NO.: **IT-120R6** DATE: July 17, 2003

SUBJECT: INCOME TAX ACT
Principal Residence

REFERENCE: The definition of "principal residence" in section 54, and paragraphs 40(2)(*b*) and 40(2)(*c*) (also sections 54.1 and 110.6; subsections 13(7), 40(4), 40(6), 40(7), 40(7.1), 45(1), 45(2), 45(3), 45(4), 107(2), 107(2.01), 107(4), 110.6(19) and 220(3.2); paragraph 104(4)(*a*); and subparagraph 40(2)(*g*)(iii) of the *Income Tax Act*; and Part XXIII of the *Income Tax Regulations*)

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Application

This bulletin replaces and cancels Interpretation Bulletin IT-120R5, dated November 30, 1999 and applies for the 2001 and subsequent taxation years. Unless otherwise stated, all statutory references throughout the bulletin are to the *Income Tax Act.*

Summary

This bulletin discusses the principal residence exemption, which can eliminate or reduce (for income tax purposes) a capital gain on the disposition of a taxpayer's principal residence.

In order for a property to qualify for designation as the taxpayer's principal residence, he or she must own the property. Joint ownership with another person qualifies for this purpose.

The housing unit representing the taxpayer's principal residence generally must be inhabited by the taxpayer or by his or her spouse or common-law partner, former spouse or common-law partner, or child.

A taxpayer can designate only one property as his or her principal residence for a particular taxation year. Furthermore, for a taxation year that is after the 1981 year, only one property per family unit can be designated as a principal residence.

If the land on which the housing unit is situated is not in excess of one-half hectare, it usually qualifies as part of the taxpayer's principal residence. Land in excess of one-half hectare may also qualify, but only to the extent that it is established to be necessary for the use and enjoyment of the housing unit as a residence.

If the taxpayer's principal residence is located on his or her farm, the taxpayer has a choice of two methods for determining what portion of any gain on a disposition of the farm can be eliminated by the principal residence exemption.

A complete or partial change in the use of a property from a principal residence to income-producing, or vice-versa, results in a deemed disposition of the property by the taxpayer at fair market value. The taxpayer may be able to elect that the deemed disposition on a complete change in use does not apply. A property covered by such an election may qualify as the taxpayer's principal residence for up to four years, or possibly longer in the case of a work relocation.

It is also possible for a personal trust to claim the principal residence exemption on the disposition of a property. Modifications to the normal principal residence exemption rules exist for this purpose.

The above topics are discussed more fully below, as well as other topics relating to the principal residence exemption.

The appendices to the bulletin contain illustrations of some of the rules discussed in the bulletin.

Discussion and Interpretation

Introduction

¶ 1. Various topics concerning the principal residence exemption are discussed in this bulletin, as indicated in the "*Contents*" section at the beginning of the bulletin. It should be noted that some of these topics are not relevant for all taxpayers. For example, a resident of Canada who owns only one housing unit which is situated in Canada on land of one-half hectare or less and which has been used since its acquisition strictly as his or her residence, will usually find that ¶s 14 to 44 have no particular relevance.

¶ 2. If a property qualifies as a taxpayer's principal residence, he or she can use the principal residence exemption to reduce or eliminate any capital gain otherwise occurring, for income tax purposes, on the disposition (or deemed disposition) of the property. The term "principal residence" is defined in section 54 of the *Income Tax Act.* The principal residence exemption is claimed under paragraph 40(2)(*b*) of the Act, or under paragraph 40(2)(*c*) where land used in a farming business carried on by the taxpayer includes his or her principal residence.

Unless otherwise stated, any reference in this bulletin to a "taxation year" or "year" means a particular taxation year for which the principal residence exemption is being claimed.

Various references are made throughout this bulletin to a taxpayer's spouse or common-law partner and child. For the 1993 to 2000 taxation years, former subsection 252(4) of the Act extended the meaning of the term "spouse" to include a common-law spouse of the opposite sex. Effective in 2001, the extended meaning of spouse in subsection 252(4) has been replaced with the term "common-law partner" in subsection 248(1) which can now also include a person of the same sex. A transitional rule for the 1998, 1999 and 2000 taxation years allowed same-sex couples to elect to be treated as common-law partners under the Act for those years. For more information about the meaning of the terms "spouse" and "common-law partner", see the current version of the *General Income Tax and Benefit Guide*. For purposes of applying the rules in subsections 70(6) and 73(1) as discussed in ¶ 38, see also the extended meaning of "spouse" and "former spouse" in subsection 252(3), as it reads for the particular taxation year being considered. Subsection 252(1), as it reads for the particular taxation year being considered, extends the meaning of "child" for purposes of applying all

the rules in the Act, including the principal residence exemption rules, for that year.

It is also possible for a personal trust to claim the principal residence exemption on the disposition of a property. This is discussed in ¶s 35 and 38.

Types of Property That Can Qualify as a Principal Residence

¶ 3. The following are the types of property that can qualify as a "principal residence":

- a housing unit, which includes:
  - a house,
  - an apartment or unit in a duplex, apartment building or condominium,
  - a cottage,
  - a mobile home,
  - a trailer, or
  - a houseboat;
- a leasehold interest in a housing unit; or
- a share of the capital stock of a co-operative housing corporation, if such share is acquired for the sole purpose of obtaining the right to inhabit a housing unit owned by that corporation. The term "co-operative housing corporation" means an association, incorporated subject to the terms and conditions of the legislation governing such incorporation, and formed and operated for the purpose of providing its members with the right to inhabit, by reason of ownership of shares therein, a housing unit owned by the corporation.

Land on which a housing unit is situated can qualify as part of a principal residence, subject to certain restrictions (see ¶s 14 to 23).

Ownership is Required

¶ 4. For a property to be a taxpayer's principal residence for a particular year, he or she must own the property in the year. The meaning of "ownership of property" for this purpose is discussed in the current version of IT-437, *Ownership of Property (Principal Residence)*. The taxpayer's ownership of the property qualifies for purposes of the section 54 definition of "principal residence" whether such ownership is "jointly with another person or otherwise". These latter words include sole ownership or a form of co-ownership such as joint tenancy or tenancy-in-common.

The "Ordinarily Inhabited" Rule

¶ 5. Another requirement is that the housing unit must be "ordinarily inhabited" in the year by the taxpayer or by his or her spouse or common-law partner, former spouse or common-law partner, or child.

The question of whether a housing unit is ordinarily inhabited in the year by a person must be resolved on the basis of the facts in each particular case. Even if a person inhabits a housing unit only for a short period of time in the year, this is sufficient for the housing unit to be considered "ordinarily inhabited in the year" by that person. For example, even if a person disposes of his or her residence early in the year or acquires it late in the year, the housing unit can be considered to be ordinarily inhabited in the year by that person by virtue of his or her living in it in the year before such sale or after such acquisition, as the case may be. Or, for example, a seasonal residence can be considered to be ordinarily inhabited in the year by a person who occupies it only during his or her vacation, provided that the main reason for owning the property is not to gain or produce income. With regard to the latter stipulation, a person receiving only incidental rental income from a seasonal residence is not considered to own the property mainly for the purpose of gaining or producing income.

If the housing unit is not ordinarily inhabited in the year by any of the above-mentioned persons, it is still possible for the property (as described in ¶ 3) to be considered to be the taxpayer's "principal residence" for the year, by means of an election under subsection 45(2) or (3). For a discussion of these provisions, see ¶s 25 to 29.

Designation of a Property as a Principal Residence

¶ 6. For a property to be a taxpayer's principal residence for a particular year, he or she must designate it as such for the year and no other property may have been so designated by the taxpayer for the year. Furthermore, no other property may have been designated as the principal residence of any member of the taxpayer's family unit for the year. For purposes of the latter rule, which applies if the taxpayer is designating a property as his or her principal residence for 1982 or a subsequent year, the taxpayer's family unit for the year includes, in addition to the taxpayer, the following persons (if any):

- the taxpayer's spouse or common-law partner throughout the year, unless the spouse or common-law partner was throughout the year living apart from, and was separated under a judicial separation or written separation agreement from, the taxpayer;
- the taxpayer's children, except those who were married, in a common-law partnership or 18 years of age or older during the year; and
- where the taxpayer was not married, in a common-law partnership or 18 years of age or older during the year,
  - the taxpayer's mother and father, and
  - the taxpayer's brothers and sisters who were not married, in a common-law partnerhip or 18 years of age or older during the year.

As discussed in ¶ 2, for the 1993 to 2000 taxation years, a spouse included a common-law partner of the opposite sex. Accordingly, these individuals will be considered a family unit for the purposes of the principal residence exemption for the 1993 and subsequent taxation years (see Example 2 in Appendix A). In the case of same-sex common-law partners,

they will be considered a family unit for the 2001 and subsequent taxation years. However, if a same-sex couple filed a joint election to be treated as common-law partners for the 1998, 1999 and/or 2000 taxation years, then they will be considered a family unit for those years.

¶ 7. According to section 2301 of the *Income Tax Regulations*, a taxpayer's designation of a property as a principal residence for one or more taxation years is to be made in his or her income tax return for the taxation year in which he or she has disposed of the property or granted an option to another person to acquire the property. The designation form used for this purpose is Form T2091(IND), *Designation of a Property as a Principal Residence by an Individual (Other Than a Personal Trust)*. However, in accordance with our practice, Form T2091(IND) need not be completed and filed with the taxpayer's income tax return unless

(a) a taxable capital gain on the disposition of the property remains after using the principal residence exemption formula (as shown in ¶ 8), or

(b) form T664 or T664(Seniors), *Election to Report a Capital Gain on Property Owned at the End of February 22, 1994* was filed with respect to the property by the taxpayer, or his or her spouse or common-law partner; and the property was the taxpayer's principal residence for 1994, or it was designated in the year as the principal residence for any taxation year.

