited in the year by a person who occupies it only during his or her vacation, provided that the main reason for owning the property is not to gain or produce income.

The ownership and ordinarily inhabited tests must be satisfied during each year for which the home is designated as principal residence. In addition to meeting the ownership and habitation requirements, the taxpayer (individual or personal trust) must also be resident or deemed to be resident in Canada during the year.

Designation and the Family Unit Rule

The principal residence rules include a set of provisions that limits the annual designation within a specified family group. For years after 1981, each family unit may designate only one home per year as a principal residence. A family unit includes the taxpayer, the taxpayer's spouse or common-law partner and unmarried minor children. In other words, where a property is designated as a principal residence for a year, no other property may be designated for that same year by the taxpayer or another member of the family unit.

Prior to 1982, each individual could designate a property as a principal residence without regard to a designation made by another family member (subparagraph 54 (c)(i) of the Act). For example, a husband could own a cottage and his wife a home in town and both could be designated as a principal residence. With the change in the rules at the beginning of 1982, a transitional rule was added to protect the gain accrued on property that could have been designated under the old rule but would not be designated under the new rule. This transitional rule is discussed in "Calculating the Gain".

Principal residence status is an annual determination. Regulation 2301 of the Income Tax Regulations requires a taxpayer to designate a property that has been disposed of as a principal residence in his/her

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[1] In Quebec civil law, ownership of property can be individual or joint.

income tax return for the taxation year in which the property was disposed of or an option granted to another person to acquire the property. Prescribed form T2091, *Designation of a Property as a Principal Residence by an Individual (Other Than a Personal Trust)* for individuals computes the amount of the gain that is taxable. CRA has an administrative position that only requires the form to be completed and filed if the principal residence exemption does not completely eliminate the gain on the sale of the property or where the 1994 capital gains exemption election was claimed in respect of the property. The Courts may require the form to be filed. The 1994 election provided an opportunity to increase the cost base of the second residence; however, this election cannot be made today under retroactive application.

1994 Capital Gains Election

The $100,000 lifetime general capital gains exemption was eliminated for gains realized on dispositions of property occurring after February 22, 1994. Where a Canadian resident individual taxpayer owned capital property (other than non-business real property) with unrealized gains on February 22, 1994, and had an unused portion of their $100,000 exemption, they were able to take advantage of the exemption by filing a prescribed election form with their 1994 individual income tax return. Where a taxpayer made the election to claim some or all of their available $100,000 capital gains exemption, the taxpayer was considered to have disposed of their property and recognized the accrued gain even though the property was not actually disposed. The lesser of the taxpayer's available capital gains exemption or the gain included in income was then deducted from taxable income. The gain that was recognized by the election reduces future capital gains on the property elected on.

However, for non-business real property such as a family cottage, chalet or vacant land, only gains accrued prior to March 1992 were eligible for the capital gains exemption and only this pre-March 1992 gain was recognized and offset by the election. The portion of the gain eligible for the election was determined by prorating the total gain based on the number of months the real property was owned before March 1992 over the number of months the property was owned before February 22, 1994. Any gain accrued on non-business real property from March 1992 to February 22, 1994, was not subject to tax upon filing the election, but rather deferred until an actual disposition of this property occurred. Where this election was made in respect of a principal residence, the principal residence designation may or may not have been made in conjunction with the election.

If the capital gains election was made, on actual disposition of the property after February 22, 1994, there may be two options available in respect of calculating the gain. The principal residence exemption can be ignored and any tax payable would be calculated on the gain or loss from the revised cost base arising from the 1994 election. The other option would be to use the principal residence exemption as calculated in the next section to supplement the election. If the principal residence exemption was used on the elected property or if 1994 was designated as a principal residence year in the 1994 election, then the gain must be calculated as outlined in the follow-up.

Calculating the Gain

The principal residence exemption is not a deduction in computing income or taxable income; it is a direct reduction of the capital gain that would otherwise be determined for a principal residence. Subsection 40(2)(b) of the Act provides the formula to determine the amount of the reduction to the capital gain from the disposition of any property that was a principal residence at any time after the acquisition date (the later of December 31, 1971 and last acquired or reacquired date). Losses on a principal residence are not deductible by virtue of subsection 40(2)(g)(iii) of the Act.

