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*REAL ESTATE*WATCH

Soaring costs got you thinking about vacating your vacation property? Think twice before you put up the sign…

Cottage for sale

Samantha Prasad LL.B.

These days the average cottage owner can be hit with a lot more than just a swarm of black flies.

The soaring cost of gas has made the weekly trip to the family cottage more of a financial investment than it used to be. And with increasing property taxes and pressure to meet local environmental zoning laws when rebuilding, the cottage might start to feel more like a millstone around your neck rather than a place where you can kick back and relax.

It's no surprise, then, that families are feeling the financial strain of maintaining a second home.

Samantha Prasad, LL.B., is a tax partner with the Toronto-based law firm Minden Gross LLP, a member of Meritas Law Firms Worldwide, and a Contributing Editor of The TaxLetter, published by MPL Communications.

sprasad@mindengross.com

As such, you may be inclined to consider offloading the cottage in order to help ease your cash flow. But along with the costs of owning a cottage, there are also costs associated with selling your second home… tax costs that is.

Tax consequence of a sale

Once upon a time, a family was eligible for a double-principal residence exemption. However, in the early 80s, the tax rules were changed so that effectively there is now a one-principal-residence-per-family rule (with some tax relief still potentially available for second properties owned prior to 1982).

What this means is that if you sell or transfer a cottage, capital gains tax may be payable on your "home away from home."

You should assume a tax rate on capital gains of about 23 per cent of the appreciation in value. So any sale of the cottage at today's value will result in a capital gain equal to the sale price less the "adjusted cost base" of the property to you.

The "adjusted cost base," in a nutshell, is the cost you paid to acquire the property, plus all capital improvements you made over the years.

If you, like many cottagers, inherited the cottage from previous generations by way of a will, your cost of the property will be equal to the fair market value of the cottage at the time that you inherited it.

Also, if you have owned your cottage for a long period of time – since before 1972, to be exact – you were able to take advantage of "Valuation Day," a.k.a. "V-day."

Since capital gains were only taxable from 1972 onwards, the increase in value of your cottage prior to December 31, 1971 (i.e. V-day) is exempt from capital gains tax.

Accordingly, you were able to elect the fair market value of the property as at December 31, 1971, to be your new cost base for future capital gains calculation purposes.

So, if you did own your cottage prior to the valuation day, you may want to check to see what your V-day value is in order to determine what your effective cost base would be.

Plus, if you made any capital improvements since V-day (pre-

sumably this would be the case since your cottage likely would have required some work over the past 40 years), those improvements can be added to your V-day value in determining your adjusted cost base.

As mentioned above, you can no longer double up on your principal residence exemption, which means that you have to designate either your principal home or your cottage in order to get the exemption.

If you think that your capital gain on the sale of the cottage would heavily outweigh any possible gain on the principal home for those years that you owned both, then you may want to designate your cottage as your principal residence and claim the exemption. However, this becomes an exercise in numbers to determine where your biggest tax liability lies.

Transferring within the family

In many cases, you may want to rid yourself of the cottage but still keep it in the family by transferring it to a family member (i.e. your kids or grandkids) for estate planning or other reasons.

However, our tax rules are clear: if you transfer a capital asset – be it a second home or otherwise – to a related person other than your spouse, there is a "deemed sale" of the property at its current market value at the time of transfer.

One of the most dangerous examples of this tax trap awaits Ontario residents (and some in other provinces as well) who change the title to their cottage from one person to joint tenancy in order to reduce probate fees.

CanRev will treat this as a deemed sale of the property at current values, to the extent that new related co-tenants (other than a spouse) come into the picture. Suppose, for example, that you decide to put your home in co-tenancy with two of your children.

CanRev has been known to carefully monitor taxpayers who consistently claim rental losses over several years

CanRev's position is that you will have sold two-thirds of your property to your kids. Furthermore, since each now owns a third of the home, the availability of the principal residence exemption for each one-third interest will depend on the individual circumstances of you and each of your children.

On some occasions, taxpayers who have unwittingly fallen into a transfer/deemed sale trap have been able to convince the CRA that they held the property "in trust" for their kids – i.e., that their kids have been "beneficial owners" of the property all along.