Note that if a taxpayer using the principal residence exemption formula (as shown in ¶ 8) to eliminate a gain on the disposition of a property is not, because of the above-mentioned practice, required to complete and file Form T2091(IND), he or she is still considered to have designated the property as his or her principal residence (i.e., to have claimed the principal residence exemption for that property) for the years in question as far as the limitations discussed earlier in this paragraph are concerned.

Calculating the Gain on the Disposition of a Principal Residence – The Principal Residence Exemption

¶ 8. Under the principal residence exemption provision contained in paragraph 40(2)(*b*) of the Act, a taxpayer's gain from the disposition (or deemed disposition) of any property that was his or her principal residence at any time after his or her "acquisition date" (see definition below) with respect to the property, is equal to his or her "gain otherwise determined" (see explanation below) less two amounts, which are described later in this paragraph.

The taxpayer's "acquisition date" with respect to the property is the later of the following two dates:

- December 31, 1971, and
- the date on which the taxpayer last acquired or reacquired the property or is deemed to have last acquired or reacquired it. (Note that, by virtue of subsection 40(7.1), if a subsection 110.6(19) capital gains election was made in respect of the property, the deemed reacquisition of the property under that election is not considered to be a reacquisition for purposes of determining the "acquisition date" used in paragraph 40(2)(*b*).)

The taxpayer's "gain otherwise determined" means the amount that the gain (if any) from the taxpayer's disposition (or deemed disposition) of the property would be—before the two reductions described later in this paragraph—if the capital gains election provision in subsection 110.6(19) and the related provision in subsection 110.6(21) were not taken into account. Thus, if a subsection 110.6(19) capital gains election has been made in respect of the property, the taxpayer's gain otherwise determined is calculated without reference to the deemed disposition and reacquisition of the property under that election. That is, the gain otherwise determined is calculated without taking into account the increase to the adjusted cost base of the property under subsection 110.6(19) or the decrease to that adjusted cost base under subsection 110.6(21).

The first amount by which the taxpayer's gain otherwise determined is reduced under paragraph 40(2)(*b*) is calculated by using the following formula:

$$A \times \frac{B}{C}$$

The variables in the above formula are as follows:

A is the taxpayer's gain otherwise determined, as described above.

B is 1 + the number of taxation years ending after the acquisition date for which the property was the taxpayer's principal residence and during which he or she was resident in Canada. (Note that both these conditions must be satisfied for a particular year in order for that year to qualify for inclusion in the numerator B.)

C is the number of taxation years ending after the acquisition date during which the taxpayer owned the property (whether jointly with another person or otherwise—see ¶ 4).

For a discussion of the meaning of "resident in Canada", see the current version of IT-221, *Determination of an Individual's Residence Status*. The word "during" in reference to a taxation year means "at any time in" rather than "throughout the whole of" the taxation year.

The second amount by which the taxpayer's gain otherwise determined is reduced is shown in paragraph 40(2)(*b*) as variable "D" and it is referred to in this bulletin as the "capital gains election reduction amount". It occurs only if

- the taxpayer's acquisition date with respect to the property (as described above) is before February 23, 1994, and
- the taxpayer, or his or her spouse, or common-law partner (see ¶ 7(b)), made a subsection 110.6(19) capital gains election for the property or for an interest in the property—if such an election was made, Form T664 or T664(Seniors), *Election to Report a Capital Gain on Property Owned at the End of February 22, 1994,* would have been filed.

The inclusion of the 110.6(19) election amount of a spouse or common-law partner of the taxpayer, when calculating the capital gains election reduction amount for the taxpayer, ensures that any elected gain reported by the spouse or common-law partner in 1994 with respect to a property that was subsequently transferred to the taxpayer through a spousal or common-law partner roll-over provision after February 1994, is properly reflected in the ultimate disposition of the property by the taxpayer. In other words, in situations where a spouse or common-law partner has transferred property to the taxpayer subsequent to 1994 and pursuant to the roll-over provisions of subsection 73(1) or 70(6), the calculation of the capital gains reduction amount of the taxpayer at the time the property is sold, must include any 1994 elected gain reported by the spouse or common-law partner with respect to the transferred property. Qualifying transfers of property under these subsections are discussed later in ¶ 38.

The capital gains election reduction amount essentially represents the total amount of the gains that resulted from the taxpayer's and his or her spouse or common-law partner's capital gains elections for the property, after taking into account any reduction in calculating those gains by virtue of the property having been designated as the principal residence of the taxpayer or his or her spouse or common-law partner for any taxation year up to and including the taxation year that included February 22, 1994. The capital gains election reduction amount cannot, however, be more than such gains—after taking into account any reduction thereto by virtue of the property having been the principal residence of the taxpayer or his or her spouse or common law partner for any taxation year up to and including the taxation year that included February 22, 1994—that would have resulted from such capital gains elections if the fair market value of the property as at the end of February 22, 1994 had been used as the designated proceeds for the property.

The taxpayer calculates his or her capital gains election reduction amount on Form T2091(IND)–WS, *Principal Residence Worksheet*, which the taxpayer files with his or her T2091(IND) designation form (see ¶ 7).

The remaining discussions in this bulletin regarding paragraph 40(2)(*b*) are concerned with the first reduction to the gain otherwise determined, i.e., the reduction provided for by means of the above-mentioned formula, A × B/C. Unless stated to the contrary, it is assumed for purposes of those discussions that the taxpayer did not make a capital gains election and thus that there is no second reduction to the gain otherwise determined, i.e., no capital gains election reduction amount.

Ownership of a Property by Both Spouses or Common-Law Partners

¶ 9. Where there is a gain on the disposition of a property owned both by a taxpayer and his or her spouse or common-law partner in one of the forms of ownership described in ¶ 4, both spouses or common-law partners will generally have a gain on the disposition. It should be kept in mind that if one of the spouses or common-law partners designates the property as his or her principal residence for any taxation year after the 1981 year, the other spouse or common-law partner will be able to designate only that same property as his or her principal residence for that year if the rule described in ¶ 6 prevents him or her from so designating any other property for that year.

More Than One Residence in a Taxation Year

¶ 10. While only one property may be designated as a taxpayer's principal residence for a particular taxation year (see ¶ 6), the principal residence exemption rules recognize that the taxpayer can have two residences in the same year, i.e., where one residence is sold and another acquired in the same year. The effect of the "one plus" in variable B (the numerator of the fraction) in the formula in ¶ 8 is to treat both properties as a principal residence in such a year, even though only one of them may be designated as such for that year.

Construction of a Housing Unit on Vacant Land

¶ 11. If a taxpayer acquires land in one taxation year and constructs a housing unit on it in a subsequent year, the property may not be designated as the taxpayer's principal residence for the years that are prior to the year in which the taxpayer, his or her spouse or common-law partner, former spouse or common-law partner, or child commences to ordinarily inhabit the housing unit. Such prior years (when the taxpayer owned only the vacant land or the land with a housing unit under construction) would not be included in the numerator "B" in the formula in ¶ 8 (or in the years included in the statement in ¶ 22(b)). However, all years, commencing with the year in which the taxpayer acquired the vacant land, would be included in the denominator "C". Therefore, it is possible that when the property is later disposed of, only part of the gain otherwise determined will be eliminated by the principal residence exemption.

Example

In 1992, Mr. A acquired vacant land for $25,000. In 1995, he constructed a housing unit on the land, costing $75,000, and started to ordinarily inhabit the housing unit. In 2001, he disposed of the property for $150,000. Mr. A's gain otherwise determined on the disposition of the property is equal to his $150,000 proceeds minus his $100,000 adjusted cost base = $50,000 (assume there were no costs of disposition). Mr. A can designate the property as his principal residence for the years 1995 to 2001 inclusive, but not for the years 1992 to 1994 inclusive because no one lived in a housing unit on the property during those years. The principal residence exemption formula in ¶ 8 cannot, therefore, eliminate his entire $50,000 gain otherwise

determined, but rather can eliminate only $40,000 of that gain:

$$A \times \frac{B}{C} = \$50{,}000 \times \frac{1 + 7 \text{ (1995 to 2001)}}{10 \text{ (1992 to 2001)}} = \$40{,}000$$

Property Owned on December 31, 1981

¶ 12. A property may not be designated as a taxpayer's principal residence for any taxation year after the 1981 year if another property has been designated for that year as the principal residence of another member of his or her family unit (for further particulars on this rule, see ¶ 6). If the taxpayer disposes of a property he or she has owned (whether jointly with another person or otherwise) continuously since before 1982 and the property cannot be designated as the taxpayer's principal residence for one or more years after the 1981 year because of the above-mentioned rule, a transitional provision in subsection 40(6) puts a cap on the amount of the taxpayer's gain (if any) on the disposition. Appendix A at the end of this bulletin provides examples which illustrate how the rule in subsection 40(6) works.

Loss on the Disposition of a Residence

¶ 13. A property which is used primarily as a residence (i.e., for the personal use and enjoyment of those living in it)—or an option to acquire a property which would, if acquired, be so used—is "personal-use property". Therefore, a loss on the disposition of such a property or option is deemed to be nil by virtue of subparagraph 40(2)(*g*)(iii).