The amount by which the capital gain for a principal residence is reduced is calculated by using the following formula: **A – (A x B / C) – D**

> **A** is simply the gain that would otherwise be determined ignoring the 1994 election. That is, the proceeds of disposition from the actual sale less the historical adjusted cost base of the residence (original cost plus major additions or renovations.)
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> **(A x B / C)** is the portion of the gain which is exempt represented by the following formula:

$$\textbf{A}\text{ Capital Gain} \quad \text{X} \quad \frac{\textbf{B}\text{ The number of taxation years ending after the acquisition date (post 1971) for which the property is designated as your principal residence during which you were resident in Canada plus one}}{\textbf{C}\text{ The number of years ending after the acquisition date (post 1971) of ownership of the property}}$$

> The inclusion of the "plus one" in this part of the formula contemplates the possible ownership of two homes in a year where one principal residence is sold and a replacement home is purchased. Where a home qualifies as a principal residence the result of the calculation arising from the application of this formula allows the full gain to be exempt from tax.
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> **D** is the adjustment to deduct the deemed capital gain created by the 1994 election. In effect, the previously claimed capital gains exemption gets recomputed to prevent a taxpayer from using both the capital gains exemption and the principal residence exemption in respect of the same gain. Note that the designated principal residence years used in the 1994 election should be the same years used when calculating the portion that is exempt.

See Example I.

Properties Owned before 1982

Where the family owned multiple properties prior to 1982, it is possible to shelter gains on those properties using the principal residence exemption. To accomplish this, an alternative gain calculation is available for properties owned before 1982 (subsection 40(6) of the Act). The alternative method essentially creates a Valuation Day on January 1, 1982 for purposes of the new family unit rule (one property per family) so that properties held before that time may be protected under the old rules on value accrued to that time. There is a notional disposition on December 31, 1981 and recognition of the capital gain to that date. The property is notionally reacquired on January 1, 1982 at its fair market value ("FMV"). A separate computation of the capital gain is made for the period from that date to the date of actual disposition. It may be necessary to obtain a valuation of the property as of the end of 1981. Note that the "plus one" rule does not apply for the post-81 period. The maximum gain determined under the alternative method is calculated as: pre-82 gain + post '81 gain – post '81 loss (cannot be negative).

Where a residence was bought before January 1, 1982 and sold after December 31, 1981 the capital gain is equal to the lesser of the amount calculated using the standard formula described in the previous section (A – (A x B / C) – D) and the amount calculated using the alternative method. The standard formula would include the total period of ownership including the "plus one" rule but restricted by the family unit rule for the years after 1981.

The alternative formula is generally used when it results in a gain that is less than the gain that would be determined using the standard formula. This could be the case where there has been a decline in the property value since 1982.

Where two properties are owned by a family unit – for example, a city home and a cottage (and at least one has been continuously owned since a date before 1982), by carefully selecting the years for which to designate the sale property as a principal residence, the taxpayer may be able to minimize the tax liability resulting from the sale of one of the properties. See Example II.

Where two residences are each jointly owned by spouses, each spouse would be entitled to designate either residence as his or her principal residence under the exemption formula. However, for the pre-1982 period this means that both spouses must designate the same property and therefore no other property could be designated during those years. Where a couple has jointly owned two residences continuously since before 1982, a transfer of ownership so that each residence is wholly-owned by one spouse can maximize the potential principal residence designation for years owned before 1982 since the entire residence can be designated as his or her principal residence. The rules on transferring ownership are explained in the follow-up.

Personal Trust

A personal trust that owns a home may claim the principal residence exemption to reduce or eliminate a gain on disposition. A personal trust as defined in subsection 248(1) of the Act also includes a spousal trust. The normal principal residence rules generally apply except for the following modifications provided under the definition of principal residence in subsection 54 of the Act:

- the personal trust must designate a property as its principal residence for one or more taxation years. The trustee should complete and file form T1079, *Designation of a Property as a Principal Residence by a Personal Trust*;
- the housing unit must be ordinarily inhabited by a specified beneficiary or a spouse or common-law partner, former spouse or common-law partner, or child of a specified beneficiary;
- no corporation (other than a registered charity) or partnership can be beneficially interested in the trust; and
- no other property can be designated as a principal residence by a specified beneficiary, or by the specified beneficiary's family unit.

