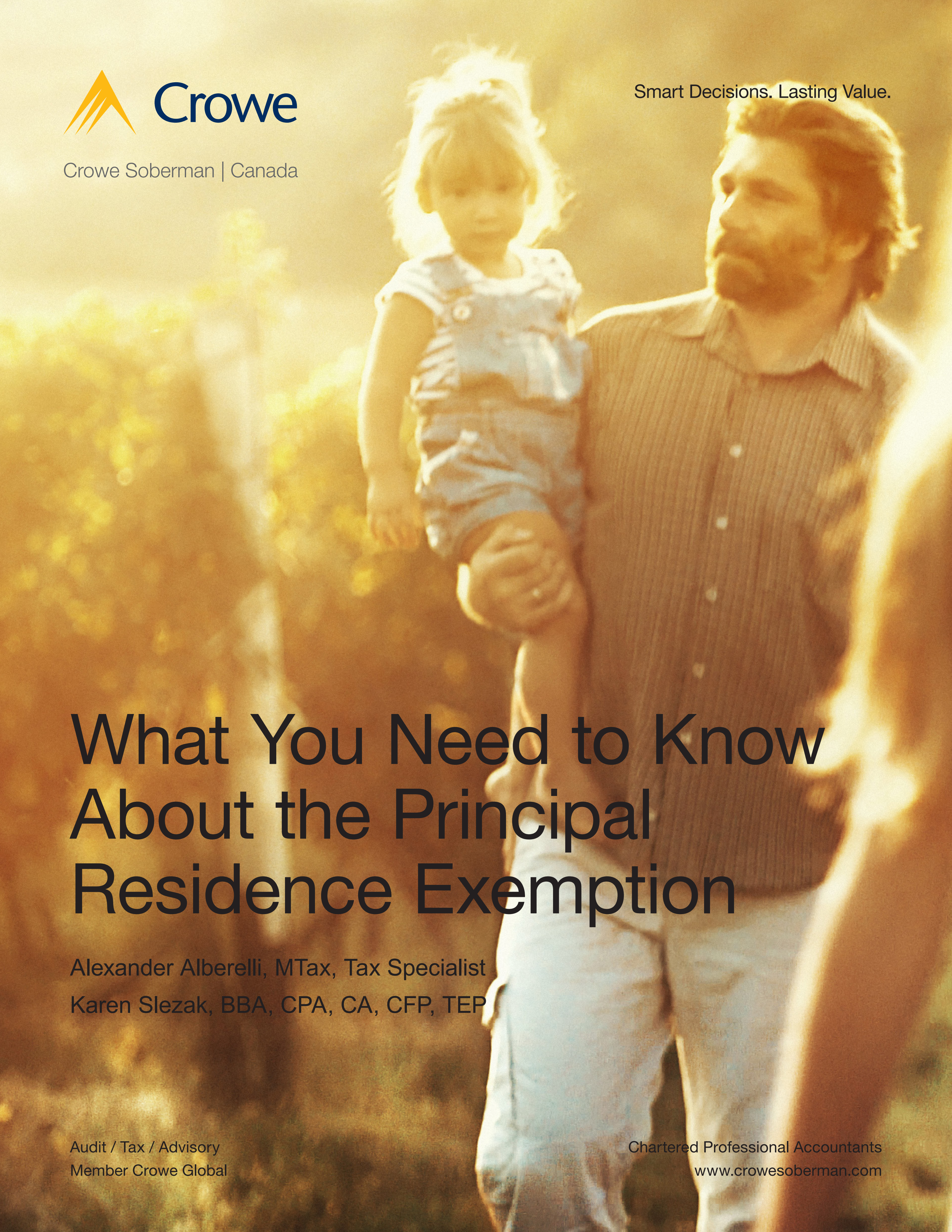

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# What You Need to Know About the Principal Residence Exemption

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With the dramatic increase in real-estate values over the past few years, many Canadians will face a hefty tax bill when they die. At an individual's time of death, they are considered to have sold all of their assets at fair market value and are consequently liable for the tax on any appreciation. This is known as a deemed disposition and it can hurt. The exception is for properties passing to a spouse or common-law. In these cases, the property passes at its adjusted cost base so no gain arises.

The deemed disposition potentially creates hardship for homeowners that may find themselves having a high value home and resultant tax bill, with little or no cash available to pay the tax. However, the Federal Government provides a mechanism to reduce and potentially eliminate tax through what is called The Principal Residence Exemption ("the Exemption"). The Exemption is available only on residential properties that are ordinarily inhabited for some period throughout each calendar year, by the individual, their spouse, or children. Only one property can be designated in a particular year by the family unit.

## Mechanics of the Exemption

In essence, the Exemption pro-rates the capital gain on an individual's home over its period of ownership. For example, a property with a $300,000 capital gain owned for 10 years is considered to have realized a capital gain of $30,000 per year. The individual then designates the years that qualify to eliminate all or a portion of his/her capital gain. A bonus year is allowed as long as the individual was resident in Canada at the time of purchase. The formula for the exemption is:

1 + Number of years designated / Total years of Ownership x Capital gain

If we assume that our property with a $300,000 gain was acquired in 2000 and deemed sold in 2017, and that the years from 2000 to 2010 were eligible for the designation, the sheltered portion of the gain would be:

1 + 11 (yrs. 2000 – 2010) / 18 x $300, 000 = $200,000

## Does the Exemption protect the land subjacent to my home?

An area of concern is the land surrounding a home. The Income Tax Act states that both the house and any land subjacent to the housing unit up to a half hectare (approximately 1.24 acres) are eligible for the Exemption. Individuals who own land in excess of a half hectare may claim the Exemption on the additional land, only if the owner can demonstrate that the land is necessary for the use and enjoyment of the housing unit. This criteria can be challenging to meet and cannot be satisfied if it is simply a preference of the owner's lifestyle. The courts have clearly shown that severance laws, physical barriers to subdivision and other relevant factors are the strongest criteria that will satisfy the condition of necessity. The most influential element supporting necessity is arguably the severance laws in place at the time of acquisition, disposition and the period of ownership in between. If the land cannot be further subdivided at the time of disposition, the courts have taken the position that the parcel of land as a whole, is considered to be necessary for the use and enjoyment of the housing unit. Therefore, for our deceased taxpayer, the deemed disposition of a larger property may still be eligible for the Exemption.

## How can I protect my family from capital gains tax?

In regards to land in excess of a half hectare, the onus is on the individual or the representative of the estate to prove that the land is in fact necessary for the use and enjoyment of the housing unit. Reviewing severance laws, and obtaining appropriate zoning and severance regulations from the appropriate government bodies are highly recommended to support the claim. Since severance laws are subject to change without notification being provided to home owners, the Estate trustees will need to review all relevant regulations up until the date of death. Any changes in the law that took place during the owner's lifetime should be carefully analyzed to determine whether the Exemption still applies on the entire property or for only part of the period of ownership. There is a significant body of court cases that support claims for larger properties, even where part of the property is used for an alternative purpose such as farming.

If you have a property or are administering an Estate with a large property and are considering how to shelter the tax on the property, speak with one of our tax professionals to review the eligibility for the Exemption.

*This article has been prepared for the general information of our clients. Specific professional advice should be obtained prior to the implementation of any suggestion contained in this article. Please note that this publication should not be considered a substitute for personalized tax advice related to your particular situation.*

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