



Principal Residence Exemption

~ including rental property

The Principal Residence Exemption ("PRE") is one of the most widely used tax breaks under the Canadian income tax system. As most readers likely know, the PRE means that in most cases individuals pay no tax on capital gains realized on the sales of their homes. However, there are various conditions that must be met.

General conditions

The PRE is only available to **Canadian resident individuals**. It is *not* available to corporations or non-residents. However, the PRE can apply to a home owned anywhere in the world—not just in Canada.

To qualify for the PRE, **the home must be capital property**. If it was purchased with the intention of resale (including "secondary intention"), it is considered inventory, not capital property, and the gain on sale is business profit, fully taxable (not half-taxed like capital property), and the PRE is not available.

If you buy a home or condominium pre-construction and sell it within a year or so after final closing—even if this is many years after you signed the original contract—the Canada Revenue Agency ("CRA") could automatically presume that you intended to sell it all along (despite your protestations that your circumstances changed), and that the gain is business profit. The CRA actively reviews real estate sales records, and has assessed over a billion dollars of tax on such sales over the past four years, most of it on this kind of sale.

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Calculating the PRE

THE AMOUNT OF THE PRE is based on a formula, and depends on the number of years of ownership that the home was your “principal residence”. The formula will exempt all or part of the gain on the sale of your home:

$$\text{EXEMPT PART OF GAIN} = \text{GAIN} \times \left\{ 1 + \left(\frac{\text{Number years of principal residence/ownership}}{\text{}} \right) \right\}$$

Thus, if the home is your principal residence for all of years of ownership, or all years but one, the entire gain will be exempt. On the other hand, if the home is your principal residence for four years and you owned the property for eight years, then five-eighths of the gain will be exempt. The other three-eighths will be a capital gain, and half of that will be a taxable capital gain included in your income.

The reason for the “1 +” in the formula relates to another rule that says you and your family can designate *only one home as your principal residence per year*. Therefore, if you sell a home and buy another one in the same year, as is typically the case, you can designate on resale one of those as your principal residence for that year.

A liberal definition

Your home can be designated as a principal residence for a year if you “ordinarily inhabit” the home during the year. This phrase has been defined liberally by the courts and the CRA. For example, if you stay at your cottage for two or three weeks during the year, that stay can satisfy the “ordinarily inhabit” requirement.

Two forms to file

The designation as principal residence for all relevant years must be made in your tax return for the year in which you sell the home. You must file **Schedule 3 “Capital gains and losses”**, as well as **Form T-2091 “Designation of a property as a principal residence by an individual.”**

For sales before 2016, the CRA allowed you to not report the gain at all if you had only one principal residence at a time. Now it must be reported or you cannot claim the exemption.

Trusts

IT USED TO BE the case that almost any trust owning and selling a home could qualify for the PRE, as long as the trust was resident in Canada and one of the beneficiaries or family members ordinarily inhabited the home. This rule was changed so that, currently, only special types of trusts can qualify, such as certain spousal trusts and qualified disability trusts.

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Penalty for not providing T5018 slips to subcontractors



Businesses engaged in construction need to be aware of this obligation!

BACKGROUND | The Contract Payment Reporting System targets the underground economy by requiring construction contractors (anyone who derives their income primarily from “construction activities”) to report to the Canada Revenue Agency (“CRA”) all payments to subcontractors (of at least \$500 services per year per subcontractor), along with the subcontractor’s business number or social insurance number. This is done either on **Form T5018** slips, or line-by-line on a **T5018 summary**. These rules are found in section 238 of the Income Tax Regulations.

ASSESSMENT | There have been cases where partnerships, in the business of developing and selling residential condominiums, have hired general contractors to handle all the construction. The general contractors hired all the subcontractors. In one case, the CRA assessed a partnership for not filing a T5018 reporting its payments to the general contractor. This was appealed to the Tax Court of Canada (the “Court”).

RULING | The Court ruled that the partnership derived its income from “construction activities” and was required to file the T5018. It was thus subject to a \$2,500 penalty for not filing the form, for each of the three years for which it was assessed.

CONCLUSION | Businesses engaged in construction—even those that leave all the actual construction work to a contractor—need to be aware of this obligation! ●



**Porter Hétu
International**
Professional Services Group

226 St. Mary's Road
Winnipeg, Manitoba
R2H 1J3

Telephone: (204) 237-6053
Fax: (204) 231-1461

Ryan Rawluk, CPA, CGA
Eric Robert, B.A., B.Comm,
CPA, CGA

www.accountants.mb

VISIT US ONLINE
www.porterhetu.com

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COORDINATION Kimberly Nguyen
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Please send your comments or
questions to Kimberly Nguyen:
knguyen@gbco.ca

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Renting out your principal residence

AS NOTED, in order for your home to count as your principal residence for a year, you normally must ordinarily inhabit the home during the year. However, special rules in the Income Tax Act allow you to designate your home while you are renting out.

The special rules apply in two instances

1 If you live in your home and subsequently move out and rent it to someone else, then during the rental period you can continue to designate the home as your principal residence for up to four years. Furthermore, if your move out of the home was caused by a relocation of your employment, the four-year period can be extended, if you subsequently move back to the home during the employment or by the end of the year following the year in which your employment is terminated.

2 If you own a home that you rent out, and subsequently move in and inhabit the home, you can also designate the home as your principal residence for up to four years while you rented it out.

Important caveats to the rules

First, you are still subject to the "one designated principal residence per year" rule. Thus, if you own another home and designate that other home as your principal residence for a year, you cannot designate the first (rented-out) home for that year.

Second, if you wish to designate the home as your principal residence while you rent it out, you should not claim capital cost allowance (tax depreciation) on the home. Doing so will eliminate or at least reduce your ability to designate it as your principal residence during the rental period. ○