In order to qualify as a specified beneficiary for the principal residence exemption, a person must be, among other things, "beneficially interested" in the trust. The effect of the last point above is that for personal trusts, only one designated principal residence per year is allotted to the trust, a specified beneficiary and the spouse, common-law partner and minor children of a specified beneficiary. This means that because the property is designated by the trust, none of the specified beneficiaries will be able to designate another property for that same year.

Change in Use of a Property

A change in use results from a change in the use of a property (in whole or in part) from a principal residence to an income-producing purpose or vice versa. When there is a conversion to or from a principal residence subsection 45(1)(a) of the Act deems a disposition of the property (land and building) at FMV and a reacquisition of the property immediately thereafter at the same amount. The disposition may result in a capital gain. The principal residence exemption may eliminate or reduce the gain on conversions from a principal residence. (See Income Tax Folio, S1-F3-C2: *Principal Residence*, sections 2.48 – 2.56, for more details regarding a change in use.)

The gain arising from the deemed disposition can be deferred up to four taxation years by electing under subsections 45(2) or (3) of the Act to be deemed not to have made the change in use in the property. The election is made by means of a letter signed by the taxpayer and filed with the income tax return for the year in which the change in use occurred. A taxpayer cannot designate another property as principal residence during this election period. This election effectively allows the principal residence characterization to continue for up to four years with no capital gain realized in the year of the change in use. This may be useful where the change in use is not of a permanent nature.

If the election is subsequently rescinded in a year, the disposition and reacquisition of the property at FMV is deemed to have occurred on the first day of that same year. Any resulting gain and principal residence exemption would be applied to that same year. When the four years expire, the principal residence designation can only be used if the residence is actually inhabited by the taxpayer.

While the election is in force no capital cost allowance claims may be made in respect of the property. Where the property is depreciable property, there may be additional rules to consider under subsection 13(7) of the Act that deems a disposition and reacquisition of the property for purposes of claiming capital cost allowance ("CCA") or the recapture of CCA previously claimed. As a result one must weigh the benefits of extending the principal residence exemption and the tax deferral on the capital gain against the capital cost allowance claim.

Partial Change in Use

A partial change in use of the principal residence arises where a portion of the residence is used on a regular basis for income-producing purposes. However, a property can retain its principal residence status on a partial change use if certain conditions are met. The partial use for income producing purposes must be ancillary to the main use of the principal residence, there is no structural change to the property and no CCA is claimed on the property. Whether the three conditions are met is a question of fact (Income Tax Folio, S1-F3-C2: *Principal Residence*, sections 2.57 – 2.64). Examples include maintaining an office or workspace in the home, renting out one room of the home or providing daycare services in the home.

Otherwise, where the residence is partially converted to an income-producing use, subsection 45(1)(c) of the Act provides for a deemed disposition of the portion of the property converted for proceeds equal to its proportionate share of the property's FMV. There is a deemed reacquisition immediately thereafter for the same portion of the property at a cost equal to the proceeds. Any gain resulting from the deemed disposition may be eliminated or reduced by the principal residence exemption. The elections available under subsections 45(2) or (3) of the Act to defer the gain would not be available where there is a partial change in use. The rules for depreciable property for purposes of claiming CCA may also apply for the portion that had changed in use.

Employment Relocation
Where the home was vacated as a result of an employment relocation, as long as an individual moves back into the original home and subject to certain conditions, all years of absence will continue to qualify as principal residence years, even though the home was not inhabited by a member of the family unit for that period. The no-change-in-use election is filed but extended indefinitely while the individual is relocated.

Transfers of Principal Residences
Where there is a transfer of property between non-arm's length parties for no consideration or for less than FMV, the property is generally deemed to be disposed of for proceeds equal to FMV for tax purposes (subsection 69(1) of the Act). However, where the transfer is between spouses or common-law partners or to a trust in favour of these individuals, subsection 73(1) of the Act provides for an automatic rollover. The subsection deems the capital property to have been transferred at proceeds of disposition equal to the ACB (the capital cost of the property). As a result, the taxpayer would realize no capital gain in the year of transfer.

