The principal residence exemption – a powerful planning tool

Canada’s capital gains exemption on a family’s principal residence offers advisors a powerful way to help improve the financial wealth of clients. But the rules have changed over the years, so clients need to understand if they qualify under the old rules, and when the new rules apply. The terminology can be confusing. Principal residence, matrimonial home and homestead are defined terms applied to real estate for different reasons. The concepts behind these terms often affect inheritance planning and beneficiary designations and are especially important for clients with more than one property.

Principal residence

Principal residence is a federal income tax concept that applies uniformly across Canada. Qualifying principal residences are exempt from Canada’s capital gains tax. The taxpayer doesn’t claim this exemption until they dispose that property. A disposition includes a sale or deemed disposition arising from a gift, emigration from Canada, or death. The tax-free status doesn’t depend on whether there are any actual proceeds received, e.g. the exemption can also eliminate capital gains tax triggered by a deemed disposition of the principal residence.

There are three main conditions that must be met for the capital gains tax exemption to apply:

- The property must be a qualifying type of property. Qualifying property includes a housing unit (such as house, condo, cottage, mobile home, trailer or houseboat); a leasehold interest in a housing unit; or a share of the capital stock in a co-operative housing corporation so long it was acquired solely to inhabite the unit. The land on which the housing unit is located can usually qualify as part of the residence, subject to certain restrictions. It’s typically limited to one-half hectare, although a larger property may qualify when it’s necessary for the use and enjoyment of the residence.
- The residence must be one that can be ordinarily inhabited. The owner, their spouse or their child must live in the residence although the rules don’t specify the length of time. An annual vacation may be enough. The goal is to ensure the property isn’t used primarily for gain or to produce an income.¹
- There must also be ownership of the property at some point during the year. This includes joint ownership – whether it is joint tenants in common, joint tenancy with rights of survivorship, or some other form of co-ownership. A taxpayer can use the exemption for periods when they owned a property either personally or through a trust.

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¹ Canada Revenue Agency (CRA) allows owners to earn incidental rental income from the principal residence without contravening the rules.
The exemption can even be allocated to different properties in different years. The rules are very complex, and are outlined in the Principal Residence Income Tax Folio (S1-F3-C2) from the Canada Revenue Agency.

From January 1, 1972 to December 31, 1981, each family member could claim a capital gains exemption on a principal residence and, in some circumstances, clients may still benefit from owning property dating back that far.

Since 1982, the rules on principal residency limit the election to one residence per couple. This tax rule applies to couples that meet the definition of spouse under the Income Tax Act. The definition includes not only those who are married, but also couples of opposite or same sex that have cohabited in a conjugal relationship for one year (or less if a child is born or adopted by the couple).

The residence can be located anywhere, even outside of Canada. Assuming all other requirements are met, an owner can sell a property abroad and still take advantage of the capital gains exemption here in Canada. However, there may be country specific taxes or fees that apply or both, when the property is sold.

**Converting to an income property**

If the owner converts a principal residence to an income property, the conversion is a disposition. The taxpayer is deemed to have sold the property at fair market value, and reacquired it immediately after at the same price. This triggers a capital gain that can then be sheltered using the principal residence election up to the date of the disposition.

The owner can defer this, and file an election to treat the property as a principal residence for up to four additional tax years, so long as they have no other principal residence elected during this time, and so long as they remain a Canadian resident. This election may be very valuable in situations where the taxpayer moves out of a property temporarily, converts it to an income property, but then moves back in at a later date. Deductions of capital cost allowances for the income property are not permitted if a taxpayer is using this deferral strategy.

**Special opportunities for property owners between 1972 and 1981**

As mentioned above, from January 1, 1972 to December 31, 1981, the capital gains exemption on a principal residence was available to each family member. Two spouses could each own a residence and elect it as their respective principal residence to claim the capital gains exemption. This could have been used, for example, in situations where one spouse owned the house and the other owned the cottage.

Clients who own property dating back that far must complete an ITA formula to determine if they are subject to any taxable gain on the second property.

**Impact of the $100,000 capital gain exemption from 1994**

On February 22, 1994, the government removed the $100,000 capital gains exemption, but allowed taxpayers to file an election with their 1994 tax return to claim this exemption against capital gains accrued to that date. If a taxpayer now sells that property, the 1994 election will be applied to reduce their capital gains. It’s critical to identify whether or not a taxpayer made this election, since it could impact whether that property should be classified as the principal residence.

For example, consider a taxpayer who dies owning two properties – a family home and a cottage. Both properties meet the requirements for claiming the principal residence election. The executor is trying to determine which property would benefit the most. While the cottage may have appreciated more in value, it’s possible that the $100,000 capital gains exemption had already been used to shelter a portion of this gain. In that case, claiming the principal residence election against the home may be more beneficial. Failure to investigate this by checking past income tax returns could result in paying more capital gains tax than necessary.
Matrimonial home

The matrimonial home (also known as the marital home, family home or family residence) is a family law concept, and has nothing to do with income tax. The precise name and corresponding legislation varies from province to province. The matrimonial home is part of the assets making up matrimonial property or family assets. Even in Quebec, which operates under civil law as opposed to common law, there’s a similar concept called family patrimony that includes the family residence and movable property owned by either spouse amongst a list of predetermined assets.

When spouses or their children use a residence, their use can create the matrimonial home status. The effect of this status is to limit the owner’s power to deal with the property. The owner of a matrimonial home cannot sell or mortgage it without the other spouse’s consent. Some provinces permit multiple homes (or even rented premises) to qualify.

The matrimonial home status also affects who has rights to occupy the home. If a spouse with sole title dies, the surviving spouse may have special rights to remain in the home, regardless of who the title passes to. These are important limitations when it comes to estate planning for the owner with sole title. Non-titled spouses may also have special rights to a portion of the proceeds on marriage breakdown if the property is sold.

Spouses can usually agree by contract to alter or give up their rights attached to any particular property. The contract may be a pre-nuptial agreement, a marriage contract, or a separation agreement. In Quebec, a spouse may execute a renunciation (release) of interest in the property upon marriage breakdown or death.

Homestead

This is a real estate concept and exists in the four western provinces and many American states. Largely a by-product of an agricultural heritage and pattern of settlement, homestead refers to a home and defined parcel of land that goes with it, most often farm acreage.

The concept predates modern matrimonial law, and arose at a time when married spouses were considered a single legal entity that the husband governed. Homestead legislation was an attempt to protect widows from past irresponsible dealings by their husbands. This legal protection has been modernized through other legislation across Canada, and extended to both spouses.

In many homestead jurisdictions, especially in the United States, the homestead property enjoys special protection from seizure and sale by creditors if there’s insolvency or bankruptcy. The same concept, preventing forced sale and division, may apply on marriage breakdown.

Homestead status is also important to the right of a surviving spouse after a death. The survivor may have a statutory right to continue occupying the homestead, protected from eviction by new owners.

Since modern agriculture businesses may have thousands of acres under cultivation, traditional homesteads may be difficult to identify. But homestead rights are very important factors in planning for clients in provinces with homestead legislation.
What advisors can do

As part of your fact-finding efforts with clients, property ownership and the timing of these purchases are important considerations in developing plans, both during the client’s lifetime and for periods following death.

- Find out if a client holds any properties dating back to 1982 or earlier.
- Include the timing of property purchases as part of your asset protection plan discussions and in completing an estate plan.
- Add property ownership to your presentations and discussions related to estate planning and wealth management.

Any examples presented in this article are for illustration purposes only. No one should act upon these examples or information without a thorough examination of the tax and legal situation with their own professional advisors after the facts of the specific case are considered.

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