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# Tax Implications on Financial Decisions

Summer months are typically spent with friends outdoors, on the beach, or at a house barbecue.

During these special times, we often discuss potential financial opportunities that will take shape in the months to follow. But, for every financial decision, there are tax implications of which we must be aware.

## Claiming Depreciation on a Principal Residence

Individuals may be able to deduct some expenses related to their principal residence. For example, if a business is operated from home, the individual may

qualify for the home office deduction or if the home is partly rented, some of the home expenses can be deducted against the rental income.

**But, for every financial decision, there are tax implications of which we must be aware.**

Depreciation or capital cost allowance is an optional deduction but it is not recommended to claim that deduction on the principal residence because making such a claim may result in a portion of the property not qualifying for the principal residence exemption.

## Claiming Principal-Residence Exemption on Land

If an individual owns a home, it will qualify for the principal residence exemption on the sale of the property. Normally, taxpayers are required to file form T2091 in the year of sale to claim the principal residence exemption; when taxpayers prepare their own tax returns, however, that is very seldom done.

If no gain is reported on the tax return when the property is sold, it is CRA administrative policy to assume the taxpayer has claimed the principal residence exemption.

Most individuals assume the sale of their home will not be taxable and there will be no issues. There may, however, be issues related to the land. The value of the building will not be taxable but the land will qualify only for the principal residence exemption if it can be considered as contributing to the use and enjoyment of the property and the land does not exceed a half hectare in size or 2.47 acres. That size will exempt most city properties but it may be a problem for cottages and individuals with large lots.

Another situation in favour of allowing the land in excess of a half hectare as principal residence is where the land was a required residential lot size under a zoning bylaw in force at the time of purchase and was not readily severable under zoning bylaws in force at the time of disposition.



It is CRA's position that land in excess of half hectare will not qualify if the land is used for recreation or for the care of animals because that does not relate to the enjoyment of the house.

If that is the case, the land must be valued separately from the house and the portion in excess of a half hectare would be taxable. The allocation between taxable and nontaxable must be determined on the original purchase price.

### **Change of Use of a Principal Residence**

- If individuals convert their principal residence to a rental or a place of business, it is considered a change in use and they are deemed to have sold the residence for income tax purposes.
- There is also a change of use when a rental property is converted to a principal residence.

Every time there is a change of use, the property is considered to have been sold at fair market value and immediately re-acquired for the same amount. Individuals must report any capital gain or loss in the year the change of use occurs.

Any gain otherwise determined on this deemed disposition may be eliminated or reduced by the principal residence exemption.

In the tax return for the year in which the change of use occurs, the individual is permitted to make a special election that deems the change of use not to have occurred. The election is made by attaching a letter to the tax return, indicating the property in respect of which the election is being made.

Most of the time, individuals forget to make this election; CRA, however, may accept a late-filed election if certain conditions exist. One of the conditions is that no capital cost allowance has been claimed on the property since the change of use. Once the election has been made, it will remain in effect for subsequent years until rescinded. The election will allow the principal residence status to continue.

The ability to designate the property as a principal residence is available only for 4 years. After the 4th year, the individual can designate the property as principal residence if he actually lives in the property in the later years.

### **The 4-year limit will not apply if all the following conditions are met.**

1. The individual lives away from the principal residence because the employer wants the employee to relocate.
2. There is an arm's length relationship between the family and the employer.
3. The original home is at least 40 kilometres farther from the new place of employment than the temporary residence.

If an individual moves to another country, the election will be of no use since the exemption for the principal residence does not apply with respect to years in which the taxpayer is a nonresident of Canada.

### **There are conditions on which the deemed sale will not occur.**

- The rental income or business use of the property is ancillary to its use as a principal residence.
- The individual has not made any structural changes to the property to make it ready for rental or business purposes.

If the conditions are not met, the taxpayer will have to report a capital gain or loss when the building is sold; the calculation of the gain is done by splitting the selling price between the part used for the principal residence and the portion used for rental or business purposes. The split can be made on square metres or the number of rooms, as long as the method is reasonable.

### **Change of Use from Rental or Business Purpose to Principal Residence**

When an individual converts rental or business property to a principal residence, he can elect not to have the deemed disposition at the time of change, provided he has not

claimed any capital cost allowance on the property.

Once the election is made, the principal residence rule applies to prorate the gain when the property is sold **for the number of years of principal residency, plus up to 4 years preceding the year the individual moves in to ordinarily inhabit it.**

### **The election must be filed by the earlier of the following dates.**

- 90 days after the date CRA requests the taxpayer to make the election
- The date when the income tax return must be filed for the year in which the property is sold

### **1994 Capital Gain Election**

Effective 1985, the government introduced the \$100,000 capital gain exemption. The exemption no longer applied to real estate transactions, as of March 1, 1992, and it was eliminated effective February 22, 1994.

As part of the elimination process, the tax department allowed individuals to utilize the unclaimed exemption by filing a capital gain election. The effect of the election was to increase the adjusted cost of the property, which in turn would reduce any capital gains on the sale.

It is possible that individuals have forgotten about the election or have lost the details. After the individual dies, that can be problematic because the executor may not have knowledge of the election.

Taxpayers should review their files and check whether an election was filed and whether the cost of the property was adjusted. If still unsure, taxpayers should contact CRA to obtain a historical report on capital gains and capital gain deductions claimed. ▲

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