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TAXSTRATEGY

Avoid capital gains on your cottage

Tax-free Retreat

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My previous article focused on the principal residence exemption and how to shelter any capital gain on the sale of your home.

But what about your cottage property? Is it possible to enjoy the lake and the perks of being out of the city without worrying about paying tax if you ever decided to sell?

Well, sometimes the view from the dock may just have to be worth the price of the taxman coming to call.

It's true that you can potentially "cover" your capital gains tax exposure on a cottage by claiming the principal residence exemption.

However, to be eligible for the exemption the property must be ordinarily inhabited by you, your spouse or your children. If the cottage is exclusively meant to be an investment property that is rented by others throughout the year, the principal residence exemption cannot be claimed.

Although keep in mind that the exemption is claimed on a year-by-year basis; so if the cottage is used for personal purposes in any one year, you may be able to apply the exemption for that year.

One per family

But… using the exemption against the cottage could leave your primary residence eventually exposed to capital gains tax since there is a "one-principal-residence-per-family" rule under the exemption. And since the appreciation on a primary residence is usually higher, it might not be prudent to use up the exemption on your cottage.

If your second home hasn't appreciated, you have nothing to worry about. That's because capital gains tax on a sale or other transfer of the second home is calculated in accordance with the normal rules: your cost base plus selling costs are netted from proceeds of disposition to come up with the capital gain.

And if you have made improvements on your second home, this should increase your cost base. However, CanRev's position is that interest charges cannot normally be used to reduce capital gains exposure.

In order to substantiate such increases in your cost base, it is a good idea to keep a record of all eligible costs. This could include things like improvements to plumbing, or a new roof. If the cottage home is outside of Canada, remember that capital gains tax is measured in Canadian dollars, rather than the currency in which the home is located.

Transfer shock

When it comes to capital gains tax exposure, one of the most dangerous traps around may arise if you simply transfer your cottage home within the family for no consideration. In many cases, you may want to do this for estate planning or other reasons.

However, our tax rules are clear: if you transfer a capital asset – be it a cottage or otherwise – to a family member other than your spouse, there is a "deemed sale" of the property at its current market value at the time of transfer and you will be taxed on any capital gain.

Planning to reduce capital gains tax

You should assume a tax rate on capital gains of about 23 per cent of the appreciation in value (based on the top personal tax rate). If this gain is taxed when the cottage passes

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to the next generation, one common approach is to buy life insurance to fund this extra tax bill. Insurance agents will, of course, be more than happy to sell you a policy.

However, there are ways to reduce or even escape this tax bill. A key strategy, for example, may be to put the cottage in the name of a child when it is purchased.

This way, you can take the position that the cottage was owned by the child all along. One of the main benefits of this strategy is that it should prevent capital gains tax on the death of the parents, and defer the tax on future appreciation of the cottage until the death of the kids.

This is particularly important when you acquire a vacation property which is intended to be held within the family after the older generation passes away. But as I outlined earlier, if you transfer a pre-existing property, the deemed sale rules apply.

If you want to do this sort of estate planning, you should therefore do so before the property appreciates – that way there's no current capital gains tax exposure.

Another advantage of putting the cottage in the name of a child is that it may be possible to claim a second principal residence exemption.

The one-principal-residence-per-family rule mentioned earlier does not apply if a home is held by a child who is 18 or over. So an adult child (or even a child under the age of 18, if married) will still be able to claim the principal residence exemption if he or she holds the cottage and intends to use it for personal use.

In fact, even if the home is owned by a younger child, once that child turns 18, the principal residence exemption may become available.

Although this sounds like a great idea, remember that the child must be eligible to claim a principal residence exemption in his or her own right. This means that the cottage must be occupied by the child for personal use.

But even if the child can currently claim the exemption, eventually, he or she may buy his or her own home and from then on will likewise be restricted by the one-principal-residence-per-family rule.

In the meantime, though, there will be benefits from the principal residence exemption for those particular years. This will be in the form of a reduction in capital gains tax when the residence is eventually transferred or sold, based on the number of years in which the exemption was available.

Bear in mind, that putting ownership of the home in the name of a child may result in complications if the child runs into creditor or marital problems.

Also, unless the cottage is owned by all of your children as co-tenants, it will be necessary to pick and choose which child receives the cottage – and you may not wish to do this. And even if the cottage is owned jointly by your kids, you will lose flexibility if the children decide later that they do not want to share ownership.

Use of a Trust

If that's a problem, another strategy is to put the cottage in a trust for your kids. This provides protection against improvident actions on the part of your kids. It is possible to put the home in what estate planners refer to as a "discretionary trust" i.e., a trust that allows the trustees (typically including the parents) to determine "who gets what and when."

The trust can claim the principal residence exemption; however, the rules in this area are relatively complex and should be reviewed in detail before the trust itself claims the exemption. This course of action may block the principal residence exemption claims of family member beneficiaries, assuming that the cottage is not used solely for rental purposes.

Fortunately, there is an alternative to the trust itself making the designation. In cases where a residence is transferred out of a trust (other than a "spouse trust") to a beneficiary, the recipient of the cottage will be considered to have owned it during the years that it was owned by the trust.

Moreover, since the beneficiary will be receiving the cottage from the trust in satisfaction of all or part of the beneficiary's capital interest in a trust, the cottage will be acquired by the beneficiary at the adjusted cost base of the property to the trust. So there is no capital gain tax on the transfer from the trust to the beneficiary.

And because the beneficiary will be deemed to have owned the cottage throughout the period that it was owned by the trust, he or she can claim the principal residence exemption (assuming, of course, that the cottage was ordinarily inhabited by that person during the time it was owned by the trust).

This alternative may be preferable to the trust claiming the principal residence exemption, since this strategy will not block out claims by other beneficiaries of the trust. ❒