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TAXMATTERS

Capital gains and . . .

The Cottage Investment

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It feels as if spring is around the corner which means that summer is not too far off. And with thoughts of warmer weather comes thoughts of spending summer days on a lake somewhere. If you are in the market for a cottage as a second home, then thought should be given to proper tax planning as any future sale or transfer within the family can result in a bundle in tax.

It's true that you can potentially "cover" your capital gains tax exposure on a cottage or vacation home by claiming the principal residence exemption. However, in order to be eligible for the exemption, the property must be ordinarily inhabited by you, your spouse or your children. If the cottage is purely meant to be an investment property, to be rented out throughout the year, the principal residence exemption cannot be claimed. However, remember that the exemption is claimed on a year-by-year basis, so that if the cottage is used for personal purposes in any one year, you may be able to apply the exemption for that particular year. However, 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. So it may be imprudent to use up the exemption on your cottage, especially since the appreciation on a primary residence is usually higher than the cottage.

If there has been no appreciation in your second home, 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 put improvements into the second home (e.g., renovations and the like), 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 maintain a file and include receipts for all eligible costs. This could include such things as improvements to plumbing, a new roof, and so on. If the home is outside the country, bear in mind that capital gains tax is measured in Canadian dollars, rather than the currency of the country in which the home is situated.

Transfer Shock

When it comes to capital gains tax exposure, one of the most dangerous tax traps around may arise if you transfer your second home within the family. In many cases, readers may want to do this for estate planning or other reasons. However, our tax rules are clear: if you transfer or gift 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.

Planning to Reduce Capital Gains Tax

You should assume a tax rate on capital gains of just over 26% (for 2016 assuming the top tax bracket). If this gain is taxed when the cottage passes to the next generation, one common approach is to buy life insurance to

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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. How do you do this? A key strategy may be to put the cottage in the name of a child when it is purchased. That way, you can take the position that the cottage is owned by the child all along. One of the key benefits of this strategy is that it should prevent capital gains tax on the death of the parents, which would otherwise occur on future appreciation of the cottage, if held by the parents. 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. Remember, though, that if you transfer a pre-existing property, the deemed sale rules apply, as discussed above. This means that, if you want to do this sort of estate planning, you should do so before the property appreciates – so 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.

While 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, for example, that the cottage must be occupied by the child for his or her 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 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, though, 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 it is later decided that some of the children should not share ownership in the cottage.

Use a Trust

If deciding how to divvy up the cottage among your children is causing you stress, another strategy would be to put the cottage in a discretionary trust for your kids. This will provide protection against improvident actions on the part of your kids while also buying you more time before having to make a decision as to ownership as a discretionary trust allows the trustees (typically the parents) to determine "who gets what and when."

It is possible for a trust to 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, as this course of action may block the principal residence exemption claims of the 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: where a residence is transferred out of a trust (other than a "spouse trust") to a beneficiary, the recipient of the home will be considered to have owned the home during the years that it was owned by the trust. Moreover, since the beneficiary will be receiving the home from the trust in satisfaction of all or a part of the beneficiary's capital interest in a trust, the home will be acquired by the beneficiary at the adjusted cost base of the property to the trust (i.e. so no capital gain tax on the transfer from the trust to the beneficiary). And because the beneficiary will be deemed to have owned the home throughout the period that it was owned by the trust, he or she can claim the principal residence exemption (assuming, of course, that the home was used as that person's principal residence 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.

Renting Out the Second Home

If the intention is to simply have the cottage double as a rental property, the rental income is potentially taxable, although 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, be it from your job, or whatever. (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."). ❐

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