CESTNICK

TAX MATTERS

Changing the use of a property can come with a tax surprise

SPECIAL TO THE GLOBE AND MAIL
PUBLISHED JULY 8, 2021

Today I want to share the story of a family where Mom and Dad have wanted to help their children with home ownership by giving them properties. They ran into a wrinkle. Let me explain.

THE STORY

Jason and Karen are a couple in their 50s with two children, Noah and Amy, in their mid-20s. Given the cost of real estate in Toronto, where they live, it's not going to be easy for the kids to afford homes of their own.

In addition to owning their home, Jason and Karen own two rental properties that they bought several years ago. The couple want to help their kids with the home-ownership conundrum and have decided to change their rental properties from rentals to homes for Noah and Amy. Jason was concerned about the taxes on a change in ownership, so the couple have decided to continue owning the properties but allow Noah and Amy to move into the homes.

THE PROBLEM

Although Jason and Karen may think that they've side-stepped a tax problem by not transferring ownership of the rental properties to the kids today, they're not quite correct. You see, when a property is converted from an income-producing property to a personal-use property, a "change in use" takes place. A change in use also takes place when the reverse happens: You convert, or partly convert, a personal-use property to an income-producing property.

A change in use will generally cause a deemed disposition, and reacquisition, of the property at fair market value under our tax law. If the property has appreciated in value, there could be tax to pay on the capital gain. This could be a problem if you owe taxes from the change in use while there has been no actual sale of the property since you may not have the cash to pay the tax.

THE SOLUTIONS

It's worth mentioning that converting a principal residence to a rental property is not as big a concern as the other way around, because the capital gain on the deemed disposition from the change in use could probably be sheltered using your principal residence exemption (PRE).

There could still be a problem, however, if you've already designated another property as your principal residence for all or some of the same years you have owned the property that you're converting to a rental. In this case, you may be able to make an election under subsection 45(2) of our tax law to defer the capital gain on the property until the year you dispose of it (unless you rescind the election later or claim capital cost allowance on the property – which you'll generally want to avoid).

This election I'm talking about must be filed with your tax return for the year in which the change in use takes place. And there's another benefit to this election: You can continue to designate the property as your principal residence for up to four more years after the change in use, even though the property doesn't really meet the criteria any longer (in some cases you may be able to extend the four years indefinitely if an employer wants you to relocate).

In the case of Jason and Karen, they're converting rental properties to personal-use properties for their kids. They're not able to use the PRE to shelter the capital gains from tax because these were rental properties. Is there any help available? Maybe.

The owner of a property can make an election under subsection 45(3) of our tax law to defer the capital gain when converting from an income-producing property to a principal residence. For this election to work, it's important for Jason and Karen to not have claimed capital cost allowance on the properties in the past. Since Jason and Karen jointly own these rental properties, they'll each have to file the election by the deadline for their tax returns in the year they change use of the properties.

Another option for Jason and Karen might be to sell the properties to the kids for fair market value. This will allow the kids to call the respective properties their own principal residences, potentially sheltering any future capital gains on those properties from tax using the kids' PREs. Jason and Karen could structure the sale so that, rather than cash changing hands, the kids pay by way of promissory notes. Those notes could be structured so that they become due upon demand, one fifth a year over the next five years, which can allow Jason and Karen to spread the tax on the capital gain over five years (the maximum deferral allowed). The notes themselves will remain outstanding until the couple collect on them, if ever. The couple could even forgive some or all of those notes at the time of death in their wills with no negative tax consequences.

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