

The Principal Residence Exemption: Till Death and Divorce Do Us Part

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The principal residence exemption (PRE) is a useful planning tool that allows a taxpayer to claim a permanent exemption from tax on the capital gain from the sale of the home in which he or she has ordinarily resided. This concept sounds straightforward, but complexities can arise in cases where the taxpayer dies or has had multiple marriages.

"Principal residence" (PR) is defined in section 54 to be

a particular property that is a housing unit, a leasehold interest in a housing unit or a share of the capital stock of a co-operative housing corporation acquired for the sole purpose of acquiring the right to inhabit a housing unit owned by the corporation and that is owned, whether jointly with another person or otherwise, in the year by the taxpayer.

Paragraph (c) of the definition restricts the PR claim to one property per family unit per year; it does so by disallowing any PR claim for a taxpayer in a particular year if a PR designation has been made on another property in that particular year by one of the following individuals:

- the taxpayer (clause (c)(ii)(A)),
- the taxpayer's spouse (clause (c)(ii)(B)),
- a child of the taxpayer under 18 years of age (unless the child is married) (clause (c)(ii)(C)),
or
- if the taxpayer is under 18, the taxpayer's parent or sibling (clause (c)(ii)(D)).

According to *Black's Law Dictionary*, joint tenancy is a legal form of ownership whereby two or more people have an undivided interest in the whole property that is identical to that of the other joint owners. One characteristic of a joint tenancy is the right of survivorship. This means that if one of the joint tenants dies, title automatically passes to the surviving joint tenant. Since the definition of PR contemplates a property that is owned "jointly with another person or otherwise," the CRA's position is that joint tenants can each claim as their PR the property that they jointly own. This was noted in *Income Tax Folio S1-F3-C2*, at paragraph 2.86.

Generally speaking, married couples own their home as joint tenants. Therefore, on the inter vivos sale of a home, each spouse can claim their respective share of the sale of their home as their PR. Then, in each case, paragraph 40(2)(b) allows the PRE to reduce the capital gain on the disposition of the property.

PRE and Death

On the death of a spouse (assuming that the property is held jointly by both spouses), property is commonly transferred from the deceased spouse to the surviving spouse on a tax-deferred basis under subsection 70(6). The surviving spouse inherits the deceased spouse's property at the original cost base of the deceased spouse, pursuant to subparagraph 70(6)(d)(ii) (commonly referred to as the spousal rollover). When the property is eventually sold, the phrasing of element C in paragraph 40(2)(b) refers to "number of taxation years . . . during which the taxpayer owned the property whether jointly with another person or otherwise," which allows the surviving spouse to claim the PRE for all of the years in which the property was jointly held.

However, element C in paragraph 40(2)(b) would not apply to a situation where the property was solely owned by the deceased spouse prior to that individual's death. If there were no mitigating rule, the surviving spouse's ability to claim the PRE for the period in which it was owned by the deceased spouse (prior to death) would be jeopardized. This is because paragraph 40(2)(b) allows the surviving spouse to claim the property as his or her PR only for the years after he or she inherited the property, not for the years before he or she inherited the property.

Fortunately, a relieving rule for such a case is found in subsection 40(4). This subsection applies in a situation where a surviving spouse sells a property that he or she acquired in a situation to which subsection 70(6) applied. Paragraph 40(4)(a) deems the surviving spouse to have owned the property throughout the period in which the deceased spouse owned it. Subparagraph 40(4)(b)(i) deems the property to be the PR of the surviving spouse for the years that the deceased person would have designated it as the deceased spouse's PR. Thus the surviving spouse, when the property is eventually sold, is able to claim the PRE for all of the years in which the property was solely owned by the deceased spouse.

If both spouses described above were in their first marriage, the application of subsection 40(4) is fairly straightforward. However, if one or both spouses have had multiple marriages, complexities can result.

Consider an example. Jay died while married to Gloria, his second wife. Jay had married Gloria in 2008, and they jointly owned a house in the city from 2008 until Jay's death in 2022. Jay had previously owned a cottage jointly with his former wife, DeeDee. The cottage was owned from 2000 to 2014, and when it was sold in 2014, Jay designated the cottage as his PR for those years. DeeDee, too, would claim the PRE on the cottage for the 2000-2014 period.

