The Institute™
for Advanced Financial Education

COMMENT

Edition 306 – Nov/Dec 2017

PRINCIPAL RESIDENCE EXEMPTION: TAX-FREE GROWTH WORTH UNDERSTANDING

Canadian residents generally enjoy tax-free growth in the capital value of their home through a tax measure referred to as the principal residence exemption. This means that many Canadians can sell their home tax-free, however, there are details to observe and criteria to be met for those who want to benefit from this opportunity.

A principal residence is a housing unit owned by an individual and ordinarily inhabited by that individual or the individual's spouse, common-law partner, former spouse, former common-law partner, or child. The definition is designed to be very broad, covering a wide variety of types of homes including a house, cottage, condominium, mobile home, trailer, or even a house boat.

Beginning in the 2016 taxation year, individuals must report the disposition of their principal residence and associated claim for principal residence exemption. The formula for the principal residence exemption is:

{ (1 + A) ÷ B } times the gain realized upon disposition

Where,

- A is the number of years that the property is designated as the principal residence and the owner was resident in Canada. This would be whole years; for example, 1979 to 2010 would be 32 years of ownership regardless of when in the year the home was bought or sold. The plus 1 is only available if the home owner was resident in Canada at the time of purchase.
- B is the number of years of ownership

The following is a discussion of key considerations, in very general terms, as they apply to a claim for the principal residence exemption.

What if there is a change-in-use?

When there is a complete change-in-use of a property (100 percent change), the owner is deemed to have immediately sold the property and immediately reacquired the property. This means the accrued capital gain is triggered when the property ceases to be a principal residence and is changed to a rental property, or when a rental property is changed to become a principal residence.

When use of a property changes from a principal residence to a rental property, the owner could use his or her principal residence exemption to shelter the gain. Alternatively, the individual could elect to defer recognition of the gain to a later year by electing to be deemed not to have made the change in use of the property. This can be achieved by submitting a letter with the individual's income tax return for the year in which the change occurred. However, any claim for capital cost allowance ("CCA") on the property will result in a rescission of the election on the first day of the year in which the CCA claim is made. While this election remains valid, the property could continue to qualify as the individual's principal residence for up to four years even though the property is not ordinarily inhabited by the taxpayer or other qualifying individuals, provided the taxpayer is a resident of Canada and no other property is designated for a similar claim. This election provides the taxpayer with opportunity to defer the associated income tax liability until the property is eventually disposed of.

Let's look at an example.

- Pat and Chris bought their home for $300,000 in 1986.
- They moved out in 2010 when the home was worth $500,000 and began to rent it to a tenant. This change would be classified as a complete change-in-use of the property.
- They elected to defer recognition of the deemed gain by filing a letter with the CRA, and chose to not claim CCA on the rental property. Pat and Chris remained resident in Canada.
- Pat and Chris sold the rental property in 2017 for $750,000, which requires them to recognize a capital gain of $450,000 ($750,000 proceeds less $300,000 cost).

- Over the couple's 32-years of ownership, they can claim 25 years as a principal residence (1986 to 2010), plus they can elect to treat four years of the rental property period as a principal residence.
- The formula for determining the exemption is (1 + 29) ÷ 32, which results in 93.75% of the $450,000 capital gain being exempt ($421,875).
- The outcome for Pat and Chris is a tax liability on the remaining $28,125 of capital gain realized in 2017.
- During the period when Pat and Chris did not reside in the home, they were living in a rental property so did not claim any principal residence exemption in respect of any other property.

A partial change-in-use would occur when a property owner decides to rent out part of the house to an arm's length individual. Alternatively, a partial change-in-use would occur when an individual no longer rents out a portion of the home and reclaims the space for his or her personal needs. The change-in-use must be substantial, such as building a self-contained dwelling in the basement or converting the front of the home into a business. In such a situation, the change-of-use rules apply, and the individual will have a partial disposition of that portion of the home that is no longer used for personal use. With a partial change-of-use, there is no opportunity to make an election to defer the gain as would be available with a complete change-in-use.

