

Planning Matters

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Principal Residence Exemption Guidelines

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In 2016, the Canada Revenue Agency (CRA) changed its administrative policy relating to the reporting of the principal residence exemption. This has made reporting the disposition or “deemed disposition” of a principal residence more important in recent years.

The concept of a deemed disposition is one we have found is not well understood by the public at large – but is important as it can lead to a potential tax liability. With deemed dispositions, for example, property owners can trigger a capital gains tax bill for several reasons beyond just selling the property outright.

Potential Deemed Dispositions

The Income Tax Act deems a taxpayer to have disposed of, and immediately reacquired, a property when the taxpayer converts a property from being “income-earning” to personal use, or vice versa. For example, when a taxpayer moves out of their principal residence and begins to rent it out, they can be deemed to have disposed of their former principal residence at fair market value.



There are several other scenarios, however, which may result in a disposition or a deemed disposition of a residence for tax purposes. **They include but are not limited to the following:**

-  Moving into a property which used to be a rental property and occupying it as your principal residence
-  Demolishing a house to construct a new home
-  Granting of an easement
-  The gift of a property (in part or in whole)
-  Proceeds received from the expropriated property
-  Insurance proceeds from a flood or fire
-  Proceeds received from the cancellation of a leasehold interest in a property

If CRA determines your property underwent a deemed disposition, however, there are strategies for deferring the tax bill.

Deferring the Capital Gain on Change in Use from Principal Residence to Income-Producing Property

If a taxpayer begins using their principal residence for an income-earning purpose, subsection 45(2) of the Income Tax Act allows the taxpayer to elect out of being deemed to have disposed of the property at fair market value and reacquired it immediately thereafter at the same amount.

By filing a subsection 45(2) election, the taxpayer would be deemed to not have begun using the property for income earning purposes until the taxpayer disposes of the property or rescinds the subsection 45(2) election. While it would defer the potential tax bill, the 45(2) election restricts the taxpayer from being able to deduct any capital cost allowance from rental income in the meantime.

The 45(2) election is due at the same time as the T1 Income Tax and Benefit Return for the year in which the deemed disposition would have occurred. For example, if a taxpayer moves out of their principal residence in 2018 and began renting it out in 2018, then absent the 45(2) election (due April 30, 2019, or June 15, 2019) the taxpayer would be deemed to have disposed of the property in 2018 for the property's fair market value at the time property was rented out.

Principal residence status can be extended up to four years while the property is rented out if this election is made. The disposition can be delayed until the election is rescinded or property disposed of.

45(2) Election – I forgot to file it!

CRA may accept a late-filed 45(2) election as long as no capital cost allowance has been claimed for the rental property. Unfortunately, the acceptance of a late-filed 45(2) election is at CRA's discretion. As such, it is important that any potentially deemed dispositions are identified in order to report the disposition of the property and make the designation as a principal residence or to file the 45(2) election before the filing due date.

If a taxpayer owns multiple properties, CRA may not accept a late-filed 45(2) election as it could be construed as retroactive tax planning.

Deferring the Capital Gain on Change in Use from Income-Producing to Principal Residence

If a taxpayer has changed the use of a property from income-producing (e.g., rental property) to a principal residence, subsection 45(3) provides an election to avoid the deemed disposition on the change in use. The filing due date for this election is the filing due date for the taxation year in which the property is ultimately disposed of, or 90 days after the Minister requests the election be filed. A subsection 45(3) election is only applicable where capital cost allowance has not been claimed on the property in question.

45(3) Election – Why use it?

This allows the taxpayer to defer the capital gains accrued while the property was rented out until it is ultimately disposed of. The 45(3) election can allow the taxpayer to look back four years when designating a property as their principal residence. It is important to note that this 45(3) election is only available if no capital cost allowance is claimed on the rental property.

Budget 2019 Changes: Deemed Disposition of *Part of a Property*

The March 19, 2019 federal budget proposes to permit the election of subsections 45(2) and 45(3) for properties for which a deemed disposition might apply to part of the property. A change in use of part of a property would occur when a taxpayer converts a portion of what was previously a residence into an income-producing use, or moved into a

part of a property that was previously an income-producing property. These amendments (which typically would apply to multi-unit residential buildings) have not yet received royal assent but will be effective for deemed dispositions March 19, 2019 onward, once passed.

Deadlines

For 2016 and later tax years, CRA will only allow the principal residence exemption if the sale is reported and a designation of a principal residence is made in the taxpayer's return for the relevant taxation year. If the disposition is not reported or the taxpayer forgets to make the designation, the full amount of the capital gain will be taxable.

The due date for reporting the sale of a principal residence and designating the property as a principal residence is the regular due date of the individual's T1 Income Tax and Benefit Return: April 30 for most individuals and June 15 for individuals with a sole proprietorship.

If you forgot or missed designating your property as a principal residence in the year of the sale, you can ask the CRA to amend your income tax and benefit return for that year. CRA is able to accept a late-filed designation in certain circumstances but a late filing penalty will apply. The penalty is equal to the lesser of: \$8,000; or \$100 for each complete month from the original due date the amendment request was made to CRA.

If you still have questions about the Principal Residence Exemption or for a general overview, please contact a member of the Manning Elliott Tax Team today at info@manningelliott.com.

A version of this article originally appeared in the Manning Elliott blog. For the original, go to <https://manningelliott.com/blog/principal-residence-exemption-deemed-dispositions>.

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