If there is a future disposition of the residence and there was an automatic rollover from a transfer between spouses, for the purpose of computing the principal residence exemption on the property, the recipient is deemed to have owned the property during the period that the transferor owned it. The property is deemed to be the recipient's principal residence for any year in which the transferor would have designated the property as a principal residence. CRA indicates that the transferor must complete the designation form and the transferee should retain the form at the time of transfer in order for the transferee to use those years in computing the principal residence exemption on a subsequent disposition (subsection 40(4) of the Act).

Elections can be made to opt out of the automatic rollover provisions between spouses[2] to transfer the residence at FMV. If the election were made, the above rule, whereby the designation of principal residence includes years of ownership by the other spouse (the transferor), would not apply for purposes of the principal residence exemption calculation. If the transfer of a residence is made to a trust for a spouse, subsection 40(4)(c) of the Act deems the trust to have been a Canadian resident for every year during which the transferor is a Canadian resident.

Where a sole owner of a principal residence transfers title to his/her child(ren), whether by joint ownership or by way of a gift, determining whether there has a disposition will first depend on whether there has been actual change in beneficial ownership of the property. Determining whether a person has beneficial ownership is a question of fact for each particular case. Income Tax Folio, S1-F3-C2: *Principal Residence*, sections 2.79provides a number of factors that are considered to distinguish beneficial ownership. Several technical interpretations confirm that where the transfer of ownership results in a change in beneficial ownership, there is a disposition for tax purposes and the child(ren) would be deemed to acquire their interest in the property at FMV (Technical Interpretations 2005-0152011E5 and 2006-0166551E5).

Capital Gains Tax at Death
Paragraph 70(5)(a) of the Act provides that a deceased taxpayer is deemed to have disposed of each capital property owned by him or her, immediately before death, for proceeds equal to the FMV at that time. At death, a capital gain will be realized for tax purposes to the extent that the FMV exceeds the deceased's ACB of the property. Any taxable capital gains that are not sheltered by the principal residence exemption (or lifetime capital gains exemption) will be subject to tax. One half of such gains will be added to the taxable income of the deceased individual.

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[2] In accordance with subsection 70(6.2) or subsection 73(1) of the Act.

For tax purposes, the Act provides that the deceased's estate is deemed to have acquired the property at FMV and accordingly this becomes the estate's ACB of the property (subsection 70(5)(b) of the Act). See also the Tax Topic entitled, "Taxation of Capital Property Held at Death".

Taxation at death may be deferred if a spouse (or common-law partner) or a qualifying spousal trust receives capital property of the deceased. The property will be deemed to have been transferred at proceeds of disposition equal to the ACB (the capital cost of the property). As a result, the taxpayer would realize no capital gain or loss in the year of death. Any capital gains are postponed until the spouse or qualifying spousal trust disposes of the property. A qualifying spousal trust is defined as a trust where only the surviving spouse or common-law partner is entitled to its income and has access to its capital until the surviving spouse's death (subsection 70(6) of the Act).

In addition, the property is deemed to be the recipient's principal residence for any year in which the deceased would have been entitled to designate the property as a principal residence (subsection 40(4)(b)(i) of the Act). Thus, when the surviving spouse/partner eventually disposes of the property or qualifying spousal trust, it is eligible for the principal residence exemption based on the combined years of ownership.

Life insurance

Life insurance may be purchased to provide the funds necessary to pay the tax liability resulting from capital gains triggered upon the death of the individual. One of the benefits of life insurance is that it provides a tax-free lump sum payment upon the death of the individual who is insured. A life insurance policy beneficiary designation enables the proceeds to be paid directly to the party indicated by the policyholder on the death of the individual insured. In the personal context, life insurance proceeds may be used to pay debts, tax liabilities and other estate costs so that estate assets do not have to be eroded, liquidated or borrowed against in order to pay for these expenses.

Where a tax rollover applies, a tax liability will result on the death of the surviving spouse. Therefore, the funding need is postponed until the second death. Joint second-to-die life insurance may be used to fund the tax liability resulting from the capital gains upon the death of the survivor spouse.

