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CESTNICK

TAX MATTERS

Beware of the tax rules for principal residences if you own a large lot

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Last week my wife Carolyn travelled to our cottage and discovered trouble. She turned the water on and noticed a leak, so she called a plumber. On the side of his truck were the words "We repair what your husband fixed." Being a handy guy, I took great offence to that slogan.

It turns out that our cottage neighbour was having trouble of his own. Not with his water, but with the Canada Revenue Agency (CRA). His story is a reminder of how the principal residence exemption can be complicated.

The story

Anthony has owned the cottage next door since 2005. The property is about 0.8 hectares in size. He also owns a vacant lot adjacent to his cottage that is about 0.5 hectares. The vacant property and his cottage used to be one lot, but Anthony severed the properties five years ago when the municipality changed its rules to allow smaller lot sizes.

Anthony then sold the vacant lot in 2022 and reported this on his tax return. He claimed the principal residence exemption (PRE) on the sale so that it was tax-free. Or so he thought. CRA has challenged the PRE on the basis that the land doesn't qualify for the exemption, and they want Anthony to pay about $100,000 in taxes on a capital gain of $375,000.

The rules

There's no doubt that a cottage can generally qualify for the PRE. But our tax law limits the size of any property that can qualify for the exemption to just half a hectare. If you sell a residence with more land than this, you might still qualify to shelter the full capital gain from tax using the PRE if you can demonstrate that the excess land was necessary for the use and enjoyment of the housing unit as a residence.

In situations where a municipality requires folks to own properties in excess of half a hectare, CRA has typically considered the excess land to be necessary and have then allowed the full PRE on a sale later.

In Anthony's case, he does have an argument that he had no choice but to own the excess land owing to municipal laws that prevented folks from owning smaller lots. So, for the first 15 years of his ownership (from 2005 when he purchased to 2020 when he severed the properties) he could argue that the excess land was necessary for the use and enjoyment of the cottage as his principal residence.

Some might argue that Anthony didn't sell a residence at all, but just a vacant property, and so no PRE should be available. That argument doesn't hold water. In the case Fourt v. MNR (91 D.T.C. 5631), the taxpayer sold a separate lot adjacent to the lot on which her principal residence was located and the PRE was allowed because the separate lot could be "reasonably regarded as contributing to the use and enjoyment of the principal residence." (In the Fourt case, the combined size of the two lots was less than half a hectare, so the lot sold only needed to be "reasonably regarded as contributing to" and not "necessary for" the use and enjoyment of the house as a residence.)

In Anthony's case, he'll need to prorate the PRE so that it only applies to the 15 years that he was required to own the excess land. So, 15 out of 20 years (75 per cent) should be sheltered using the exemption. So, just 25 per cent of the capital gain, or $93,750 ($375,000 x 25 per cent), would be subject to tax. At a 50-per-cent inclusion rate, just $46,875 of that gain should be taxable, with taxes owing of $25,092 in the highest tax bracket in Ontario.

The nuances

We can learn a few things from Anthony's story. First, owing land in excess of half a hectare can still qualify for the PRE if the excess land was necessary for the use and enjoyment of the housing unit as a residence – even if that land is a separately titled lot.

Whether excess land was truly "necessary" could be challenged. In its Income Tax Folio S1-F3-C2, Principal Residence, the CRA says in paragraph 2.33 that "the excess land must clearly be necessary for the housing unit to properly fulfill its function as a residence and not simply be desirable. Generally, the use of land … 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 …"

The moral of the story? If you own a property that is larger than half a hectare or want to sell a severed portion of your property, you'd be wise to visit a tax professional to plan for any tax implications

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