Because Jay claimed the PRE on the cottage for 2000 to 2014, Gloria cannot claim the city home as her PR for 2008 to 2014: she was married to Jay during that period, and the definition of PR does not allow a taxpayer to claim a PR if the taxpayer's spouse made a PR designation on another property for that same year.

Subsection 40(4) does not provide any relief to Gloria in this case. The conditions of subparagraph 40(4)(b)(i)—which would have required Jay to designate the city home as his PR from 2008 to 2014—are not met, and therefore Gloria is precluded from claiming the PRE during those years. She could, however, claim the PRE from 2015 onward, plus one additional year for the "plus 1" rule as allowed by paragraph 40(2)(b), and her eventual gain on the sale of the home may be partially sheltered by the PRE.

Consider a second example. A married couple, Barney and Robin, purchased a home as joint tenants in 2005. They divorced in 2018, and at that time changed the ownership of the property from a joint tenancy to a tenancy in common, so that each of them could deal with their share of the property independently of the other. According to *Black's Law Dictionary*, tenancy in common is a legal form of

ownership whereby each tenant in common has an undivided ownership interest in the particular property, but it is not an interest in the whole property. Furthermore, tenancy in common involves no right of survivorship.

This raises a question: Does the change in ownership from joint tenant to tenant in common trigger a disposition for tax purposes?

In technical interpretation no. 2004-0078771E5 (September 8, 2004), the CRA commented on a situation where two siblings were each 50 percent tenants in common of a property, and they desired to change the ownership to a joint tenancy. The CRA noted that, in this particular case, a change from tenancy in common to joint tenancy would not result in a deemed disposition. This is because both siblings held 50 percent interests both before and after the change, so there was no change in either sibling's underlying interest. The CRA also noted that there would be a disposition in a situation where a property was held equally by three tenants in common and the property was transferred to two of those owners as joint tenants.

Presumably, the CRA's position on a change of ownership from joint tenancy to tenancy in common would mirror its position in the above TI; thus, a change in ownership from joint tenancy to tenancy in common would not result in a deemed disposition if the property were owned by the same two joint tenants/co-owners immediately before and immediately after the change. However, there is no specific guidance on this point. The CRA's position also raises a question: If the change in ownership structure does not result in a disposition for tax purposes, does the CRA still recognize that the property becomes a tenancy in common subsequent to the change, and, if the CRA does not recognize this, does it follow that the property would remain a joint tenancy for tax purposes even after the change in legal status?

The PRE needs to be considered in the light of the scenarios discussed above. For the period of ownership in which the property was a joint tenancy, the spouses would have to agree to claim their jointly owned home as their PR. In the second example we considered, complexities could arise if Barney owns another property independently of Robin, and it would be more beneficial for Barney, for the good of his own tax situation, to claim that other property as the PR.

For the period of ownership in which the property was a tenancy in common, each spouse could claim the PRE for their respective portions of the property from 2018 onward, independent of any designation made by the other spouse. This is because a tenancy in common creates distinct properties, independent of each other. In TI no. 2010-0354361E5 (April 22, 2010), the CRA commented on a situation in which two individuals own a duplex as tenants in common and each ordinarily inhabits one unit in the duplex. The CRA's position was that each respective apartment unit in the duplex is a housing unit for the purpose of the definition of "principal residence" in section 54 of the Act.

Furthermore, with respect to Barney and Robin, even if the property were still held as a joint tenancy after the divorce, each of them should still be able to claim the PRE on their respective shares, if they both agree.

Once again, as is common with the Act, what began as a straightforward concept—allowing individuals to be exempt from tax on the sale of their primary place of residence—becomes fairly complicated once various fact patterns are introduced. Here we see yet another example of why a comprehensive review of the entire income tax system is long overdue. When these rules were originally enacted in 1971, divorce and separation were far less common than they are now, and situations such as those discussed above were likely not foreseen.

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BIBLIOGRAPHIC INFORMATION

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