Land Contributing to the Use and Enjoyment of the Housing Unit as a Residence

¶ 14. By virtue of paragraph (*e*) of the section 54 definition of "principal residence", a taxpayer's principal residence for a taxation year shall be deemed to include, except where the property consists of a share of the capital stock of a co-operative housing corporation, the land upon which the housing unit stands and any portion of the adjoining land that can reasonably be regarded as contributing to the use and enjoyment of the housing unit as a residence. Evidence is not usually required to establish that one-half hectare of land or less, including the area on which the housing unit stands, contributes to the use and enjoyment of the housing unit as a residence. However, where a portion of that land is used to earn income from business or property, such portion will not usually be considered to contribute to such use and enjoyment. Where the taxpayer claims a portion of the expenses related to the land (such as property taxes or mortgage interest) in computing income, the allocation of such expenses for this purpose is normally an indication of the extent to which he or she considers the land to be used to earn income.

Land in Excess of One-Half Hectare

¶ 15. Where the total area of the land upon which a housing unit is situated exceeds one-half hectare, the excess land is deemed by paragraph (*e*) of the section 54 definition of "principal residence" not to have contributed to the use and enjoyment of the housing unit as a residence and thus will not qualify as part of a principal residence, except to the extent that the taxpayer establishes that it was necessary for such use and enjoyment. The excess land must clearly be necessary for the housing unit to properly fulfill its function as a residence and not simply be desirable. Generally, the use of land in excess of one-half hectare in connection with a particular recreation or lifestyle (such as for keeping pets or for country living) does not mean that the excess land is necessary for the use and enjoyment of the housing unit as a residence.

Land in excess of one-half hectare may be considered necessary where the size or character of a housing unit together with its location on the lot make such excess land essential to its use and enjoyment as a residence, or where the location of a housing unit requires such excess land in order to provide its occupants with access to and from public roads. Other factors may be relevant in determining whether land in excess of one-half hectare is necessary for the use and enjoyment of the housing unit as a residence, such as, for example, a minimum lot size or a severance or subdivision restriction (see ¶ 16). In all cases, however, it is a question of fact as to how much, if any, of the excess land is necessary for the use and enjoyment of the housing unit as a residence.

¶ 16. In order to acquire a property for use as a residence, a taxpayer may be required by a law or regulation of a municipality or province with respect to residential lots to acquire more than one-half hectare of the property. Such a law or regulation could, for example,

(a) require a minimum lot size for a residential lot in a particular area, or

(b) impose a severance or subdivision restriction with respect to residential lots in a particular area.

To the extent that a taxpayer, in order to acquire a property as a residence, is required because of such a law or regulation to acquire land that exceeds one-half hectare, the land that must be so acquired is generally considered to be necessary for the use and enjoyment of the housing unit as a residence throughout the period that the property is continuously owned by the taxpayer after the acquisition date. However, it should be noted that the mere existence of such a municipal law or regulation on the date the taxpayer acquired the property does not immediately qualify the excess land for purposes of the principal residence exemption. For example, if the taxpayer could have made an application for severance of the excess land and it is likely that such a request would have been approved, the taxpayer would generally not be considered to have been required to acquire the excess land.

Furthermore, regardless of the above, where any portion of the land in excess of one-half hectare is not used for residential purposes but rather for income-producing

purposes, such portion is usually not considered to be necessary for the use and enjoyment of the housing unit as a residence.

Disposition of Bare Land in Excess of One-Half Hectare

¶ 17. If the housing unit is situated on land in excess of one-half hectare and part or all of that excess land is severed from the property and sold, the land sold is generally considered not to be part of the principal residence unless the housing unit can no longer be used as a residence due to the land sale. If the housing unit can still be so used, such a sale indicates that the land sold was not necessary for the use and enjoyment of the housing unit as a residence.

Circumstances or events beyond the taxpayer's control may cause a portion of the land to cease to be necessary for the use and enjoyment of the housing unit as a residence (e.g., a minimum lot size requirement or severance or subdivision restriction in effect at the date of acquisition is subsequently relaxed). If the taxpayer then subdivides the excess land, it will be considered to have been "necessary" until the time of its subdivision. After subdivision, each newly created lot is a separate property and only the property on which the housing unit is located may continue to be designated as the taxpayer's principal residence. Furthermore, it is possible for the vacant land which previously formed part of the principal residence to be considered to have been converted to inventory at the time of the subdivision (see the rules on partial changes of use in ¶ 30).

Disposition of Part of a Principal Residence

¶ 18. Where only a portion of a property qualifying as a taxpayer's principal residence is disposed of (e.g. the granting of an easement or the expropriation of land), the property may be designated as the taxpayer's principal residence in order to use the principal residence exemption for the portion of the property disposed of. It is important to note that such a designation is made on the entire property (including the housing unit) that qualifies as the principal residence, and not just on the portion of the property disposed of. Accordingly, when the remainder of the property is subsequently disposed of, it too will be recognized as the taxpayer's principal residence for the taxation years for which the above-mentioned designation was made. No other property may be designated as a principal residence for any of those years by the taxpayer (or, for any of those years that are after the 1981 taxation year, by the taxpayer or any of the other members of his or her family unit) as discussed in ¶ 6.

Disposition of a Property Where Only Part of It Qualifies as a Principal Residence

¶ 19. In some cases, only a portion of a property that is disposed of for a gain will qualify as a principal residence (see ¶s 14 to 16). If such qualifying portion of the property is designated as the taxpayer's principal residence, it will be necessary to calculate the gain on such portion separately from the gain on the remaining portion of the property which does not qualify as the taxpayer's principal residence. This is because the gain otherwise determined on the portion of the property designated as the principal residence may be reduced or eliminated by the principal residence exemption, whereas the gain on the remaining portion of the property results in a taxable capital gain. The allocation of the proceeds of disposition and adjusted cost base of the total property between the two portions does not necessarily have to be on the basis of area—consideration should be given to any factors which could have an effect on the relative value of either of the two portions.

Example

Mr. A's house is on a property with a total land area of three-quarters of a hectare. He sells the property at fair market value and realizes an actual gain on the disposition. The house and one-half hectare of land qualify as his principal residence for all the years he has owned it. The extra one-quarter hectare does not qualify as part of his principal residence for these reasons:

- There has never been any law or regulation requiring the extra one-quarter hectare to be part of the property as a residence (see ¶ 16)—it has always been severable from the one-half hectare on which the house is situated.
- There has never been, as elaborated on below, any other valid reason for considering the extra one-quarter hectare to be necessary for the use and enjoyment of the house as a residence (see ¶ 15).

If the extra one-quarter hectare were severed, it would still be accessible from the road by which the principal residence's one-half hectare is accessed. However, it would be difficult to sell the extra one-quarter hectare on its own because it forms part of a shallow gully through which a small brook flows. In fact, the only feasible use for the extra one-quarter hectare is to enhance the enjoyment of Mr. A's residence or, if severed, the residence of his next door neighbour, i.e., by providing the owner with the enjoyment of such additional land with its natural beauty. Nevertheless, the extra one-quarter hectare is not necessary for the use and enjoyment of Mr. A's house as a residence. Note that in these circumstances, the portion of Mr. A's gain that is considered to pertain to the extra one-quarter hectare may not simply be one-third of the gain pertaining to the entire three-quarters of a hectare of land he sold, but would probably be a lower amount (a determination of the actual amount in such a case could require a real estate appraisal).

The comments in this paragraph do not apply if the property includes land used in a farming business (see instead ¶s 20 to 23).

Principal Residence on Land Used in a Farming Business

¶ 20. If a taxpayer disposes of land used in a farming business which he or she carried on at any time and such land includes property that was at any time his or her principal residence, paragraph 40(2)(*c*) of the Act provides that any gain on the disposition of the land may be calculated using either of the two methods discussed below. It should be noted that the reference to "land" in paragraph 40(2)(*c*) includes the buildings thereon.

¶ 21. *First Method*: The taxpayer may regard the property as being divided into two portions: the principal residence portion and the remaining portion, part or all of which was used in the farming business. The proceeds of disposition and adjusted cost base of the total property must be allocated on a reasonable basis between the two portions in order to determine the gain for each portion. The gain otherwise determined for the principal residence portion may be reduced or eliminated by the principal residence exemption provided for in paragraph 40(2)(*b*) of the Act, as described in ¶ 8 (including, if applicable, the capital gains election reduction amount, i.e., variable "D" in paragraph 40(2)(*b*)); the gain on the remainder of the property results in a taxable capital gain (see, however, ¶ 24). For purposes of determining what portion of the proceeds of disposition of the land may reasonably be allocated to the principal residence, it is our usual practice to accept the greater of the following two amounts:

(a) the fair market value, as of the date of disposition of the land, of one-half hectare of land estimated on the basis of comparable sales of similar farm properties in the same area (the fair market value of more than one-half hectare could be used to the extent that such excess land was necessary for the use and enjoyment of the housing unit as a residence – see ¶s 15 and 16); and

(b) the fair market value, as of the date of disposition of the land, of a typical residential lot in the same area.

Whichever basis is chosen, (a) or (b), for allocating a portion of the proceeds of disposition of the land to the principal residence, the same basis should be used to allocate a portion of the adjusted cost base of the land to the principal residence. For purposes of making this allocation of the land's adjusted cost base, the fair market value of the land referred to in (a) or (b), as the case may be, would be as of the taxpayer's acquisition date for the land rather than as of the date of its disposition.

