



## Principal Residence Exemptions:

### Clearing the Muddy Waters

There seems to be a lot of confusion about the principal residence exemption. I field questions about it all the time. “When I sell my house, do I have to pay tax on the profits?” “What about if I ran my business from home?” “What if I was renting part of it?” “What happens if I don't report the sale?” Ok, let's take a second to sift through the muck and clear this up, shall we?

#### *What is it?*

First things first. According to the CRA guidelines, to qualify as a principal residence, your property needs to be:

- a house
- a cottage
- a condominium
- an apartment in an apartment building
- an apartment in a duplex
- a trailer, mobile home, or houseboat

If you are selling any one of these abodes, then the profit you make on the sale may not be taxed if you meet the criteria for the *principal residence exemption*. The CRA defines the exemption this way: “*When you sell your home, you may realize a capital gain. If the property was solely your principal residence for every year you owned it, you do not have to pay tax on the gain*”.

#### *Your business-use home*

That's pretty straight-forward if the home you are selling was just that; a home. But what happens if you were using a portion of that home for work, or if you were renting out part of the house? Would the exemption still apply?

The answer is 'yes' you would still qualify for the exemption under the following provisions:

- The income-producing use is secondary to the main use.
  - In other words, you are not claiming more than 50% of the home as a business.
  - I realize that it can *feel* like you're working all the time, but I like to keep the business use of a home at 30% or less to prevent any misunderstanding or misinterpretation by CRA.
- There is no structural change to the property.
  - You can finish the basement, but don't claim 100% of the basement and don't deduct the cost of finishing the basement.
  - Add a shed, but not a building. The portion of the property where the building sits could be taxable.
  - Because this is a grey area, the CRA will consider the circumstance of each case. Please be careful and consult a designated accountant.
- You claim no depreciation (CCA) on the property.

#### *Duty to report*

You must now report the sale of a principal residence to the CRA. There is no tax effect as the principal residence is exempt from tax, however, if you neglect to report the sale of your home, the penalties could be steep. How steep, you ask? How about \$100 per month from the original due date (to a maximum of \$8000). So if you don't report the sale and

the Feds discover the ‘error’ four or five years down the road—well, you do the math! Oh, and yes, the CRA can evaluate your returns beyond the normal reassessment period if you haven’t reported something relevant like, let’s say ... the sale of your principal residence! That throws the ‘I’m safe after three years’ theory right out the window!

In today’s real estate market it is not likely that you’ve lost money on the property, but it’s still on you to report the sale even if you sold at a loss. You do not want a return with an unreported sale to get statute barred, or it could create a conflict with future property sales or the sale of a cottage.

### *When you sell*

When making the designation of principal residence at the time of sale, make sure you consider your other unsold properties. It may be more advantageous, for example, to pay the capital gains tax on the principal residence because the cottage has appreciated in value. Once you’ve designated a property as the principal residence, it cannot be undone. So the sale of the cottage five years later could result in you paying more taxes.

“Wait! Hold up! What was that about the designation? I can’t change it?” That’s right; this is one of those, ‘make a decision and stick to it’ kind of moments. There is, however, an exception built into the legislation (shocker, I know!). When a taxpayer completes the required Schedule 3 and selects Box 1 (principal residence for all years owned), it is considered to be *designated* as the taxpayer’s residence for ‘all years except one year.’ (Yes, this is so even though that’s not what the form says [##%#!]). That means you can purchase another home in the year and also designate it as your principal residence for that year. For more info: <https://www.canada.ca/en/revenue-agency/services/tax/individuals/topics/about-your-tax-return/tax-return/completing-a-tax-return/personal-income/line-127-capital-gains/principal-residence-other-real-estate/sale-your-principal-residence.html>

I recommend keeping a tax return with a principal residence designation on it forever, especially if you own multiple properties at the same time or if you move frequently. That way, if you dispose of a second property (not a home) in the future, you can prove to CRA that you already designated a principal residence and can show the particulars of that designation.

So, to sum up, you are exempt from paying capital gains taxes on the profit you make on your principal residence. You still qualify for the exemption if you do more living than working in your residence, don’t change the structure, or don’t claim depreciation. You need to designate one property as your principal residence, and you need to report the sale of that principal residence to the CRA. That’s it in a nutshell! What did I tell you? Clear as the Caribbean shallows!

Remember, if you have an extraordinary circumstance or you need a little more clarity, book some time with me, and we’ll chat.