It is the Canada Revenue Agency's (CRA) administrative practice to not apply the deemed disposition rules where the income producing element is ancillary to the main use of the property, where no structural changes are made to the home and no CCA is claimed on the property. For example, renting out one or two existing bedrooms would generally fit within the CRA's administrative practice as being ancillary in nature, while building a new self-contained rental unit in the basement would generally not be treated as ancillary.

It is important to note that administrative practices can change and are utilized at the CRA's discretion.

How are larger-size properties handled?

The definition of principal residence limits the amount of land associated with the home to one-half hectare. A hectare is a metric unit of 10,000 square meters, or about 2.47 acres.

The taxpayer may be able to claim more land as part of his or her principal residence, but would have to prove the excess land was necessary for the use and enjoyment of the property as their principal residence. For example, a municipality may have a minimum lot size in excess of one-half hectare.

What is the application for farmers?

It is common to find a family home located on the family farm property. In these cases, when the farm (including the family home) is sold, some of the resulting gain can be sheltered from tax by claiming the principal residence exemption.

There are two options for individuals in this situation.

a) The individual could make a reasonable allocation of the sale proceeds and determine a fair amount that could be allocated between the family home and surrounding land. In this situation, a capital gain would be determined for each of the home and surrounding land. The principal residence exemption would be applied as a reduction to the gain in respect of the principal residence portion.

b) The individual could claim a principal residence exemption comprised of $1,000 plus an additional $1,000 for every year of ownership since 1971. In this situation, the principal residence exemption is deducted from the overall capital gain otherwise determined.

While the principal residence exemption is a valuable benefit enjoyed by many Canadians, there has been increased attention by the CRA in the administration and taxpayer compliance associated with this generous tax provision. As such, it becomes increasingly important that taxpayers follow the details and seek professional advice to ensure overall compliance. The above discussion is very general in nature and may not address issues specific to each taxpayer's situation.

TAX ASSESSMENTS AND REASSESSMENTS

The Canadian tax system is based on a self-assessment or honour system, requiring every taxpayer to file an annual income tax return with the Canada Revenue Agency (CRA), which sets out income earned, eligible expenses, deductions and credits. The CRA does an initial review, taking into account items such as the taxpayer's filing history, relevant tax information filed in the current return, and systematic red flags such as risk assessment checks.

The CRA's initial communication with the taxpayer after having received the income tax filing is a notice of assessment. The CRA could accept the tax return as filed or immediately challenge the return. In challenging the tax return, the CRA would set out their reasoning for determining a different income tax liability or request more information to substantiate an element of the taxpayer's return. In general, the CRA will issue a notice of assessment within a few months of having received the taxpayer's return.

When the CRA requests additional information in their notice of assessment, the taxpayer has 90 days to provide such information. If the CRA's notice of assessment objects to an element of the taxpayer's annual filing, the taxpayer has 90 days to file a notice of objection.

Beyond the CRA's notice of assessment, the CRA has the right to issue a notice of reassessment. This situation can arise when the CRA has taken a further look at a taxpayer's return or other information has arisen. For example, the CRA matches the income claimed by a taxpayer with the T-slips filed by employers and financial institutions. Should the CRA note a discrepancy, either in the amount reported or a situation where income has not been self-reported, the CRA will issue a notice of reassessment to adjust the discrepancy. The evolution of technology has enhanced the CRA's ability to identify non-compliance in a wide-variety of areas through in-depth statistical analysis.

The period during which the CRA may issue a notice of reassessment differs by the type of taxpayer as follows:

- three years for individuals;
- three years for Canadian controlled private corporations; and,
- four years for other corporations,

from the date of mailing the taxpayer's notice of assessment. The taxpayer has 90 days from the date the notice of reassessment was mailed to comply or file a notice of objection.