Appendix B at the end of this bulletin provides an example which illustrates the use of the first method allowed under paragraph 40(2)(*c*).

¶ 22. *Second Method*: The taxpayer may elect under subparagraph 40(2)(*c*)(ii) to compute the gain on the disposition of the total property (including the property that was the principal residence) without making the allocations described above or using the principal residence exemption provided for in paragraph 40(2)(*b*) of the Act as described in ¶ 8. With regard to this election under subparagraph 40(2)(*c*)(ii) of the Act, section 2300 of the *Income Tax Regulations* requires that a letter signed by the taxpayer be attached to the income tax return filed for the taxation year in which the disposition of the property took place. The letter should contain the following information:

(a) a statement that the taxpayer is electing under subparagraph 40(2)(*c*)(ii) of the Act;

(b) a statement of the number of taxation years ending after the acquisition date for which the property was the taxpayer's principal residence and during which he or she was resident in Canada (for the meanings of "resident in Canada" and "during", see ¶ 8); and

(c) a description of the property sufficient to identify it with the property designated as the taxpayer's principal residence.

Under the subparagraph 40(2)(*c*)(ii) election, the gain on the disposition of the total property is equal to the gain otherwise determined less the total of $1,000 plus $1,000 for each taxation year in (b) above. Two points should be noted for purposes of calculating the gain under subparagraph 40(2)(*c*)(ii):

- The "acquisition date" mentioned in (b) is the later of
  - December 31, 1971; and
  - the date on which the taxpayer last acquired or reacquired the property or is deemed to have last acquired or reacquired it. If the taxpayer made a subsection 110.6(19) capital gains election in respect of the property, the deemed reacquisition of the property immediately after the end of February 22, 1994 under that election is considered to be a reacquisition for purposes of determining the "acquisition date" when calculating the gain otherwise determined. The reason for this is that, although subsection 40(7.1) prevents a subsection 110.6(19) deemed reacquisition from being considered a reacquisition for purposes of determining the "acquisition date" used in paragraph 40(2)(*b*) (as indicated in ¶ 8), neither subsection 40(7.1) nor any other provision prevents a subsection 110.6(19) deemed reacquisition from being considered a reacquisition for purposes of determining the "acquisition date" used in subparagraph 40(2)(*c*)(ii).
- If the "acquisition date" is in fact the date of the deemed reacquisition under a subsection 110.6(19) capital gains election, i.e., immediately after the end of February 22, 1994, the gain otherwise determined is calculated by taking into account the taxpayer's cost of the property under that deemed reacquisition rather than his or her actual cost at some earlier date. (Variable "A" in paragraph 40(2)(*b*), as discussed in ¶ 8, does not apply for the purposes of subparagraph 40(2)(*c*)(ii).)

Appendix B at the end of this bulletin provides an example which illustrates the use of the second method allowed under paragraph 40(2)(*c*).

¶ 23. When the second method is used, the exemption of $1,000 per year, which is to allow for the fact that a portion of the total property pertains to the principal residence rather than the farm, is not reduced where part of the residence itself is used to earn income (e.g., there could be an office in the house which is used in connection with a business). However, any gain or recapture of capital cost allowance pertaining to the portion of the residence (i.e., building) so used to earn income (either or both of which can occur, for example, where the use of such portion of the residence is changed back from income-producing to non-income-producing – see ¶s 30 and 34) cannot be reduced by the $1,000 per year exemption.

¶ 24. Where an individual has a taxable capital gain from the disposition of a farm property, a section 110.6 capital gains deduction (which is a deduction in calculating taxable income) may be possible on the basis that the property is qualified farm property. For further particulars on this topic, see either the *Farming Income* tax guide or the *Farming Income and NISA* tax guide.

Complete Change in Use of a Property From Principal Residence to Income-Producing

¶ 25. If a taxpayer has completely converted his or her principal residence to an income-producing use, he or she is deemed by paragraph 45(1)(*a*) to have disposed of the property (both land and building) at fair market value (FMV) and reacquired it immediately thereafter at the same amount. Any gain otherwise determined on this deemed disposition may be eliminated or reduced by the principal residence exemption. The taxpayer may instead, however, defer recognition of any gain to a later year by electing under subsection 45(2) to be deemed not to have made the change in use of the property. This election is made by means of a letter to that effect signed by the taxpayer and filed with the income tax return for the year in which the change in use occurred. If the taxpayer rescinds the election in a subsequent taxation year, he or she is deemed to have disposed of and reacquired the property at FMV on the first day of that subsequent year (with the above-mentioned tax consequences). If capital cost allowance (CCA) is claimed on the property, the election is considered to be rescinded on the first day of the year in which that claim is made.

Subsection 220(3.2) of the Act, in conjunction with section 600 of the *Income Tax Regulations*, provides the authority for the Canada Customs and Revenue Agency (the CCRA) to accept a late-filed subsection 45(2) election. Such a late-filed election may be accepted under certain circumstances, one of which is that no CCA has been claimed on the property since the change in use has occurred and during the period in which the election is to remain in force. For further particulars on the acceptance of late-filed elections, see the current version of Information Circular 92-1, *Guidelines for Accepting Late, Amended or Revoked Elections*.

¶ 26. A property can qualify as a taxpayer's principal residence for up to four taxation years during which a subsection 45(2) election remains in force, even if the housing unit is not ordinarily inhabited during those years by the taxpayer or by his or her spouse or common-law partner, former spouse or common-law partner, or child (see ¶ 5). However, the taxpayer must be resident, or deemed to be resident, in Canada during those years for the full benefit of the principal residence exemption to apply (see the numerator "B" in the formula in ¶ 8 or the years included in the statement in ¶ 22(b), as the case may be). It should also be noted that the rule described in ¶ 6 prevents the designation of more than one property as a principal residence for any particular year by the taxpayer (or, for any particular year after the 1981 taxation year, by the taxpayer or any other member of his or her family unit). Thus, for example, a taxpayer's designation for the same year of one property by virtue of a subsection 45(2) election being in force, and another property by virtue of the fact that he or she ordinarily inhabited that other property, would not be permitted.

Example

Mr. A and his family lived in a house for a number of years until September 30, 1993. From October 1, 1993 until March 31, 1998 they lived elsewhere and Mr. A rented the house to a third party. On April 1, 1998, they moved back into the house and lived in it until it was sold in 2001. When he filed his 2001 income tax return, Mr. A designated the house as his principal residence for the 1994 to 1997 taxation years inclusive (i.e., the maximum four years) by virtue of a subsection 45(2) election (which he had already filed with his 1993 income tax return) having been in force for those years. (He was able to make this designation because no other property had been designated as a principal residence by him or a member of his family unit for those years.) He designated the house as his principal residence for all the other years in which he owned it by virtue of his having ordinarily inhabited it during those years, including the 1993 and 1998 years. Having been resident in Canada at all times, Mr. A's gain otherwise determined on the disposition of the house in 2001 was, therefore, completely eliminated by the principal residence exemption.

Any income in respect of a property (e.g., the rental income in the above example), net of applicable expenses, must be reported for tax purposes. However, for taxation years covered by a subsection 45(2) election, CCA should not be claimed on the property (see ¶ 25).

¶ 27. Section 54.1 removes the above-mentioned four-year limitation for taxation years covered by a subsection 45(2) election if all of the following conditions are met:

(a) the taxpayer does not ordinarily inhabit the housing unit during the period covered by the election because the taxpayer's or his or her spouse's or common-law partner's place of employment has been relocated;

(b) the employer is not related to the taxpayer or his or her spouse or common-law partner;

(c) the housing unit is at least 40 kilometers farther from such new place of employment than is the taxpayer's subsequent place or places of residence; and

(d) either

- the taxpayer resumes ordinary habitation of the housing unit during the term of employment by that same employer or before the end of the taxation year immediately following the taxation year in which such employment terminates; or
- the taxpayer dies during the term of such employment.

With regard to condition (d), two corporations that are members of the same corporate group, or are otherwise related, are not considered to be the same employer.

Complete Change in Use of a Property From Income-Producing to Principal Residence

¶ 28. If a taxpayer has completely changed the use of a property (for which an election under subsection 45(2) is not in force) from income-producing to a principal residence, he or she is deemed by paragraph 45(1)(*a*) to have disposed of the property (both land and building), and immediately thereafter reacquired it, at FMV. This deemed disposition can result in a taxable capital gain. The taxpayer may instead defer recognition of the gain to a later year by electing under subsection 45(3) that the above-mentioned deemed disposition and reacquisition under paragraph 45(1)(*a*) does not apply. This election is made by means of a letter to that effect signed by the taxpayer and filed with the income tax return for the year in which the property is ultimately disposed of (or earlier if a formal "demand" for the election is issued by the CCRA). Also, subsection 220(3.2) of the Act, in conjunction with section 600 of the *Income Tax Regulations*, provides the authority for the CCRA to accept a late-filed subsection 45(3) election. Such a late-filed election may be accepted under certain circumstances. For further particulars on the acceptance of late-filed elections, see the current version of Information Circular 92-1, *Guidelines for Accepting Late, Amended or Revoked Elections*.

