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TAX*PLANNING*

Avoid capital gains on that cottage investment

Tax--free retreat

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Earlier this year, the Bank of Canada promised to leave borrowing costs at a record low of 0.25 per cent until June 2010, providing the inflation outlook doesn't shift (although there are some rumblings that this rate could increase shortly).

While interest rates remain low and the real estate markets remain depressed (especially in the U.S.) some of you may consider investing in a vacation property, such as a cottage.

As one person said to me: "It's free money in the bank, so why not?"

However, before you consider this kind of investment, give some thought to proper tax planning. That's because you could be stuck with a bundle in tax if you sell it or even transfer it to someone in your family when you pass away.

In other words, there could be potential capital gains tax to pay at a later date, so this purchase may not be as "free" as you think.

It's true that you can potentially "cover" your capital gains tax exposure on a cottage 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 meant to be an investment property (rented out throughout the year) the principal residence exemption cannot be claimed.

Although, remember that the exemption is claimed on a year-by-year basis. That means if the cottage is used for personal purposes in any one year, you may be able to apply the exemption for that 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 not be wise to use up the exemption on your cottage. Especially since the appreciation on a primary residence is usually higher than a cottage.

Of course, if your second home has not appreciated in value, you have nothing to worry about.

That's because capital gains tax on a sale or other transfer of a second home is calculated in accordance with the normal rules. Your cost base and selling costs are netted from the proceeds of the disposition to come up with the capital gain.

And if you have made improvements in your second home such as renovations, 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 these increases in your cost base, it is a good idea to keep a file and include receipts for all eligible costs.

This could include improvements like plumbing or a new roof. If the home is outside the country, take into

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account that capital gains tax is measured in Canadian dollars, rather than the currency where the home is located.

Avoid transferring your second home

When it comes to capital gains tax exposure, one of the most dangerous tax traps around may arise if you transfer your second home.

You may want to do this for estate planning or a number of 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.

One of the most dangerous examples of this tax trap awaits those who put their home in joint tenancy in order to reduce probate fees. CanRev treats this as a deemed sale of the property at current values, to the extent that new co-tenants (other than a spouse) come into the picture.

Suppose, for example, that you decide to transfer your cottage into a co-tenancy with your two children. CanRev's position is that you will have sold two-thirds of your property to your kids.

Furthermore, since each child now owns a third of the home, the availability of the principal residence exemption for each interest will depend on the individual circumstances of yourself and each child. Keep in mind that if the cottage is used only for investment purposes, without any personal usage, this principle residence issue will be moot.

Sometimes, 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 be supported by the particular circumstances. For example, it is possible that statements listing ownership of assets provided to a financial institution could trip you up.

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 to the next generation, one common approach is to buy life insurance to fund this extra tax bill.

However, there are ways to reduce or even escape this tax bill. How? A key strategy is to put the cottage in the name of a child when it is purchased. That way, you can take the position that the cottage was owned by the child all along.

One of the key benefits of this strategy is that it should prevent capital gains tax on the eventual death of the parents, which would otherwise appreciate, if held by the parents.

This is particularly important when you acquire a vacation property which is intended to be held within the family for generations.

Remember, though, that if you transfer a pre-existing property, the deemed sale rules apply. This means that, if you want to do this sort of estate planning, you should do this before the property appreciates – so there's no current capital gains tax exposure.

Another advantage of putting the cottage in the name of your 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 years or older. 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 his or her personal use.

But even if the child can currently claim the exemption, eventually, he or she may buy their 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.

Complications may arise 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 want to do this. And even if the cottage is owned jointly by your children, you will lose flexibility if it is later decided that some of them do not want to share ownership in the cottage.

Using a trust

If the issues I have mentioned above are a concern, there is another strategy. You could put the cottage in a trust for your children. This will provide protection against improvident actions on their part. It is possible to put the home in what estate planners refer to as a "discretionary trust". This means a trust that allows the trustees (typically including the parents) to determine "who gets what and when."

Trusts may also 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: 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 it, the home will be acquired by the beneficiary at the adjusted cost base of the property (i.e. so there is no capital gain tax on the transfer).

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. That assumes, 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 your intention is to have your cottage double as a rental property, the rent 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 this happens, the losses may potentially shelter other sources of income, for example your employment income.

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."

But for those who are tempted to pile up the write-offs, a word of warning: CanRev has been known to 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 kayoed 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.

U.S. homes and withholding tax

Other complications may arise if the second home is located outside of Canada, particularly south of the border:

If you sell U.S. real estate, there is a 10 per cent U.S. withholding tax. It is however, possible to go through certain procedures to reduce the 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 it 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 tax return.

U.S. estate tax may apply when you pass away. There is currently a US$3.5 million exemption available to Canadians, but this is based on world-wide assets. Interestingly enough, U.S. estate tax is repealed for 2010 only. On January 1st, 2011, estate taxes will spring back to life and the exemption will be reduced to US$1 million on world-wide assets. ❑