However, this can be an uphill battle and must not only be supported by the particular circumstances but also by proper documentation. For example, it is possible that statements listing ownership of assets provided to a financial institution could trip you up.

Renting out the second home

If you are concerned about triggering capital gains tax by selling the cottage, you may want to consider a scenario wherein your second home doubles as a rental property.

And while rental income is potentially taxable, you are entitled to claim applicable expenses. Often, these expenses can really mount up and may put you into an overall loss position.

If so, the losses are potentially available to shelter other sources of income e.g., from your job. (If the second home is a farm, there are usually restrictions on the amount of annual losses that can be claimed, known as "restricted farm losses.")

And for those who are tempted to pile up the write-offs, a word of warning: CanRev has been known to carefully monitor taxpayers who consistently claim rental losses over a period of several years, and may well attack your claim based on the premise that there must be a reasonable expectation of profit.

Although this line of attack was generally shot down by the Supreme Court of Canada in two landmark cases (*Stewart & Walls*), the cases drew an exception for properties which involve an element of personal use. So CanRev can – and will – still attack.

Cottages south of the border

There are other complications that may arise if the second home is located outside of Canada, particularly in the U.S.:

✓ If you sell U.S. real estate, there is a 10 per cent U.S. withholding tax. The tax withheld may be offset against U.S. tax payable on the capital gain.

Happily, there is no withholding if the sale price is less than US$300,000 and the purchaser intends to use the proper-

ty as a principal residence.

However, the gain on the sale will still be taxable in the U.S. and you will have to file a U.S. tax return. (It is also possible to go through certain procedures to reduce the withholding tax.)

✓ On a sale of your real estate, you will need to provide an Individual Taxpayer Identity Number ("ITIN") to the transfer agent.

This is still the case even if no withholding tax is due. The sale cannot close without both the vendor and purchaser providing an ITIN.

In addition the IRS will not issue a receipt for the withholding tax paid unless both the vendor and purchaser provide this number. An ITIN can be obtained by filing Form W-7 with the IRA. Note: This is at least a six-week process.

✓ If you sell your real estate, you will have to file a U.S. tax return to report the gain (a credit may be claimed for tax withheld under the Foreign Investment in Real Property Tax Act of 1980).

This filing requirement is true even where there is no withholding tax due. The capital gains rate in the U.S. is currently 15 per cent (if you own the property personally).

If you have owned the property since before September 27, 1980, you can take advantage of the Canada-U.S. tax treaty to reduce the gain.

In this case, you will only have to pay tax on the gain that accrued since January 1, 1985 (this does not apply to business properties that are part of a permanent establishment in the U.S.).

To claim this treaty benefit, you have to make the claim on your U.S. tax return and include specific information about the sale.

✓ Any U.S. tax paid on the sale of the property will generate a foreign tax credit under the Canada-U.S. Tax Treaty which you can use to reduce your Canadian tax on the sale. Note: This tax credit may be limited if you use your principal residence exemption to reduce your Canadian gain. ❐

VACATION PROPERTIES AND CAPITAL GAINS

Remember to track your costs

As most Canadians know, the capital gain that you may realize when you sell your home is exempt from tax. Under our tax rules, a family unit (generally you, your spouse and your minor children) can exempt a gain from one residence only (before 1982, each taxpayer in a family could exempt one property that they own).

If you or your family unit owns more than one property, this means that some tax will be payable on the gain from one property when it is sold. Often, tax is paid on the sale of the property with the lower value (on the assumption that the gain is lower on that property) and this property is often the vacation property.

Because the gain on your vacation home may be taxable in the future, it is important to keep track of the cost to acquire the property - both at the time of purchase and for any improvements made. The higher your documented cost, the lower the gain when you sell. So, be sure to track these costs and keep receipts.

And, remember to keep in mind that some items may be difficult to categorize in terms of an expense vs. an improvement. Unlike normal tax planning for income calculations, you'll want to justify (within reason) as many expenditures as you can as improvements as opposed to operating costs.

The key test is whether the expenditure maintained or returned the property to its original condition, or the expenditure made the property better than it was previously.

Source: BDO Dunwoody LLP *www.bdo.ca*

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