Even if a subsection 45(3) election is filed in order to defer recognition of a gain from the change in use of a property from income-producing to principal residence, the net income from the property for the period before the change in use must still be reported. However, for purposes of reporting such net income, it should be noted that an election under subsection 45(3) is not possible if, for any taxation year ending after 1984 and on or before the change in use of the property from income-producing to a principal residence, CCA has been allowed in respect of the property to

- the taxpayer;
- the taxpayer's spouse or common-law partner; or
- a trust under which the taxpayer or his or her spouse or common-law partner is a beneficiary.

CCA so allowed would cause subsection 45(4) to nullify the subsection 45(3) election.

¶ 29. Similar to the treatment for a subsection 45(2) election (see ¶ 26), a property can qualify as a taxpayer's principal residence for up to four taxation years prior to a change in use covered by a subsection 45(3) election, in lieu of fulfilling the "ordinarily inhabited" rule (discussed in ¶ 5) for these years. As in the case of a subsection 45(2) election, residence or deemed residence in Canada during these years is necessary for the full benefit of the principal residence exemption to apply. Furthermore, the rule described in ¶ 6 prevents the designation of more than one property as a principal residence for any particular year by the taxpayer (or, for any particular year after the 1981 taxation year, by the taxpayer or any other member of his or her family unit).

Example

Mr. X bought a house in 1993 and rented it to a third party until mid-1999. Mr. X and his family then lived in the house until it was sold in 2001. Mr. X has been resident in Canada at all times. When he filed his 2001 income tax return, Mr. X designated the house as his principal residence for the 1999 to 2001 taxation years inclusive, by virtue of his having ordinarily inhabited it during those years. He also designated the house as his principal residence for the 1995 to 1998 years inclusive (i.e., the maximum 4 years) by virtue of a subsection 45(3) election, which he filed with his 2001 income tax return (he was able to make this designation because (i) no other property had been designated by him or a member of his family unit for those years, and (ii) he did not claim any CCA when reporting the net income from the property before the change in use). However, his gain otherwise determined on the disposition of the house in 2001 could not be fully eliminated by the principal residence exemption formula in ¶ 8 because he could not designate the house as his principal residence for the 1993 and 1994 years.

Partial Changes in Use

¶ 30. If a taxpayer has partially converted a principal residence to an income-producing use, paragraph 45(1)(*c*) provides for a deemed disposition of the portion of the property so converted (such portion is usually calculated on the basis of the area involved) for proceeds equal to its proportionate share of the property's FMV. Paragraph 45(1)(*c*) also provides for a deemed reacquisition immediately thereafter of the same portion of the property at a cost equal to the very same amount. Any gain otherwise determined on the deemed disposition is usually eliminated or reduced by the principal residence exemption. If the portion of the property so changed is later converted back to use as part of the principal residence, there is a second deemed disposition (and reacquisition) thereof at FMV. A taxable capital gain attributable to the period of use of such portion of the property for income-producing purposes can

arise from such a second deemed disposition or from an actual sale of the whole property subsequent to the original partial change in use. An election under subsection 45(2) or (3) cannot be made where there is a partial change in use of a property as described above.

¶ 31. The above-mentioned deemed disposition rule applies where the partial change in use of the property is substantial and of a more permanent nature, i.e., where there is a structural change. Examples where this occurs are the conversion of the front half of a house into a store, the conversion of a portion of a house into a self-contained domestic establishment for earning rental income (a duplex, triplex, etc.), and alterations to a house to accommodate separate business premises. In these and similar cases, the taxpayer reports the income and may claim the expenses pertaining to the altered portion of the property (i.e., a reasonable portion of the expenses relating to the whole property) as well as CCA on such altered portion of the property.

¶ 32. It is our practice not to apply the deemed disposition rule, but rather to consider that the entire property retains its nature as a principal residence, where all of the following conditions are met:

(a) the income-producing use is ancillary to the main use of the property as a residence,

(b) there is no structural change to the property, and

(c) no CCA is claimed on the property.

These conditions can be met, for example, where a taxpayer carries on a business of caring for children in his or her home, rents one or more rooms in the home, or has an office or other work space in the home which is used in connection with his or her business or employment. In these and similar cases, the taxpayer reports the income and may claim the expenses (other than CCA) pertaining to the portion of the property used for income-producing purposes. Certain conditions and restrictions are placed on the deductibility of expenses relating to an office or other work space in an individual's home—see the current version of IT-514, *Work Space in Home Expenses* (if the income is income from a business) or the current version of IT-352, *Employee's Expenses, Including Work Space in Home Expenses*. In the event that the taxpayer commences to claim CCA on the portion of the property used for producing income, the deemed disposition rule is applied as of the time at which the income-producing use commenced.

Change in Use Rules Regarding CCA, Deemed Capital Cost, and Recapture

¶ 33. If a taxpayer has completely or partially changed the use of property from principal residence to income-producing, subsection 13(7) provides for a deemed acquisition of the property or portion of the property so changed that is depreciable property. For purposes of claiming CCA, the deemed capital cost of such depreciable property is its FMV as of the date of the change in use unless that FMV is greater than its cost to the taxpayer. In that case, the deemed capital cost of such depreciable property is equal to its cost to the taxpayer plus an amount which represents the taxable portion of the accrued gain on the property (before any reduction to that gain by means of the principal residence exemption) to the extent that a section 110.6 capital gains deduction has not been claimed in respect of that amount (this latter rule has no particular significance for dispositions of residence properties occurring after February 22, 1994, because of the elimination of the $100,000 lifetime capital gains exemption for dispositions after that date).

Example

Mr. A completely converted his house to a rental property in January 2001, at which time its cost to him and its FMV were $60,000 and $100,000 respectively (both amounts pertain only to the housing unit and not the land). The change in use resulted in a deemed disposition of the property at FMV (see ¶s 25 and 26—assume that Mr. A did not make a subsection 45(2) election in respect of the property because he wanted to use the principal residence exemption for his cottage for the years after 2001). Mr. A was able to use the principal residence exemption formula in ¶ 8 to bring his gain on the January 2001 deemed disposition of the house to nil. Mr. A's deemed capital cost for the house (i.e., for CCA purposes) at the time of its change in use to a rental property was $80,000. This amount was calculated by taking the $60,000 cost and adding $20,000, the latter amount being one-half of the excess of the $100,000 FMV over the $60,000 cost. (Note that the $20,000 potentially taxable portion of the gain was included in Mr. A's deemed capital cost for CCA purposes even though he eliminated the gain by means of the principal residence exemption.)

In the case of a complete change in use of a property from principal residence to income-producing, a subsection 45(2) election will cause subsection 13(7), as described above, not to apply. However, if the election is rescinded in a subsequent taxation year (e.g., by claiming CCA on the property—see ¶ 25), a subsection 13(7) deemed acquisition of depreciable property will occur on the first day of that subsequent year.

Because a subsection 45(2) election is not available where there is only a partial change in use of a property from principal residence to income-producing, subsection 13(7) applies in such a situation in the manner described above (except where conditions (a) to (c) in ¶ 32 have been met, including the condition not to claim CCA on the portion of the property used to earn income).

¶ 34. If a taxpayer completely or partially changes the use of a property from income-producing to principal residence, there is a deemed disposition at FMV, by virtue of subsection 13(7), of the portion of the property so changed that is depreciable property. This can result in a recapture of CCA previously claimed on the property. A subsection 45(3) election cannot be used to defer such a recapture (e.g., a

recapture of CCA claimed for a taxation year ending before 1985—see the comments regarding CCA in ¶ 28).

Personal Trusts

¶ 35. It is possible for a "personal trust" (this term is defined in subsection 248(1) of the Act) to claim the principal residence exemption to reduce or eliminate a gain that the trust would otherwise have on the disposition of a property. For this purpose, the normal principal residence exemption rules generally apply, subject to the following modifications:

(a) When a personal trust designates a property as its principal residence for one or more taxation years, the trustee of the trust should complete and file Form T1079, *Designation of a Property as a Principal Residence by a Personal Trust.* For purposes of calculating a capital gains election reduction amount (see ¶ 8) for the trust, the trustee should complete Form T1079–WS, *Principal Residence Worksheet*, and file it with the T1079 designation form.

(b) For each taxation year for which the trust is designating the property as its principal residence, the trust must specify in the above-mentioned designation each individual who, in the calendar year ending in that taxation year,

- was beneficially interested in the trust, and
- ordinarily inhabited the housing unit or who had a spouse or common-law partner, former spouse or common-law partner, or child who ordinarily inhabited the housing unit (a subsection 45(2) or (3) election can be used, however, in essentially the same manner as, and subject to the limitations discussed in, ¶s 26 and 29, to remove the requirement that the "ordinarily inhabited" rule be fulfilled for the year by one of these persons).

Any individual specified by the trust to be an individual as described above is referred to as a "specified beneficiary" of the trust for the year.

(c) For each taxation year for which the trust is designating the property as its principal residence, there must not have been any corporation (other than a registered charity) or partnership that was beneficially interested in the trust at any time in the year.

(d) For each taxation year for which the trust is designating the property as its principal residence (including years before 1982), no other property may have been designated as a principal residence, for the calendar year ending in the year, by any specified beneficiary of the trust for the year, or by any person who throughout the calendar year ending in the year was a member of such a beneficiary's family unit. For this purpose, a specified beneficiary's "family unit" includes, in addition to the specified beneficiary, the following persons (if any):

- the specified beneficiary's spouse or common-law partner throughout the calendar year ending in the year, unless the spouse or common-law partner was throughout that calendar year living apart, and was separated pursuant to a judicial separation or written separation agreement, from the specified beneficiary;
- the specified beneficiary's children, except those who were married, in a common-law partnership or 18 years of age or older during the calendar year ending in the year; and
- where the specified beneficiary was not married, in a common-law partnership or 18 years of age or older during the calendar year ending in the year,
  - the specified beneficiary's mother and father, and
  - the specified beneficiary's brothers and sisters who were not married, in a common-law partnership or 18 years of age or older during that calendar year.

