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INCOME TAX RULES REGARDING PRINCIPAL RESIDENCE

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Most individuals who sell real estate are aware that a sale of a principal residence does not attract income tax.

The Income Tax Act requires the individuals to file a prescribed form with their income tax return for the year in which the principal residence is sold. In practice, however, the vast majority of individuals who sell their principal residence will merely ignore the requirement to file the proper forms under the assumption that the sale is not taxable.

In order for a property to qualify as a principal residence during any particular year it must:

1. be a housing unit, a leasehold interest therein, or a share of stock of the co-operative housing corporation. The Canada Revenue Agency (CRA) interprets the term housing unit as being a house, an apartment, condominium or cottage, a mobile home or houseboat; and
2. be "ordinarily inhabited" during the year by the individual, the individual's spouse or former spouse, or the individual's dependant child. The CRA has adopted a very liberal approach as far as administering what is meant by the term "ordinarily inhabited". For example, a summer cottage or winter home which is used (by the owner) for a portion of the year (ie a period of two weeks appears to qualify), could meet the definition of "ordinarily inhabited". Furthermore, properties occupied for a portion of the year because they were purchased late or sold early in the year will also qualify.

The principal residence can include land upon which a housing unit is situated if the land contributes to the "use and enjoyment of the housing unit as a residence". However if the land exceeds one and one quarter acres, in order for the excess to qualify, the onus is on the individual to prove that the excess was necessary for the "use and enjoyment as a principal residence".

For the years subsequent to 1981, an individual may not designate more than one property as a principal residence with respect to that year.

Tax issues may arise when the use of a property is changed from a principal residence to income earning, or vice versa. These are described below.

Conversion of Principal Residence to Income Earning Use

Situations do arise whereby individuals will commence leasing their principal residence, for example where they have temporarily moved to another location.

In such cases the Income Tax Act provides that the individual is deemed to have sold their principal residence at a price equal to its current value and to have reacquired it at a cost equal to that same value. Assuming the principal residence has increased in value from the original purchase date, the above treatment will result in a gain. This gain, however, will generally be exempt from tax pursuant to the principal residence rules. Any subsequent gain though, has the potential to be taxable.

To alleviate the above, the Income Tax Act contains an elective provision under which the individual is considered not to have sold (for tax purposes) his or her principal residence and thereby not to have changed its use. Furthermore this particular section of the Income Tax Act provides that for a period of four years beyond the date of the deemed sale, the individual may continue to consider the property as a principal residence even though it was not ordinarily inhabited by the individual.

To utilize the above, the individual should enclose with the income tax return for the year in which he or she moved out, correspondence in the form of a letter indicating that they are electing pursuant to section 45(2) of the Income Tax Act with respect to the above noted property.

Conversion of Income-Earning Property to Principal Residence

There are also situations where individuals will move into a property that originally was being used to produce rental income. Under these circumstances, similar to the above, individuals will be faced with a deemed sale at the time the property is converted to a principal residence. However, provided the individual has not claimed what is known as capital cost allowance, he or she may elect that for tax purposes there is no disposition (sale) and avoid any potential taxable gain. Furthermore, the election also provides that the property can be treated as a principal residence for up four years prior to the year the individual commenced to occupy it as a principal residence.

Please remember the Income Tax Act may be changed at any time by the federal government. The information above is accurate as of the date of writing but please review the government website or discuss your situation with your accountant to ensure the proper amount of taxes are being paid. If you do not have an accountant, we would be happy to refer you to our partners, Newport Group of Chartered Accountants, contact us at www.bcrealestatelawyers.com.

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