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CESTNICK

TAX MATTERS

Renting out your cottage could have tax implications

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It seems that a lot of folks are trying to get out of the city these days – away from congested neighbourhoods and any chance of getting COVID-19. The demand for cottage rentals appears to be skyrocketing. About five years ago, an international property-rental service found a seven-bedroom castle on 200 acres in France for a friend of mine that was available to rent for the equivalent of $4,300 a month. Today, a simple cottage on a lake somewhere here in Canada would almost surely rent for a lot more than that.

I've seen a definite uptick in the number of people looking to cash in by making their cottages available for rent this summer. Renting out a cottage can be profitable, but here are some things to keep in mind if you plan to do it.

1. **Avoid a change in use.** If you rent out your cottage more than just occasionally, or incidentally, you could run into the "change in use" rules. These rules will deem you to have sold your cottage on the date you begin primarily using it as an income-producing property, and to have reacquired the property on that same day. So, if your cottage has increased in value, you could trigger a capital gain on the change in use. While you may be able to shelter the gain using your principal-residence exemption (PRE), you'll likely want to avoid a tax bill. Your best bet is to make your rental activity ancillary to use of the cottage as a personal retreat by not renting it for more than half the time it's available for use. If you do want to rent your cottage more than just occasionally (that is, in an ancillary manner), you can elect to defer the deemed disposition on a change in use for a period of up to four years. (The rules are complicated, so visit a tax professional to talk it over.)

2. **Report your rental income.** If you earn rent on your cottage, you'll generally have to report the rental income. The exception to this is if you're renting to family or

friends for less than market value and don’t expect to make a profit. If you’re properly reporting the other rents you earn, you’ll be entitled to claim expenses as well. Claiming rental losses on your cottage could raise a red flag on your tax return if it happens year after year, and Canada Revenue Agency will want to see that your rental activities are truly commercial in nature, or your claim for losses could be denied.

3. **Claim the right expenses.** You can deduct all types of costs against the rent you collect, including insurance, mortgage interest, property taxes, utilities, repairs and maintenance, professional fees, advertising, cleaning costs, commissions to rental agents, and even motor vehicle or travel expenses connected to the business of renting the property. The costs have to be reasonable in amount – which should not be an issue in most cases. Finally, you’ll have to distinguish between operating costs, which are deductible, and capital costs, which can’t be deducted. Capital costs are factored into the adjusted cost base of the property to save you tax when you sell. Major improvements like a new roof, or new dock, are typically considered capital costs.

4. **Beware of claiming CCA.** You can also claim capital-cost allowance (CCA), which is depreciation for tax purposes, against your rental income. But I don’t generally recommend it since this could jeopardize your ability to claim the PRE to shelter a gain on the sale of the property later. Further, while claiming CCA could save you tax today, you may have to include that CCA in your income later (what is known as “recapture”) if you sell the property for more than its undepreciated cost. If you do choose to claim CCA, you won’t be able to create or increase a rental loss with the deduction. One more thing: If you happen to make a change in use of your property (see Point 1 above) and elect to defer the deemed disposition I mentioned earlier, speak to a tax pro as your claim may be affected.

5. **Understand the PRE.** Your cottage will generally qualify to be designated as a principal residence for purposes of sheltering any capital gains later using the PRE. You’ll bypass the ability to claim the PRE to fully shelter a gain if you do change the use of the property from primarily a personal-use to a primarily income-producing property. And if you do claim CCA on the property, you may jeopardize use of the PRE as I mentioned. In short, renting out the cottage for less than half the time it’s available and avoiding CCA deductions should allow you to claim the PRE on the cottage later.

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