Furthermore, if a personal trust designates a property as its principal residence for a particular taxation year, the property is deemed to be property designated, for the calendar year ending in the year, as the principal residence of each specified beneficiary of the trust. This deeming rule can be applied, in conjunction with the other principal residence exemption rules, to various situations not explicitly described in those rules.

Example

Personal Trust A owned a house in its taxation year ended December 31, 2001. The house was ordinarily inhabited in 2001 by Mr. X, a specified beneficiary of Personal Trust A (and also by his spouse, Mrs. X). The trust has designated the house as its principal residence for its taxation year ended December 31, 2001. The house is therefore deemed to have been designated as Mr. X's principal residence for 2001.

Personal Trust B owned a cottage (see ¶ 3) in its taxation year ended December 31, 2001. The cottage was ordinarily inhabited (see ¶ 5) in 2001 by Mrs. X, a specified beneficiary of Personal Trust B (and also by Mr. X). As discussed in ¶ 6, a taxpayer and his or her spouse or common-law partner cannot designate different properties for the same year. Therefore, since the house has already been deemed to have been designated as Mr. X's principal residence for 2001, Personal Trust B cannot designate the cottage as its principal residence for 2001 because that would have resulted in the cottage being deemed to have also been designated as Mrs. X's principal residence for 2001.

¶ 36. Where a beneficiary has acquired a property from a personal trust in satisfaction of all or any part of the beneficiary's capital interest in the trust and

- the rollover provision in subsection 107(2) applied (see discussion in ¶ 37 for an exception to this rollover provision) and

- subsection 107(4) did not apply,

subsection 40(7) provides a deeming rule when the beneficiary disposes of the property. For purposes of claiming the principal residence exemption, the beneficiary is deemed by subsection 40(7) to have owned the property since the trust last acquired it.

The following example illustrates the effect of this deemed ownership provision in subsection 40(7) (in conjunction with subsection 107(2)).

Example

A personal trust acquired a residential property on October 1, 1997 for $75,000. On January 10, 1999, the property was distributed to Mr. X in satisfaction of his capital interest in the trust. Subsection 107(4) did not apply with respect to this distribution, and the rollover provision in subsection 107(2) prevented the gain on the property accrued to January 10, 1999 from being taxed in the hands of the trust. Instead, the potential for taxing that gain was transferred to Mr. X because subsection 107(2) deemed him to have acquired the property at a cost equal to $75,000, i.e., the cost amount of the property to the trust. Mr. X lived in the residence from October 15, 1997 until he disposed of the property on December 1, 2001 for $125,000, incurring no costs in connection with the disposition. Mr. X's gain otherwise determined on the disposition of the property was equal to his $125,000 proceeds minus his $75,000 adjusted cost base = $50,000. Subsection 40(7) deemed him to have owned the property from October 1, 1997 rather than from January 10, 1999. Since Mr. X ordinarily inhabited the residence in all of the years from 1997 to 2001 inclusive (i.e., all of the years in which he either owned the property or was deemed to have owned it), he was able to designate the property as his principal residence for all those years. Thus, he was able to use the principal residence exemption formula in ¶ 8 to fully eliminate his $50,000 gain otherwise determined. However, if neither Mr. X nor his current or former spouse or common-law partner, or child had ordinarily inhabited the residence (see the rule discussed in ¶ 5) until it was distributed by the trust to Mr. X on January 10, 1999, he would have been able to designate the property as his principal residence only for 1999 to 2001. In other words, he would have been able to use the formula in ¶ 8 to eliminate only the following portion of his $50,000 gain otherwise determined:

$$A \times \frac{B}{C} = \$50{,}000 \times \frac{1 + 3 \text{ (1999 to 2001)}}{5 \text{ (1997 to 2001)}} = \$40{,}000$$

¶ 37. In order to prevent the rollover rule in subsection 107(2) from applying with respect to a trust's distribution, to a beneficiary, of a property that qualifies for designation as the trust's principal residence before the distribution, a personal trust can use an election under subsection 107(2.01) of the Act. Under this election, the trust would instead be deemed, just before the distribution of the property to the beneficiary, to have disposed of and then to have reacquired the property at fair market value. This could be done, for example, in order for the trust to use the principal residence exemption to eliminate or reduce any gain on the property accrued to that point in time (see ¶ 35), ideal in circumstances where the recipient beneficiary is not the specified beneficiary and has owned another home during the period in which the trust owned the home being distributed. The cost of the property to the beneficiary would be that same fair market value, and the beneficiary would not be deemed by subsection 40(7) (see ¶ 36) to have owned the property during the period of time in which it was owned by the trust prior to the distribution.

Transfer of a Principal Residence

¶ 38. Subsection 40(4) can apply if a property of a taxpayer (hereinafter referred to as the "transferor")

- has been transferred *inter vivos* to:
  - the transferor's spouse or common-law partner,
  - the transferor's former spouse or common–law partner,
  - a spousal or common-law partner trust,
  - a joint spousal or common-law partner trust or
  - an alter ego trust

and the subsection 73(1) rollover rule has applied; or

- has been transferred or distributed, as a consequence of the transferor's death, to his or her spouse or common-law partner or to a spousal or common-law partner trust, and the subsection 70(6) rollover rule has applied.

If the spouse or common-law partner, former spouse or common-law partner, spousal or common-law partner trust, joint spousal or common-law partner trust, or alter ego trust (hereinafter referred to as the "transferee") subsequently disposes of the property, subsection 40(4) can apply with respect to a principal residence exemption, claimed by the transferee, for the property. For purposes of the transferee's claiming the principal residence exemption under either paragraph 40(2)(*b*) (see the formula in ¶ 8) or paragraph 40(2)(*c*) (see ¶s 20 to 23), the following rules apply under subsection 40(4):

(a) The transferee is deemed to have owned the property throughout the period that the transferor owned it.

(b) The property is deemed to have been the transferee's principal residence

- in a case where the subsection 73(1) rollover rule applied—for any taxation year for which it was the transferor's principal residence; and
- in a case where the subsection 70(6) rollover rule applied—for any taxation year for which it would have been the transferor's principal residence if he or she had so designated it.

(c) If the transferee is a trust, it is deemed to have been resident in Canada during each of the taxation years during which the transferor was resident in Canada.

Any year included in the period described in (a) is included by the transferee in variable C (the denominator of the fraction) in the formula in ¶ 8. Any year described in (b) is included by the transferee in variable B (the numerator of the fraction) in the formula in ¶ 8 or in the years included in the statement in ¶ 22(b), as the case may be, assuming that the transferee meets the residence requirement mentioned therein, as the case may be, for that year. (If the transferee is a trust, see (c) above with regard to this residence requirement.)

Example 1

Mr. X was the sole owner of a house in Canada, which he had acquired in 1985. In 1990, Mr. X got married and his spouse, Mrs. X, moved into the house with him. In 1995, Mr. X died and the house was transferred to a spousal trust for Mrs. X. The trust was a trust as described in subsection 70(6). The trust's taxation year-end was December 31. If Mr. X had not died (and if he had sold his house in 1995), he could have designated it as his principal residence for any of the years 1985 to 1995 inclusive.

Under the rollover rule in subsection 70(6), Mr. X was deemed to have disposed of the house immediately before his death for proceeds equal to his cost of the house. Thus, Mr. X had no gain or loss on the deemed disposition of the house. The spousal trust for Mrs. X was deemed under subsection 70(6) to have acquired the house, at the time of Mr. X's death, at a cost equal to Mr. X's deemed proceeds, i.e., at Mr. X's cost of the house.

In 2001, Mrs. X died and the trust sold the house at fair market value. Since this amount was greater than the trust's deemed cost of the house, the trust had a "gain otherwise determined" from the disposition, which the trust (i.e., its trustee) wishes to eliminate by using the principal residence exemption.

Subsection 40(4) deems the trust to have owned the house in all the years in which Mr. X owned it, i.e., 1985 to 1995 inclusive, in accordance with the rule described in (a) above. (The house was, of course, owned by the trust in 1995 in any event.) This means that the years that the trust must include in variable C (the denominator of the fraction) in the principal residence exemption formula in ¶ 8 are 1985 to 2001 inclusive.

Since the trust is a personal trust resident in Canada and also since Mrs. X lived in the house and qualified as a specified beneficiary of the trust for the years 1995 to 2001 inclusive (see ¶ 35), the trust can designate the house as its principal residence for those years. The trust cannot designate the house as its principal residence for the years 1985 to 1994 inclusive; however, such a designation by the trust is not necessary—the house is already deemed by subsection 40(4) to have been the trust's principal residence for those years, in accordance with the rule described in (b) above, because Mr. X could have designated the house as his principal residence for those years. Also, in accordance with the rule described in (c) above, the trust is deemed to have been resident in Canada for the years 1985 to 1994 because Mr. X was resident in Canada during those years. Therefore, the trust is able to include all of the years from 1985 to 2001 inclusive in variable B (the numerator of the fraction) in the formula in ¶ 8. In other words, the trust is able to use the principal residence exemption formula in ¶ 8 to completely eliminate the gain otherwise determined on its disposition of the house in 2001.

