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Change in Use Rules — Principal Residence and Rental Properties

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When you change the use of an asset, from income producing to personal use, or vice versa, there is a deemed disposition on the date that the change of use occurred. This will result in a capital gain or loss on the property realized from the date of purchase until the date of the deemed disposition.

This deemed disposition applies if you choose to convert a property from your principal residence to a rental property, or vice versa.

When converting from a principal residence to a rental property, the deemed disposition may not have an effect on your tax situation if you are able to claim the principal residence exemption. However, when converting a rental property to a principal residence, the capital gain could result in significant taxes owing with no funds generated to pay those taxes.

Luckily, there are elections available under subsections 45(2) and 45(3) of the Income Tax Act that allow a deferral of the capital gain until the year in which the property is actually sold. These elections also allow a four-year extension to the period for which the principal residence exemption can apply to the property.

The election to defer the gain on a rental property converted to a principal residence has to be filed with your income tax return for the year in which the property is ultimately sold. The election cannot be made if any capital cost allowance was claimed in any year against the rental income.

The election to defer the gain on a principal residence converted to a rental property has to be filed with your income tax return for the year in which the change of use occurs. Once the election has been made, no capital cost allowance may be claimed on the property. If a claim for capital cost allowance is made in a future year, the election will be automatically rescinded.

If your return will be electronically filed, you can file the election by writing a letter indicating your intention to use the election and sending it to the Tax Centre that processes your income tax return. This letter should be sent prior to the due date of your income tax return for the year.

Regardless of the above elections that extend the period for the eligibility of the principal residence exemption, remember that only one property can be claimed under the exemption for each taxation year. Therefore, while you may able to claim the principal residence exemption for one of the years that the property was a rental property, you will lose the ability to use the exemption on any other properties for that year. The extension of time to claim the principal residence exemption is exceptionally beneficial if you rented your home, or lived in a retirement or nursing home, while the property was rented.