In the CRA's 2016-2017 annual report to parliament, they reported having assessed over 31 million income tax returns and over $2.1 billion in additional taxes.

Even though there is a time limit for the CRA to issue a notice of reassessment, they have the right to assess beyond this limit if the taxpayer has committed fraud or misrepresented information on the tax return filed. The onus of proof is on the CRA to prove that the taxpayer did indeed commit fraud or make a misrepresentation. The misrepresentation could be intentional or a simple misunderstanding.

In a recent situation, the CRA assessed a taxpayer in respect of two tax returns beyond the normal reassessment period. The disputed issue related to the taxpayer's claim for a charitable donation. In this situation, the preparer of the taxpayer's return included a claim for a charitable donation on the individual's income tax return, although no donation had been made by the taxpayer. The charitable donation scheme was subsequently identified as fraudulent. The taxpayer appealed the CRA's decision to the Tax Court of Canada (TCC) suggesting that she was a victim of a fraud perpetrated by the tax preparer. The TCC found in favour of the CRA, explaining that the taxpayer was negligent in the filing of her return by not having verified why the refund was so large and why there were associated carrying charges. The TCC was clear in finding that the taxpayer "made misrepresentations that were attributable to neglect, carelessness or wilful default."

Communicating with the CRA can be unnerving for many taxpayers, but it is important to comply or file a notice of objection within the prescribed timeframes. For situations where a taxpayer is uncertain or disputes an assessment, it is advisable to seek timely professional assistance when responding to the CRA.

CANADA/QUEBEC PENSION PLAN AND EMPLOYMENT INSURANCE 2018

Contributions under the Canada/Quebec Pension Plan (C/QPP) and Employment Insurance (EI) change annually. The following table presents the 2018 C/QPP and EI contributions amounts based on the new maximum earning amounts and the 2018 rates, with comparable figures for each of the three prior years.

		2018	2017	2016	2015
C/QPP	**Maximum Pensionable Earnings**	$55,900	$55,300	$54,900	$53,600
CPP	**CPP Rate**	4.95%	4.95%	4.95%	4.95%
	Basic Exemption Amount	$3,500	$3,500	$3,500	$3,500
	Employee Contribution	$2,593.80	$2,564.10	$2,544.30	$2,479.95
QPP	**QPP Rate**	5.40%	5.40%	5.325%	5.25%
	Employee Contribution	$2,829.60	$2,797.20	$2,737.05	$2,630.25
Federal					
EI	**Maximum Insurable Earnings**	$51,700	$51,300	$50,800	$49,500
	Employee Rate	1.66%	1.63%	1.88%	1.88%
	Employee Contribution	$858.22	$836.19	$955.04	$930.60
Quebec					
EI	**Maximum Insurable Earnings**	$51,700	$51,300	$50,800	$49,500
	Employee Rate	1.30%	1.27%	1.52%	1.54%
	Employee Contribution	$672.10	$651.51	$772.16	$762.30

For CPP and EI, an employer will withhold amounts, based on the schedule above, from the employee's periodic pay and remit the amounts withheld to the Receiver General. In addition to the employee's contribution to each of these plans, there is an employer required contribution as well. Employers are required to match the employee's contribution to CPP and to contribute 1.4 times the employee's contribution for EI.

A self-employed individual is responsible for their own CPP contributions and must submit an amount equal to twice the employee contribution amount. Generally, a self-employed person is not responsible for EI contributions nor eligible for an EI benefit unless registered for the EI Special Benefits for Self-Employed People.

Authors:

James W. Kraft, CPA, CA, MTAX, TEP, CFP, FEA, CLU

Deborah Kraft, MTAX, LLM, TEP, CFP, CLU

Published by:

The Institute

390 Queens Quay West, Suite 209

Toronto, Ontario M5V 3A2

T: 416.444.5251 or 1.800.563.5822

F: 416.444.8031

www.iafe.ca • info@iafe.ca

Edition 306 – Nov/Dec 2017

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Publication Agreement # 40069004

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