Example 2

Assume all the same facts as in Example 1, except the following: Mr. X could not have designated the house as his principal residence for the years 1985 to 1988 inclusive because he had already designated his cottage (see ¶s 3 and 5) as his principal residence for those years (see the designation rules discussed in ¶ 6). Under these circumstances, the house that was transferred to the spousal trust for Mrs. X cannot be deemed to have been the principal residence of the trust for the years 1985 to 1988 inclusive. Therefore, the trust can only partially eliminate the gain otherwise determined on its disposition of the house in 2001 by means of the principal residence exemption formula in ¶ 8.

In the case of an *inter vivos* transfer of property under subsection 73(1) of the Act, the following should be noted for purposes of any subsequent disposition of the property by the transferee:

- A designation of the property as the principal residence of the transferor—for one or more years prior to the transfer—may be needed in order for the property to be deemed to have been the principal residence of the transferee for those years by means of subsection 40(4) (see (b) above). Note that the transferor will not be able to designate the property as a principal residence for any particular year if another property is designated as a principal residence for that year by the transferor (or, if the year is after the 1981 taxation year, by the transferor or any of the other members of the transferor's family unit)—see ¶ 6. If the transferor is able to, and does in fact, designate the property as his or her principal residence for one or more years prior to the transfer, this does not necessarily mean that the transferor must actually file the designation form with the return for the year of the transfer (although the transferor may do so)—for further comments on the necessity to file a designation form, see ¶ 7. The transferor should, in any event, complete the designation form and, if it is not filed by the transferor, **it should be retained by the transferee**. Subsequently, if the transferee disposes of the property (or grants an option to another person to acquire the property) and wishes to use the principal residence exemption, the transferee would need to file the designation forms—i.e., the transferee's designation form for any years for which the transferee is designating the property as a principal residence and the transferor's designation form for any

years for which his or her designation of the property causes the property to be deemed to have been the principal residence of the transferee

- if the transferee is the transferor's spouse or common-law partner—only when the situation described in ¶ 7(a) or (b) exists in connection with the transferee's disposition of the property; or
- if the transferee is a personal trust—in every case (see ¶ 35(a)).

- Any taxable capital gain of the transferee (excluding an alter ego trust) from the disposition of the property or substituted property (which might occur, for example, because the transferee was not able to completely eliminate the gain otherwise determined by means of the principal residence exemption) could be deemed to be the taxable capital gain of the transferor by virtue of the attribution rules in section 74.2 of the Act. For a discussion of these rules, see the current version of IT-511, *Interspousal and Certain Other Transfers and Loans of Property*.

Partnership Property

¶ 39. Although a housing unit, a leasehold interest therein, or a share of the capital stock of a co-operative housing corporation (see ¶ 3) can be a partnership asset, a partnership is not a taxpayer and it cannot use the principal residence exemption on the disposition of any such property. However, a member of the partnership could use the principal residence exemption to reduce or eliminate the portion of any gain on the disposition of the property which is allocated to that partner pursuant to the partnership agreement, provided that the other requirements of the section 54 definition of "principal residence" are met (e.g., if the partner resides in the partnership's housing unit, this would satisfy the "ordinarily inhabited" requirement discussed in ¶ 5).

A Principal Residence Outside Canada

¶ 40. A property that is located outside Canada can, depending on the facts of the case, qualify as a taxpayer's principal residence (see the requirements discussed in ¶s 2 to 6). A taxpayer that is resident in Canada and owns such a qualifying property outside Canada during a particular taxation year can designate the property as a principal residence for that year in order to use the principal residence exemption (see ¶ 8 for the meanings of "resident in Canada" and "during"). Should a non-resident of Canada who owns a property outside Canada become a resident of Canada at any particular time, the provisions of the Act normally apply to deem that person to acquire the property at that time at fair market value, thereby ensuring that any unrealized gain on the property accruing to that time will not be taxable in Canada. Thereafter, the comments in the first two sentences of this paragraph may apply.

Non-Resident Owner of a Principal Residence in Canada

¶ 41. It may be possible for a property in Canada that is owned in a particular taxation year by a non-resident of Canada to qualify as the non-resident's principal residence (i.e., satisfy all the requirements of the section 54 definition of "principal residence" for the non-resident) for that year. The non-resident's spouse could be the one, for example, who satisfies the "ordinarily inhabited" rule—see ¶ 5 (or, alternatively, a subsection 45(2) or (3) election could make the designation of the property as the non-resident's principal residence possible—see ¶s 26 and 29). However, the use of the principal residence exemption by a taxpayer is limited by reference to the number of taxation years ending after the acquisition date during which the taxpayer was resident in Canada—see ¶s 8 and 22 (as indicated in ¶ 8, "during" a year means at any time in the year). Thus, even if a property in Canada owned by a non-resident qualifies as the non-resident's principal residence, the above-mentioned "residence in Canada" requirement typically prevents the non-resident from using the principal residence exemption to eliminate a gain on the disposition of the property.

¶ 42. In spite of the limitation mentioned in ¶ 41 in connection with the principal residence exemption, an election under subsection 45(2) or (3) could allow a non-resident owning a property in Canada to defer a taxable capital gain which would otherwise result from a deemed disposition of a property on a change in its use (see ¶s 25 and 28).

¶ 43. Where a non-resident owner of a property in Canada has rented out the property in a particular taxation year and has filed a subsection 45(2) or (3) election in respect of the property, see ¶s 25 and 28 regarding the restrictions on claiming CCA. These restrictions apply where the non-resident elects to report the rental income under section 216. (That election is discussed in the current version of IT-393, *Election re Tax on Rents and Timber Royalties – Non-Residents*.)

Section 116 Certificate for a Disposition of a Principal Residence in Canada by a Non-Resident Owner

¶ 44. Where a non-resident wishes to obtain a certificate under section 116 of the Act for a property in Canada which the non-resident proposes to dispose of or has disposed of within the last 10 days, a prepayment on account of tax must be made or security acceptable to the CCRA must be given before the certificate will be issued. Form T2062, *Request by a Non-Resident of Canada for a Certificate of Compliance Related to the Disposition of Taxable Canadian Property*, or a similar notification, must be filed in connection with a

request for a section 116 certificate. Further particulars regarding the above are contained in the current version of Information Circular 72-17, *Procedures Concerning the Disposition of Taxable Canadian Property by Non-Residents of Canada – Section 116*. Where part or all of any gain otherwise determined on the disposition of the property by the non-resident is or will be eliminated by the principal residence exemption, the amount of prepayment on account of tax to be made or security to be given may be reduced accordingly. An application for such a reduction should be made by means of a letter signed by the taxpayer and attached to the completed Form T2062 or similar notification. Such letter should contain a calculation of the portion of the gain otherwise determined that is or will be so eliminated by the principal residence exemption.

Appendix A – Illustration of the Rule in Subsection 40(6)

If a taxpayer disposes (or is deemed to dispose) of a property which the taxpayer has owned (whether jointly with another person or otherwise) continuously since before 1982, the rule in subsection 40(6) (see ¶ 12) provides that the gain calculated under the usual method, using the principal residence exemption formula in ¶ 8, cannot be greater than the maximum total net gain determined under an alternative method. Under the alternative method, there is a hypothetical disposition on December 31, 1981 and reacquisition on January 1, 1982 of the property at fair market value (FMV). The maximum total net gain determined under the alternative method is then calculated as follows:

pre-1982 gain + post-1981 gain – post-1981 loss = maximum total net gain

where

- the **pre-1982 gain** is the gain (if any), as reduced by the principal residence exemption formula in ¶ 8, that would result from the hypothetical disposition at FMV on December 31, 1981,
- the **post-1981 gain** is the gain (if any), as reduced by the principal residence exemption formula in ¶ 8 without the "1 +" in the numerator "B" in that formula, that would result from the hypothetical acquisition at FMV on January 1, 1982 and the subsequent actual (or deemed) disposition, and
- the **post-1981 loss** is the amount of any loss that has accrued from December 31, 1981 to the date of the subsequent actual (or deemed) disposition, i.e., the excess (if any) of the FMV on December 31, 1981 over the proceeds (or deemed proceeds) from the subsequent actual (or deemed) disposition.

The examples which follow illustrate the rule in subsection 40(6). It has been assumed in these examples that, on each actual disposition, no costs were incurred in connection with that disposition.

Example 1

Mrs. X acquired a house in 1975 for $50,000. She and her husband lived in it until February 1996, when she sold it for $115,000, resulting in an actual gain of $65,000 ($115,000 – $50,000). Ever since the sale of the house in 1996, Mr. and Mrs. X have been living in rented premises. In filing her 1996 income tax return, Mrs. X designated the house as her principal residence for 1975 to 1995 inclusive, and thus her gain otherwise determined was completely eliminated by the principal residence exemption formula in ¶ 8:

Gain otherwise determined ($115,000 – $50,000)	$ 65,000
Reduce by principal residence exemption:	
$A \times \frac{B}{C} = \$65,000 \times \frac{1 + 21 \text{ (1975 to 1995)}}{22 \text{ (1975 to 1996)}}$	65,000
Gain	$ NIL

Mr. X acquired a lot in 1975 for $7,000 and built a cottage on it in 1979 for $13,000. Mr. and Mrs. X used the cottage as a seasonal residence from 1979 to 2001 inclusive. In the fall of 2001 Mr. X sold the cottage for $65,000, resulting in an actual gain of $45,000 ($65,000 – ($7,000 + $13,000)). In filing his 2001 income tax return, Mr. X designated the cottage property as his principal residence for 1979 to 1981 inclusive, as well as for 1996 to 2001 inclusive. He could not designate the property as his principal residence for 1975 to 1978 inclusive because it was only a vacant lot and thus no one "ordinarily inhabited" it in those years (see ¶ 11); nor could he designate the property as his principal residence for 1982 to 1995 inclusive because of his wife's designation of the house as her principal residence for those years (see ¶ 6). As a result, not all of his $45,000 gain otherwise determined was eliminated by the principal residence exemption formula in ¶ 8. However, because the property had been owned by Mr. X continuously since before 1982, subsection 40(6) applied for purposes of computing his gain. The fair market value of the cottage on December 31, 1981 was $30,000.

