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Renting out your home

Effect on principal residence exemption

MOST READERS are likely aware of the principal residence exemption, which generally exempts all or a portion of the gain from the sale of your home from tax. Basically, if the home was your principal residence for all years in which you owned it (or all years but one), the gain on the sale of the home will not be taxable. The calculation to determine the exempt portion follows:

$$\text{Gain} \times \left[1 + \begin{array}{c}\text{Number of years}\\ \text{during which the home is}\\ \text{your principal residence}\end{array} \div \begin{array}{c}\text{Number of years}\\ \text{in which you owned}\\ \text{the property}\end{array} \right] = \begin{array}{c}\textbf{Tax}\\ \textbf{exemption}\\ \textbf{portion}\end{array}$$

For this calculation, the home will be your principal residence for a year if you (or your spouse or child) "ordinarily inhabited" it in the year, generally meaning that you lived in the home for at least some period in the year. A cottage or other vacation home can qualify even if you lived there only for a couple of weeks. But only one home per family unit (you and your spouse and unmarried minor children) can qualify as your principal residence for any particular year.

There are provisions in the Income Tax Act that extend the principal residence exemption for years in which you do not live in the home. If you lived in the home and subsequently rent it out, the home can still qualify as your principal residence for up to four years during the rental period (as long as you do not claim another home as your principal residence for any of those four years).

This special treatment is elective – you must make an election with your tax return for the year in which you start renting it out. However, if you make this election, you cannot claim capital cost allowance (tax depreciation) on the home in a year during the rental period.

Example

You bought your house in 2003 and lived there until 2007, and then rented it out until 2013. You sold the house in 2013 and realized a gain of $110,000.

Your house was your principal residence from 2003 through 2007 (five calendar years). If you make the election and designate the house as your principal residence for (the maximum) four of the six years during which you rented it out, under the above formula the exempt portion of your gain will be:

$$\$110{,}000 \times [1 + 5 + 4] \div 11 = \$100{,}000$$

i.e. one plus the five years you lived there plus up to four years during which you rented it out divided by the 11 years in which you owned the property.

For the remaining $10,000 gain, one-half of that, or $5,000, will be a taxable capital gain included in your income.

[SEE **RENTING OUT YOUR HOME** P. 4]

Inside this issue

Spousal and child support payments

THE RULES for the deductibility and income inclusion of spousal and child support payments are complex, and still cause confusion. We hope this article clarifies some of these rules.

As a general rule, spousal support payments made to a (separated or divorced) spouse or common-law partner are deductible in computing the payer's income, if they are required by a Court Order or a written agreement. The payments are included in the recipient's income. However, there are certain conditions that must be met, as summarized below.

On the other hand, child support payments are no longer deductible for the payer and are tax-free for the recipient (for court orders and agreements made or varied after April 1997).

Conditions for deduction and inclusion of spousal support payments

Generally, the payments will be deductible for the payer and taxable for the recipient if the payments are made on a "periodic basis" for the maintenance of the recipient and if the recipient has "discretion as to the use of the amount". As such, in most cases lump sum payments will not be deductible (or taxable), nor will payments over which the recipient does not have discretion over the use of the funds. *(See 'The Larivière case' on page 3, for a recent case on "discretion" heard by the Tax Court of Canada.)*

However, the periodic and discretion requirements are waived if the court order or agreement specifies as such and indicates that they are to be deductible and taxable (the order or agreement should specify the applicable provisions in the Income Tax Act – subsections 56.1[2] and 60.1[2]). In such case, payments on account of the recipient's rent, mortgage, housing costs, medical expenses, tuition costs, among others, will be deductible to the payer even if they are not made directly to the former spouse. These payments can be made in a lump sum. In the case of mortgage payments, this treatment is limited each year to one fifth of the original principal amount of the mortgage loan.

Another general condition is that the spousal support payments must be made after the relevant court order or written agreement is made. Payments made prior to that time are normally not deductible or taxable. However, if the court order or agreement specifies as such, payments made before the date of the order or agreement but in the same year or in the immediately preceding year will be deductible and taxable.

[SEE SPOUSAL AND CHILD SUPPORT PAYMENTS P. 4]

DEDUCTING LUMP SUM PAYMENTS

The Canada Revenue Agency states that lump sum payments can be deducted – and are taxable – in either of the following circumstances:

- The lump sum payment represents amounts payable periodically that were due after the date of the order or written agreement that had fallen into arrears.
- The lump sum amount is paid pursuant to a court order and in conjunction with an existing obligation for periodic maintenance, where the payment represents the acceleration of future support that was payable on a periodic basis, for the sole purpose of securing the funds to the recipient.

Otherwise, a lump sum payment made to release the payer from making future or past support payments will generally not be deductible or taxable.

