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TAXSTRATEGY

Cottage Life

Caveat Venditor

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Last year was a seller's market for summer homes. With the pandemic and lock down, city folks were paying premium prices for a place by the water. This year might be an even "hotter" market for sellers – the pandemic is still in full force but it feels like people are even more determined to get out of the city after not being able to travel for over a year. So demand is high. And if you are thinking of cashing on that demand as a seller, then consider the following tax issues before you decide to put the For Sale sign up.

Tax consequence of a Sale

Many, many years ago, a family was eligible for a double principal- residence exemption. However, in the early 80s, the tax rules were changed so that now there is essentially 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 the cottage, capital gains tax may be payable on your "home away from home".

You should assume a tax rate on capital gains of about 26.7 per cent (Ontario rates) on 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 to the property over the years. If you, like many cottagers, inherited the cottage from previous generations by way of will, your cost of the property will be equal to the fair market value of the cottage at the time that you inherited it.

You should also ask yourself whether you have owned the cottage since before 1972. Why that far back? Well, if you owned property prior to December 31, 1971, 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 V-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 (presumably this would be the case since your cottage likely would have required some work over the past 49 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

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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.

Transfer 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. This could then trigger capital gains tax to you (even though you did actually sell the property nor receive any proceeds).

One of the most dangerous examples of this tax trap awaits those readers in provinces that have a probate tax. A common strategy is to change the title to the cottage from one person to joint tenancy with another person in order to avoid probate fees on the first to die. CanRev will treat this as a deemed sale of the property at current value to the extent that new joint tenants (other than a spouse) come into the picture. Suppose, for example, that you decide to put your home in joint tenancy with your two kids. CanRev's position is that you will have sold two-thirds of your property to your kids. Furthermore, since each kid 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 yourself and each kid.

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 where your second home doubles as a rental property. And from my desperate searches on VRBO and AirBNB, renting your cottage over the summer can also net you quite a windfall. Moreover, even though such rental income is taxable income to you, you are entitled to claim applicable expenses (including any mortgage payments). Often, these expenses can really mount up and may put you into an overall loss position (although maybe not this summer with the premium rents). But, any 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.")

But 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

Other complications 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 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 USD $300,000 and the purchaser intends to use the property 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.)

☛ On a sale of your real estate, you will need to provide an Individual Taxpayer Identity Number ("ITIN") to the transfer agent. This is so, even if there is no withholding tax 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 an ITIN. An ITIN can be obtained by filing Form W-7 with the IRA. This is at least a 6 week process.

☛ If you sell your U.S. home, you will have to file a U.S. tax return to report the gain (a credit may be claimed for tax withheld under FIRPTA). This filing requirement is true even where there is no withholding tax due. The current capital gains rate in the U.S. for individuals is currently 15 per cent if held for a long time and the gain is under $445,800; for those with gains above such amount, the capital gains rate is 20 per cent; however, the Biden Administration has proposed an increase of this rate to just over 39 per cent for those who have income over $1,000,000 (which is well over the Canadian tax rate of 26.7 per cent). So, depending on the amount of the gain on your US property, your US tax bill can be higher than your Canadian tax bill.

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 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. ❑