In addition to the above facts, assume also that Mr. X did not make a subsection 110.6(19) capital gains election with respect to the cottage (see the discussion of this election in ¶ 8) because he had already used up his $100,000 lifetime capital gains exemption before 1994. Therefore, he had no capital gains election reduction amount (as described in ¶ 8) with respect to the cottage.

The calculations under subsection 40(6) in connection with Mr. X's 2001 gain on the cottage were as follows:

USUAL METHOD FOR CALCULATING GAIN:

Gain otherwise determined ($65,000 – $20,000)	$ 45,000
Reduce by principal residence exemption:	
$A \times \frac{B}{C} = \$45,000 \times \frac{1 + 9 \text{ (1979 to 1981 and 1996 to 2001)}}{27 \text{ (1975 to 2001)}}$	16,667
Gain	$ 28,333

ALTERNATIVE METHOD – CALCULATION OF MAXIMUM TOTAL NET GAIN:

Pre-1982 gain:	
Gain otherwise determined ($30,000 – $20,000)	$ 10,000
Reduce by principal residence exemption:	
$A \times \frac{B}{C} = \$10,000 \times \frac{1 + 3 \text{ (1979 to 1981)}}{7 \text{ (1975 to 1981)}}$	5,714
Gain	$ 4,286
Post-1981 gain:	
Gain otherwise determined ($65,000 – $30,000)	$ 35,000
Reduce by principal residence exemption:	
$A \times \frac{B}{C} = \$35,000 \times \frac{6 \text{ (1996 to 2001)}}{20 \text{ (1982 to 2001)}}$	10,500
Gain	$ 24,500
Post-1981 loss:	
N/A	$ NIL

Pre-1982 gain + post-1981 gain – post-1981 loss
= $4,286 + $24,500 – $Nil
= $28,786.

RESULT: Mr. X's gain remained at the $28,333 calculated under the usual method since that amount did not exceed the maximum total net gain of $28,786 calculated under the alternative method.

Example 2

Assume the same facts in Example 1 except that the couple are in a common-law relationship rather than a married couple.

In filing his 2001 income tax return, Mr. X designated the cottage property as his principal residence for 1979 to 1992 inclusive, as well as for 1996 to 2001 inclusive. He could not designate the property as his principal residence for 1975 to 1978 inclusive because it was only a vacant lot and thus no one "ordinarily inhabited" it in those years (see ¶ 11); nor could he designate the property as his principal residence for 1993 to 1995 inclusive because of his common-law partner's designation of the house as her principal residence for those years (see ¶ 6). As a result, not all of his $45,000 gain otherwise determined was eliminated by the principal residence exemption formula in ¶ 8.

The calculations under subsection 40(6) in connection with Mr. X's 2001 gain on the cottage were as follows:

USUAL METHOD FOR CALCULATING GAIN:

Gain otherwise determined ($65,000 – $20,000)	$ 45,000
Reduce by principal residence exemption:	
$A \times \frac{B}{C} = \$45,000 \times \frac{1 + 20 \text{ (1979 to 1992 and 1996 to 2001)}}{27 \text{ (1975 to 2001)}}$	35,000
Gain	$ 10,000

ALTERNATIVE METHOD – CALCULATION OF MAXIMUM TOTAL NET GAIN:

Pre-1982 gain:	
Gain otherwise determined ($30,000 – $20,000)	$ 10,000
Reduce by principal residence exemption:	
$A \times \frac{B}{C} = \$10,000 \times \frac{1 + 3 \text{ (1979 to 1981)}}{7 \text{ (1975 to 1981)}}$	5,714
Gain	$ 4,286

Post-1981 gain:

Gain otherwise determined ($65,000 – $30,000) $ 35,000

Reduce by principal residence exemption:

$$A \times \frac{B}{C} = \$35{,}000 \times \frac{17 \text{ (1982 to 1992 and 1996 to 2001)}}{20 \text{ (1982 to 2001)}}$$ 29,750

Gain $ 5,250

Post-1981 loss:

N/A $ NIL

Pre-1982 gain + post-1981 gain – post-1981 loss

= $4,286 + $5,250 – $Nil

= $9,536.

RESULT: Although Mr. X's gain calculated under the usual method was $10,000, such gain could not exceed the maximum total net gain of $9,536 calculated under the alternative method. Therefore, the gain was reduced to $9,536.

Appendix B – Illustration of Calculation of Gain on Disposition of a Farm Property

Assume that a taxpayer resident in Canada sold a 50 hectare farm. The taxpayer owned the farm and occupied the house on it from July 30, 1993 to June 15, 2001. The house and one-half hectare of the land have been designated as the taxpayer's principal residence for the 1993 to 2001 taxation years inclusive. The taxpayer's calculations of the gain on the disposition of the farm property, using the two methods permitted by paragraph 40(2)(*c*) of the Act, are as follows:

FIRST METHOD (see ¶ 21)

	Principal Residence	Farm	Total Property
Proceeds of disposition			
Land	$ 10,000*	$ 90,000	$ 100,000
House	50,000	—	50,000
Barn	—	35,000	35,000
Silo	—	15,000	15,000
	$ 60,000	$ 140,000	$ 200,000
Adjusted cost base			
Land	$ 2,000*	$ 58,000	$ 60,000
House	20,000	—	20,000
Barn	—	11,000	11,000
Silo	—	4,000	4,000
	$ 22,000	$ 73,000	$ 95,000
Gain otherwise determined	$ 38,000	$ 67,000	$ 105,000
Less: Principal residence exemption	38,000	—	38,000
Gain	$ NIL	$ 67,000	$ 67,000

* Since the principal residence portion of the land is 1/100 of the total land (i.e., one-half hectare divided by 50 hectares), one way (as described in ¶ 21(a)) of assigning values to the principal residence portion of the land would be to simply use $1,000 (i.e., 1/100 of $100,000) for the proceeds for such portion of the land and $600 (i.e., 1/100 of $60,000) for the adjusted cost base of such portion. Assume, however, that a typical residential lot in the area, although less than one-half hectare in this example, had a fair market value of $10,000 as of the date of sale and $2,000 as of the date of acquisition. As indicated in ¶ 21(b), we would accept the taxpayer's use of the latter amounts, which in this case would result in a greater portion of the gain otherwise determined being eliminated by the principal residence exemption.

SECOND METHOD (see ¶ 22)

Proceeds of disposition for total farm property	$ 200,000
Adjusted cost base for total farm property	95,000
Gain otherwise determined	$ 105,000
Less: Principal residence exemption using subparagraph 40(2)(c)(ii) election: $1,000 + (9 × $1,000)	10,000
Gain	$ 95,000

RESULT: In this example, the first method results in a lower gain to the taxpayer.

Explanation of Changes

Introduction

The purpose of the *Explanation of Changes* is to give the reasons for the revisions to an interpretation bulletin. It outlines revisions that we have made as a result of changes to the law, as well as changes reflecting new or revised CCRA interpretations.

Reasons for the Revision

This bulletin is being revised to reflect legislative changes enacted under S.C. 2000, c.12 (formerly Bill C-23) and S.C. 2001, c.17 (formerly Bill C-22). The comments in the bulletin are not affected by any proposed legislation released before June 9, 2003.

Legislative and Other Changes

The bulletin has been revised to reflect the repeal of subsection 252(4) and the addition of the term "common-law partner" to the Act. Specific discussions on this topic have been added to ¶s 2 and 6 of the bulletin.

The discussion in former ¶ 12 on spousal trusts and subsection 107(4) has been removed since paragraph 104(4)(a) now also refers to joint spousal or common-law partner trusts and alter ego trusts. A discussion on these types of trusts and the application of subsection 107(4) to these trusts is outside of the scope of this bulletin. The remainder of former ¶ 12 has been moved to ¶ 36.

We have added a comment in ¶ 15 regarding recreational or lifestyle uses for land in excess of one-half hectare.

¶ 17 has been expanded to clarify the CCRA's interpretation. The previous version contemplated that a taxpayer would subdivide and immediately sell the newly created lots. Comments have been added to also address the situation where a taxpayer subdivides his or her property but then holds the lots for a period of time.

¶ 38 (formerly ¶ 36) now addresses the rules in subsection 40(4) as they relate to alter ego trusts and joint spousal and common-law partner trusts by virtue of their addition to the list of qualifying transfers set out in new subsection 73(1.01) of the *Income Tax Act*. Specific references to spousal trusts have been removed from ¶ 38 as the rules now apply to the aforementioned trusts as well.

The various examples in the bulletin and its appendices have been updated to reflect more current years and current law.

Throughout the bulletin, we have made other changes for clarification or readability purposes, and we have deleted items which were redundant or which no longer have any relevance.