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CESTNICK

TAX MATTERS

This is how the principal residence rule works for Canadian homeowners

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There's no shortage of folks wanting to buy homes. Last week, I wrote about ways to pay for a home, and some thinking around structuring ownership. Today, I want to cover a potpourri of ideas you should keep in mind if you're hoping to own a property – or a second property – some time in the future.

PRINCIPAL RESIDENCE RULES

Since 1982, each family unit (which includes you, your spouse or common-law partner, and any unmarried kids under the age of 18) has been able to designate one property as its principal residence for each calendar year. To simplify the explanation, if you own a property for, say, 10 years and you designate it as your principal residence for five of those 10 years, you'll be able to shelter one half of any gain on that property from tax using the principal residence exemption (PRE).

To designate a property as your principal residence you must "ordinarily inhabit" the place. There's no definition of "ordinarily inhabit" in our tax law, but the Canada Revenue Agency takes the position that living in the place for even a "short period of time" should be sufficient. So, a seasonal cottage could qualify, for example. But it must also be true that the property is not primarily used for earning income – like a rental property. Finally, the property must also be a "capital property" (more on this below).

SHORT-TERM OWNERSHIP ISSUES

While there's no specific time frame over which you have to own a property for it to qualify as a principal residence, the taxman will take offence if you try to claim the PRE when your intention was really to flip the property for a profit after a short time. To qualify for the PRE, the property must be a "capital property," and if your intention is to buy, perhaps fix and then flip the property, the taxman takes the view that this is more akin to business inventory than a capital property. In this case, you could be taxed on your profits as regular business income. If you buy a property for long-term personal use or to earn income, then you'll have a better argument that the property is a capital property subject to capital gains tax treatment on a sale. Again, if it's for personal use (not primarily income-producing), then you may be able to shelter any capital gain from tax using the PRE.

CAPITAL IMPROVEMENTS

Be sure to keep track of all your capital improvements on your property – particularly if you're going to face tax on all or any portion of a gain on a sale later. Capital improvements can be added to your initial cost of the property when calculating your adjusted cost base (ACB). The difference between your sale proceeds and your ACB will be the capital gain that could be taxable. Capital improvements are things that extend the useful life of the property or restore it beyond its original condition. Things such as a new roof, swimming pool, permanent landscaping, major renovation or a new addition to a home are typically capital improvements.

LONG-STANDING OWNERSHIP

If you already own a home that you've held since before 1982, it may be possible to shelter more than one property with the PRE. Prior to 1982, each individual – not each family unit – was entitled to their own PRE.

Today, it's still possible to shelter pre-1982 gains on more than one property – including the cottage. And if you've owned a home since before 1972, you won't face tax on any capital gains prior to that year since capital gains weren't taxable back then. Speak to a tax professional about these ideas.

CHANGING USE OF THE PROPERTY

If you change the use of a property from personal use to income-producing, or the other way around, you'll be deemed to have sold, and to have reacquired, the property at the time of the change in use. This could trigger a tax bill if you're converting a rental property to personal use. (See my article, Changing the Use of a Property Can Come with a Tax Surprise, dated July 8, 2021, for more on this.)

Next time, I'll finish this conversation by talking about cottages, income properties and U.S. real estate.

Tim Cestnick, FCPA, FCA, CPA(IL), CFP, TEP, is an author, and co-founder and CEO of Our Family Office Inc.
He can be reached at tim@ourfamilyoffice.ca