Conclusion

For many Canadians, the gain on the sale of their home is exempt from tax because of the principal residence exemption. However, numerous rules and calculations apply making this exemption quite complex, particularly where a family unit owns and occupies more than one home at a time. With some planning, the exemption may be used to minimize the tax in relation to the sale of a home or vacation property. Where a property is held until death, life insurance is particularly important as a funding vehicle for the tax liability on gains of properties not covered by the principal residence exemption.

Last updated: November 2015

Tax Topic: The Principal Residence Exemption
Example I - General Rules

	City	Cottage
Purchase Date	1989	1997
Cost	150,000	80,000
Selling Price	400,000	280,000
Selling Date	2009	2009
Total Years of Ownership	21	13
Capital Gain (40(2)(b))	250,000	200,000
Gain per year	11,905	15,385
Designation dates	1989-1996, 2009	1997-2008
# of designation years	9	12 **
Less: Principal Residence Exemption	(1+9) / 21 x 250,000 = 119,048	(1+12) / 13 x 200,000 = 200,000
Net Capital Gain	**130,952**	0
Taxable capital gain (50%)	**65,476**	0

Since the cottage has the higher gain per year, the principal residence exemption generally is applied to the cottage first and then the remainder to the city home.

Assume no costs incurred on the diposition of the property.

** Due to the "plus one" factor of the exemption formula, allocating 13 years of ownership would waste 1 year of exemption. Thus only 12 years are designated and still receive the full exemption.

Tax Topic: The Principal Residence Exemption

Example II - Residences owned before 1982

	City	Cottage
Purchase Date	1968	1977
Cost	65,000	48,000
V-day Dec 31, 1971	110,000	n/a
V-day Dec 31, 1981	180,000	110,000
Selling Price	349,500	169,500
Selling Date	1998	1998
Total Years of Ownership	27	22
Pre-82 years of ownership	10	5
Post-81 years of ownership	17	17

	General Rules (40(2)(b))		Alternative Method			
			Pre-82 gain (40(6)(a))		Post-81 gain (40(6)(b))	
Residence	City	Cottage	City	Cottage	City	Cottage
Sale Price or Valuation	349,500	169,500	180,000	110,000	349,500	169,500
Cost / Vday value	110,000	48,000	110,000	48,000	180,000	110,000
Capital Gain	239,500	121,500	70,000	62,000	169,500	59,500
Gain per year	8,870	5,523	7,000	12,400	9,971	3,500
Designation dates	1972-1976, 1978-1998 [A]	1977	1972-1977 [B]	1978-1981 [B]	1982-1998	nil [C]
# of designation years	26	1	6	4	17	0
less: Principal Residence Exemption	(1+26)/27 x 239500 = 239,500	(1+1)/22 x 121500 = 11,045	(1+6)/10 x 70000 = 49,000	(1+4)/5 x 62000 = 62,000	17/17 x 169500 = 169,500	0/17 x 59500 = 0.00
Net Capital Gain / property	0.00	110,455	21,000	0.00	0.00	59,500
Total Net Capital Gain		110,455				80,500

Lesser of General Rules & Alternative Method	**80,500**
Taxable capital gain (50%)	**40,250**

A. Due to the "plus one" in the formula, one year would be wasted on the city home. Applying one year to the cottage reduces the capital gain on the cottage and still get the full exemption on the city home.

B. The years 1972-1976 must be used for the city home, which was the only residence owned in those years. The cottage has the highest gain per year in the pre-82 period so most of the exemption should be applied to the cottage. As in Note 1, the "plus one" rule allows the extra year to be allocated to the city home.

C. The city home has the higher gain per year in the post-'81 period, generally all of the exemption is applied to the city home for this period. Note there is no "plus one" factor for this period.

Under the alternative method, there is a hypothetical disposition on December 31, 1981 and subsequent reacquisition on January 1, 1982 of the property at fair market value.

Asume no costs incurred on the disposition of the property.

Assume no capital gains election made under subsection 110.6(19) of the Act, related to the $100,000 lifetime capital gains exemption.