

TAX ALERT



TAX ALERT is a commentary on topics of current interest – usually topics relating to recent changes in tax law, new CRA administrative practices or current interpretations arising from tax cases. Professional advice should be obtained before acting on any of this information. ed.5/11

OUR HOME, OUR COTTAGE, OUR FARM, OUR WINTER CONDO! TAX PLANNING = MEGA TAX SAVINGS

So many choices – so little time! That is often the dilemma for families when they decide to move on in life and sell their home, their cottage or their weekend farm. A place where they have spent so much time and with such fond memories.

An emotional roller coaster for sure but life is taking the family in a new direction. Maybe its retirement, maybe it's just time for change or maybe someone is in poor health. Whatever the reason, there can be significant opportunities for tax savings if families properly plan the reporting of the sale of their homes.

It is indeed unfortunate that tax planning is such a root canal. Many people just want to get it done as cheaply as possible. E-filing is the mission and saving the cost of tax return preparation is the bonus. Drat! But what if you paid a little money to get your return done – maybe a nice refund would happen. Would it be worthwhile? Certainly, planning the sale of your home or the family retreat is a good place to put in some serious effort.

Everyone probably knows that the gain on your home (CRA calls it your principal residence) is not taxable. And a recreational property qualifies as a principal residence. The trick is deciding which one gives you the best tax advantage because you can only choose either one of them in any year. There is such a myriad of rules surrounding this exemption that it is mind boggling. The following questions might occur to you.

- ◆ What if we own two homes at the same time?
- ◆ What if our farm retreat is not just a couple of acres but has fifty acres of bush and some farmland? Does all the property qualify as a principal residence?
- ◆ What happens if our Shangri-la is in Portugal?
- ◆ What's the situation if we move away for a few years, rent out our home and then come back to live in it again?

What if? What if? Every one of these situations is fraught with rules and rules to interpret the rules but the tax savings we are talking about here can be huge. In some cases the gain (depending on your choice of principal residence) could be say \$250,000 – in another case maybe a million. Remember that about 25% of your gain could come back as tax savings. Still planning on tackling this problem yourself? I wouldn't think so!

A single newsletter can't possibly deal with all of the nuances of the principal residence rules. Therefore, this one will only review the scope for tax planning when you have more than one qualifying residence. In future, we can talk about other issues and some solutions.

Let's look at an example. Don't try to follow the math too closely because the Income Tax Act throws in some curves you will not understand.

Bob and Sandy own two residences. They paid \$150,000 for their home in 1972 and spent another \$160,000 on renovations over the years bringing the total cost up to \$310,000. The property is worth \$630,000 today so they have a handsome gain of \$320,000.

In 2005 they bought a cottage for \$90,000. Cottage property has done well and it is now worth \$300,000 giving them a nice gain of \$210,000.

It is their intention to sell both properties this year and use some of the proceeds to buy a condo in Port Hope, Ontario. They plan to spend about \$350,000 on the condo and invest the balance of \$580,000 (less any tax on capital gains) for their retirement so they want to minimize income taxes.

Which property should they choose as their principal residence for the most tax savings or should they select both of them in some combination. Although they can only designate one of the properties as their principal residence in a particular year, they can pick and choose which one is the principal residence in each year over the total period of ownership.

It seemed to Bob and Sandy that they should select their home as their principal residence for the entire period since their home shows a gain of \$320,000 compared to a gain of only \$210,000 on the cottage – hence a bigger capital gains exemption.

The peculiarities of the tax calculation (as mentioned above) will still allow them to designate one year to the cottage in the principal residence exemption calculation. In the end, this will mean that \$60,000 of the cottage gain and all of the gain on their home will be exempt from tax. Therefore, they will only pay tax on a cottage gain of \$150,000 and the remaining \$380,000 of gains will be completely tax free. Tax of about \$35,000 on the combined gains of \$530,000 seems like a pretty good deal to Bob and Sandy.

Bob decides to do a little more work because he starts to think that maybe they should select the cottage as their principal residence for some of the years. After all, the gain on the cottage on a per year basis is larger than the per year gain on their home. Maybe this allocation will work out better.

Bob reverses the calculation so the cottage becomes their principal residence from 2006 to 2011 (not 2005 due to a plus 1 factor in the calculation) and their home for all other years. Now the entire gain on the cottage is tax exempt. Their home becomes the principal residence from 1972 to 2005 and \$280,000 of that gain is tax free based on 35 years out of 40 being exempt. When the house and cottage exemptions are added together, the total exemption is \$490,000 and only \$40,000 is taxable. The tax bill just went under \$10,000 or a savings of \$25,000.

Hold on a minute – \$490,000 is a larger exemption than the \$380,000 when their home was designated for the longer period. How can that be since there was a larger gain on their home? Well the answer lies in the fact that their home had an annual gain of \$8,000 while the cottage had a gain of

\$30,000 a year so a larger election in favour of the cottage gives a larger overall exemption for that year. What do you know!

One thing I have learned in this business is never trust final conclusions without checking things out. Put everything down on paper and test it. More often than not that the result is different than what you may have originally thought. Of course it helps to know the rules of the game and that is where professional advice comes in.

This is just one simple example of how the principal residence exemption rules can work to your advantage. There are many more and they need to be road tested if you are about to sell a property that qualifies as your principal residence. It is really the only legitimate tax shelter left. *This article first appeared in a newsletter for Castlemoore Inc.*

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