Beware the big tax hit that could be lurking in your house if you decide to rent part of it out or have your office in it

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In troubled financial times, some Canadians are looking for ways to earn additional funds to help cover expenses. One way to help cover the costs of home ownership, such as mortgage payments, maintenance or utilities, is to consider renting out a room or perhaps even the entire basement of your home. But before you decide to take on a tenant in your principal residence, be sure to familiarize yourself with the change-of-use rules which could limit the availability of the principal residence exemption (PRE) if you subsequently sell your home at a profit. Under the *Income Tax Act*, you can be considered to have disposed of either part or all of your principal residence even if you didn't actually sell it to a third party. This can occur if you convert part (like a room or basement) or all of your principal residence to a rental property. The tax rules state that if you change the use of a property, you are "deemed" to have disposed of the property at its fair market value and to have immediately reacquired the property for the same amount, which becomes your new tax cost or adjusted cost base (ACB).

As a result, the general rule is that upon such a change in use, you are required to report the resulting capital gain in the tax year that the change-in-use occurs. While any initial gain resulting from the deemed disposition related to the change-in-use may qualify for the PRE, the concern is that when you subsequently sell your home to a third-party, part of the gain may be taxable.

Fortunately, if you change your principal residence to a rental property, there is a special tax election you can make that will allow you to designate the property as your principal residence for up to 4 years, even if you don't use your property as your principal residence, provided you don't claim any tax depreciation against the rental income. But you can only do this if you don't designate any other property, such as a vacation home or cottage, as your principal residence during this period of time.

In addition, the Canada Revenue Agency (CRA) has a longstanding administrative policy wherein it will consider you to have not changed your home's use if you meet 3 conditions: the rental use of the property is "ancillary" in relation to its use as your principal residence, you don't make any "structural changes" to the property and you don't deduct any tax depreciation on the portion of your home you are using for rental purposes.

If you meet these 3 conditions, the whole property may qualify as your principal residence, even though you are using part of it for rental purposes. CRA has stated that these conditions could be met, for example, if you run a daycare business in your home, you rent out one or more rooms in the home, or you maintain an office or other work space in the home which you use in running your own business.

If you don't meet the 3 conditions, then when you sell your home which contained a rental unit, the income tax rules require you to allocate the selling price between the part you used for your principal residence and the part you used for rental purposes. The CRA will accept a split based on square metres or the number of rooms, provided the split is "reasonable." You must then report any capital gain on the part you used for rental purposes.

One CRA technical interpretation clarified how the CRA interprets the factors "ancillary" and "structural change" in the context of the partial change-in-use rules.

In determining whether the income-producing use is "ancillary" to the main use of the property as your principal residence, the CRA stated that it generally interprets ancillary as being "subordinate or secondary to a more important or primary purpose." The CRA added that there is no specific percentage or threshold which may be used in determining whether the particular change in use of a particular property is, indeed, ancillary to the use of the property as the taxpayer's principal residence. Such determination can only be made "by a review of the particular facts and circumstances in each case."

The CRA will also look at whether there have been any structural changes to make the property more suitable for rental purposes. Generally speaking, such changes must be of a more permanent nature, such as installing a separate entry for tenants, adding a second kitchen or reconfiguring the space by adding, moving or removing walls. While the ultimate determination, again, will be made by "a review of all the particular facts and circumstances in each case," the CRA did state that the conversion of a portion of a taxpayer's principal residence into a separate, self-contained housing unit, such as a basement apartment, used for earning rental income will generally result in the application of the change-in-use rules and the CRA's administrative policy described above would likely not apply.

With the requirement to report the sale of a principal residence on your tax return to be eligible for the PRE, the CRA can review the sale of your home and determine whether any potential gain on disposition qualifies for exemption. If you've historically been reporting rental income on your return from the same property, this could raise a red flag as to your eligibility to claim the full PRE.

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