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Considering a laneway house? Before you decide, be aware of the tax implications

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Anyone who lives in Vancouver will tell you that new home construction is everywhere. In fact, the City of Vancouver's agenda includes promoting affordable housing through densification, now permitting up to three dwelling units on a single family lot—the main house, a rental suite or apartment within the main house and a separate laneway home in the backyard. With hundreds of laneway homes already constructed, it is clear that homeowners are taking advantage of these changes.

While there's plenty of information available on laneway housing, there is little guidance available on the related income tax implications. This article focuses on these tax implications and what you will need to keep in mind if you are considering building or renting self-contained laneway housing.

One of the most generous tax breaks provided to Canadian resident individuals is the principal residence exemption. Under certain circumstances, the principal residence exemption permits individual taxpayers to shelter gains realized on the sale of a housing unit that qualifies as the taxpayer's principal residence in any given year. A key concern when it comes to laneway housing is the impact that building or renting a self-contained laneway house will have on the ability to use the principal residence exemption. The principal residence rules are very complex and professional advice is recommended anytime a taxpayer owns more than one housing unit in a year, or starts using all or part of their main home for the purpose of earning income.

The main distinction for income tax purposes between building and renting a self-contained laneway house—versus renting out a suite in your home—is that the laneway house, and the land it is situated on, will commence to be considered a separate housing unit that is not part of your original principal residence, and unless the laneway house is subsequently occupied by a you or your child, it may not be eligible for the principal residence exemption.

In the year that a laneway house begins to be rented, the owner will realize a disposition, for income tax purposes, of the portion of the property used for the laneway house. If the owner is not entitled to use the principal residence exemption to shelter gains for every year of ownership, then any gain realized could result in a tax liability for the owner. Depending upon the value of the property, the number of years the principal residence exemption is available to the owner, and the portion of the property used for the laneway house, this tax liability could be significant.

Furthermore, if the property owner does not designate which years they are claiming the principal residence exemption for the property, the Canada Revenue Agency will arbitrarily designate the principal residence exemption to apply to each eligible year of ownership. While this might be the best result in some situations, it may not be an appropriate strategy if the owner owns another property, which also qualifies for the principal residence exemption. This is because any ability to designate that second property for the same years will be lost. If the average annual gain on the second property was larger, then ultimately more tax could be payable.

When the entire property is eventually sold (or when the owner dies), any gain realized on the laneway house portion will not be eligible for the principal residence exemption. The owner is required to track all costs associated with building the laneway house as well as keep records related to the original cost of the property, capital improvements made, the relative value of the land versus the main residence on the date of the deemed disposition and on the date of sale.

When considering the economic benefits of building and renting a laneway house, the potential income tax implications should first be considered. Professional tax advice is recommended—contact a tax adviser near you to get started today.

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