Spousal support taxable as recipient had discretion over use

IN ORDER for spousal support payments to be deductible for the payer and taxable for the recipient, the recipient must normally have discretion over the use of funds. *(See 'Spousal and child support payments' on page 2.)*

THE LARIVIÈRE CASE

In the recent Larivière case, pursuant to a court-approved written agreement, the taxpayer's former husband was obligated to pay her $420 of weekly support. The agreement provided that the taxpayer was allowed to live in their former home, but that she was required to pay certain expenses relating to the home, including mortgage payments, insurance, taxes, and utilities. The support payments were calculated using an estimate of those expenses. As such, the taxpayer argued that she had no discretion over the use of the payments, because she was obligated to use the funds to pay the expenses. The CRA disagreed, and assessed her to include the support payments in her income.

THE DECISION: DENIED

On appeal to the Tax Court of Canada, the Court upheld the CRA assessment. According to the Court, although the amount of support payments was determined by reference to the home expenses, the payment of the support was not conditional upon the taxpayer paying the home expenses. As such, the Court ruled that Larivière had discretion over the use of the funds, and so the payments were taxable to her.

Moving expenses denied in year of move… but allowed when job found

YOU ARE allowed to deduct certain moving expenses incurred in an eligible relocation, which is generally one that enables you to carry on business or employment in a new work location. Your new home must be at least 40 kilometres closer to the new work location than your former home. Your deductible expenses are limited to your income in the year from the new work location. (Any excess can be carried forward and deducted in a later year.)

THE EVANGILIST CASE

In the recent Evangelist case, the taxpayer lost his job in the town of Rivière-du-Loup QC in 2010. Later in the same year, he moved to Sherbrooke QC to look for work, incurring over $8,000 in moving expenses. He did not find work in 2010 or 2011, but eventually found a job in 2012. Evangilist attempted to deduct the moving expenses in 2010. The CRA denied the deduction, apparently on the grounds that his move was not an eligible relocation.

THE DECISION: DENIED…

Upon appeal to the Tax Court of Canada, the Court agreed that a deduction was not permitted in 2010 because the taxpayer had no income from a new work location.

…and ALLOWED

The Court also held that for the purposes of the deduction, moving expenses can be incurred in a year other than the year in which the new work is obtained or begins. As such, it allowed the taxpayer to deduct his moving expenses in 2012 even though Evangilist moved and incurred the expenses at a time when he did not have a new job.

RENTING OUT YOUR HOME [CONT'D FROM P. 1]

Note that the four-year limit is waived (i.e. the home can qualify for your principal residence throughout the rental period) if you meet any of these criteria:

- You moved out of your home because of a relocation of your employment or your spouse's employment.
- Your new place of residence is at least 40 kilometres closer to the new work location than your home.
- You move back into the home during your employment or by the end of the year following the year in which your employment ends.

A corollary rule provides that where you first rented out the home and subsequently moved in, an election allows the home to qualify as your principal residence for up to four years during the previous rental period. This rule does not apply if you claimed capital cost allowance during the rental period. There is no extension to the four-year period in these circumstances.

SPOUSAL AND CHILD SUPPORT PAYMENTS [CONT'D FROM P. 2]

Rules distinguishing spousal and child support

If the court order or agreement provides for support for both the recipient spouse and a child, any amount that is not identified as being solely for the use of the recipient spouse is deemed to be child support. Effectively, this rule means that any amount that is not so identified will be non-deductible (non-taxable) child support. Therefore, proper drafting of the order or agreement is necessary to ensure that spousal payments are clearly identified as being for the support of the recipient spouse, if the parties want deductibility and taxability.

Furthermore, an ordering rule effectively provides that where both spousal and child support are payable under the order or agreement, the child support is deemed to be paid first. As such, if the full support payments owing are not made in the year, some of the spousal support will not be deductible or taxable.

As mentioned, the rules for the tax treatment of spousal and child support payments are complex. Given their complexity you should ensure you receive appropriate advice and have the necessary documentation to avoid any unpleasant tax surprises when you file your tax return.

Galloway Botteselle & Company

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Professional Services Group

Brian M. Galloway, CFP, FCGA
E. Albert Botteselle, CGA, CFP
Brian R. Blamey, BA, CGA
David P. Van Gruen, CGA
Saskia N. Muller, BCOM, CGA
Selena G. Nisbet, BCOM, CGA

Maple Place Professional Centre
300 – 2000 West 12th Avenue
Vancouver (BC) V6J 2G2
TEL (604) 736-6581
FAX (604) 736-0152
EMAIL info@gbco.ca

VISIT US ONLINE **WWW.GBCO.CA**

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COORDINATION Flora Hugon
DESIGN JAM Design
FRENCH TRANSLATION Noëlla Bordage
SEND COMMENTS/QUESTIONS TO FLORA HUGON fhugon@gbco.ca