FINANCIAL POST

What you need to know about claiming the principal residence exemption on the sale of property

Jamie Golombek: Tax case illustrates how designating a property as a 'principal residence' comes with fulfilling a set of specific criteria

Under the Income Tax Act, in order for a property to qualify as your principal residence for a particular tax year, four criteria must be satisfied.*Mike Hensen/The London Free Press/Postmedia Network*

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January 11, 2019
12:59 PM EST

Filed under Personal Finance **Taxes**

One of the most valuable tax breaks Canadians have is the ability to claim the principal residence exemption (PRE) on the sale of a home. The PRE provides homeowners with an exemption from tax on the capital gain realized when you sell the property that you have designated as your principal residence.

Recent changes to the Canada Revenue Agency's requirements now require you to report the sale of your principal residence on your tax return. The designation of your principal residence is reported on *Schedule 3* of your return and you must also complete the appropriate sections of Form T2091(IND), *Designation of a Property as a Principal Residence by an Individual*.

Under the *Income Tax Act*, in order for a property to qualify as your principal residence for a particular tax year, four criteria must be satisfied: the property must be a housing unit; you must own the property (either alone or jointly with someone else); you or your spouse or kids must "ordinarily inhabit" the property; and you must "designate" the property as a principal residence.
Note that a seasonal residence, such as a cottage, cabin, lake house or even ski chalet can be considered to be "ordinarily inhabited in the year" even if you only use it during vacation periods "provided that the main reason for owning the property is not to gain or produce income."

The statutory definition of "principal residence" limits the amount of land that qualifies for the exemption to half a hectare (one hectare contains 2.47 acres) unless the taxpayer can show that the excess land was necessary for the use and enjoyment of the housing unit. This "half-hectare rule" was the subject of a recent tax case in which the taxpayer attempted to claim the PRE on the 2012 sale of a portion of her property. The CRA denied the PRE and assessed capital gains tax, which is why the matter wound up in court.

Between 1985 and 1991, the taxpayer purchased four adjacent pieces of land in rural Quebec, in four separate real estate transactions, amassing a total of approximately 4.17 acres. Her housing unit was located on the land acquired in the first transaction. The other three pieces of land, ultimately merged to form a second lot, were used to build a pool, a barn, a garage, a septic field and a sugar shack.

In July 2012, the taxpayer sold 1.47 acres of the property to the local municipality for the expansion of the municipal aqueduct. The property sold was a woodlot representing 33 per cent of the second lot. She received $100,000 for this piece of land which she had acquired in 1986 for $500. Needless to say, she did not report the capital gain on her return, maintaining that the PRE should apply. She argued that the woodlot sold was “the main source of wood used to heat (her) house” and thus was integral to her use and enjoyment of the property.

The CRA disagreed and reassessed the taxpayer, adding a taxable capital gain of nearly $50,000 to her income for 2012, maintaining that the “disposition of 1.47 acres of land immediately contiguous to the housing unit was in excess of half a hectare and that excess did not contribute to the use and enjoyment of the housing unit as a residence,” as required by the statute.

Thus, the only issue before the court was whether the piece of land sold was actually necessary for the use and enjoyment of the housing unit as a residence.

The judge reviewed the usual criteria which sometimes can allow a piece of property greater than a half hectare to qualify for the PRE. In this case, the lot sold did not include the house or any other buildings which would have contributed to the use and enjoyment of the housing unit by the taxpayer. The three subsequent land purchases after the initial transaction “were not made by necessity for the use and enjoyment of her housing unit but rather as a choice of lifestyle." The land sold was not required in order to provide the taxpayer with access to and from a public road and the local municipality does not have any regulation requiring that a housing unit residence must be built on a lot that exceeds a half hectare.

In her defence, the taxpayer argued that her housing unit is equipped with a wood heating system, an electrical system and a gas fireplace and that hardwood cut on her property is normally sufficient to heat her house during the winter. She said that occasionally, she had to purchase supplementary wood to heat her house which was poorly insulated when she acquired it.

Yet, in court, the taxpayer could not provide any detailed information concerning the heating system now in place in her house nor the type and quantity of wood cut every year from her property to heat her house and the sugar shack.

The judge therefore concluded that the taxpayer could not establish "on a balance of probabilities" that the land sold, which represented 33 per cent of the total area of the property, was necessary for the use and enjoyment of her housing unit as a residence. In fact, she still kept 2.7 acres with a woodlot on it.

The judge felt that the land sold was not necessary to fulfill its function as a residence. As the judge wrote, "A simple statement that wood was cut on the piece of land sold, to heat her house, is not sufficient to allow the (taxpayer) to meet her burden of proof that the piece of land was necessary for the use and enjoyment of her housing unit as a residence."

As a result, the CRA's assessment was confirmed and the taxpayer was required to include the taxable capital gain in her 2012 income.

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