JUGGLING THE PRINCIPAL RESIDENCE DEDUCTION

Dave has finally begun the arduous task of filing the final tax return for his mother Audrey who passed away in July 2018. As part of Dave's Executor duties, he is responsible to gather all Audrey's final tax information and have the final returns completed. Trouble was, her records were either a mess, or in some cases, there simply weren't any. Worse, they would need many of these records for something new; completion of the Principal Residence Election (PRE) form. Audrey owned both a home in Chilliwack and a cottage property on Salt Spring Island.

Prior to 2016 anyone that sold their principal residence did not have to report it on their income tax return. The lack of reporting allowed for abuse of the PRE. There were stories of property speculators, flippers and foreign buyers who were flouting the rules with impunity. On October 3, 2016 the federal government tightened the PRE rules. The changes were intended to ensure that the PRE would only be used in appropriate cases and that the one-property-per-family limit would be followed.

To be clear, a principal residence is one that a taxpayer's family (the taxpayer, his or her spouse, common-law spouse and any children under the age of 18) ordinarily inhabits. Since 1982, a family is entitled to designate only one principal residence per year. Any family owning more than one property must choose which to designate as the principal residence in any given year.

These opportunities are not new, however Canada Revenue Agency (CRA) now requires taxpayers to declare the PRE and provide basic information in their income tax return. As Dave is working on his mother's final tax return, he must file documentation that discloses the original purchase of the home, major capital improvements, proceeds of sale and years that they are claiming the PRE.

Dave was surprised by this requirement, and knew it would be a challenge to sort through Audrey's records to find the needed information. Luckily, he found some of the information in a box of his late father's papers that he fortunately had not yet got around to shredding. There were some other useful invoices and receipts for bathroom and kitchen renovations that he was able to unearth from his mother's records. In the end he was able to piece together enough information to be able to file a tax return.

There were some other considerations. In the last 4 years, Dave's niece Phillipa had been renting the basement suite of the house in Chilliwack while she went to school at the University there. Dave wondered if this would cause trouble claiming the PRE. Thankfully, the rules allow for this as long as there were no structural changes to the building to accommodate the rental, no capital cost allowance was claimed on the units or buildings, and the rental use was relatively small in relation to its use as a principal residence. Further, Audrey had been careful to pay income tax on the rental income. That said,

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anyone using part of their principal residence for rental income or for a home office should take care not to fall afoul of the rules. CRA looks carefully at the relationship between family use and other use. The Salt Spring cottage had never been rented.

On November 1st 2017, Audrey had moved to a senior's assisted living residence. Phillipa continued living in the house, looking after it in case Audrey decided to move back. As Audrey did not ordinarily inhabit her home, Dave would not be able to claim the PRE for 2018.

Dave now was able to work out the most tax efficient way to file the PRE for Audrey's final return. The island property had been purchased in 1975 for about $80,000 but was now worth just over $700,000. Audrey's home, purchased in 1984 for $100,000, was now worth $500,000. Records showed that a further $50,000 had been spent on improvements to the home. This meant that the capital gain on the home was $350,000 ($500,000 – ($100,000 + $50,000). At the same time, Salt Spring, purchased for $80,000, with another $100,000 of improvements, carried a $520,000 capital gain. As taxpayers can use the PRE for any property Audrey ordinarily inhabited, Dave decided to utilize the PRE for the Salt Spring property for the available years it was owned.

Here's how the math worked:

CHILLIWACK HOME:

1984 purchased:	$100,000
Improvements:	$50,000
2018 value at death:	$500,000
Capital gain:	$350,000
PRE claimed for:	1984 – 1994 (11 years until the purchase of Salt Spring)
Exemption Calculation: ([1 + 11] / 35 X $350,000	= $120,000

SALT SPRING PROPERTY:

1995 purchased:	$80,000
Improvements:	$100,000
2018 value at death:	$700,000
Gain	$520,000
PRE claimed for:	1995-2017, or 22 years
Exemption Calculation: ([1 + 22] / 24 X $520,000	= $498,333

With a total of $870,000 in capital gains, the combination of the PRE for the home from 1984 to 1994 and later Salt Spring for 1995 - 2018, allowed Dave and Melanie to exempt $618,333, or 71%, from capital gains tax on the final return, an approximate tax savings of as much as $150,000.

For anyone owning two residences, it is impossible to know in advance which property might best benefit from the principal residence exemption. There may be times where we may change the use of a property from a personal use to something else, like a rental property. This means that it has become important to keep track of the purchase, capital improvements, usage, and the sale of a principal residence in much the same way as an investment property. Having armed yourself and your heirs with records you will, in future, be able to best take advantage of the PRE.

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