THE GLOBE AND MAIL

CESTNICK

TAX MATTERS

Make plans to deal with the taxes on your cottage!

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It was about 90 years ago that my great-grandfather built his first cottage. It had no running water, no electricity and an outhouse in the backyard. One day, some children from town played a practical joke and moved his outhouse back about two metres, exposing the hole. When nature called and my great-grandfather stepped into the hole, he decided it was time for an upgrade. So, he put plumbing in the cottage. Over the years, he made a lot of improvements and the value of the property grew.

Thousands of Canadians are heading to the cottage, or cabin, for this long weekend. Many of those properties have grown in value in a big way over the past year. It begs the question: How much tax will eventually be owing on the property, when will those taxes be due, and what can we do about it?

THE BASICS

You could end up paying tax on your cottage property if it has grown in value, and those taxes will generally be due when you sell, transfer ownership or pass away – whichever comes first. As a general rule, pushing that tax bill as far into the future as possible makes sense, which often means keeping the property as long as you can.

But let's face it, there are many reasons why this may not be practical. You may have to sell, or want to sell, for many reasons. Or perhaps you want to transfer ownership to the children before you pass away. What can be done about the tax liability?

The CRA is focusing online to collect taxes

How small-business owners can save for retirement

Consider these ideas:

MAXIMIZE YOUR ADJUSTED COST BASE

You'll only face tax on the value of your property over and above your cost amount – that is, your adjusted cost base, or ACB. If you're like my great grandfather and have improved your cottage over time, create a list of all those improvements. You may not have receipts for those costs, but don't lose sleep over that. If it's clear that those improvements were made, list them anyway, then estimate as best you can the costs. You should add those costs to your ACB. Canada Revenue Agency will not likely ask to see the receipts and, if the department does, you can deal with that battle at the time. There are court decisions that could help you at that time (speak to a tax pro). Going forward, keep any receipts or proof of the costs of these improvements.

CLAIM THE PRINCIPAL RESIDENCE EXEMPTION

As long as you "ordinarily inhabit" your cottage property (there is no definition of what length of time is required, but even a week or two a year should be fine), then you can generally claim the principal residence exemption, or PRE, to shelter all or part of any gain on the sale or transfer of the property, or upon your passing. Many people keep the PRE to shelter their city home from tax. But given the big jumps in value of many cottages over the past year, this should be rethought. It generally makes sense to shelter the property with the biggest gain per year of ownership – which could be the cottage today.

TRANSFER OWNERSHIP TODAY

The advantage of transferring ownership to your heirs today is that any future growth on the property will not face tax in your hands in the future. So, this is a type of "estate freeze" (where the future growth, and tax bill attached to that growth, is passed to the next generation). The challenge is that you could pay tax today when making the transfer. If you can claim your PRE, then there might not be a tax cost. And if there is going to be a tax cost, you'll pay tax at today's capital gains inclusion rate (just 50 per cent of capital gains are taxable today). It's commonly believed that the capital gains inclusion rate could increase in the near future given the need for our government to raise tax revenue to pay for all the pandemic support that's been provided. Speak to a tax pro or trusted financial adviser before you make a decision to pay tax on a transfer today.

CONSIDER LIFE INSURANCE TO COVER TAXES

Finally, dealing with a tax bill on the cottage can be as easy as buying a life insurance policy to cover the taxes upon your death. This way, you won't leave your heirs in a pickle if they want to keep the cottage but don't have much in liquid assets to pay the taxes owing. Take the time to understand what that tax bill might look like today, then consider a permanent life insurance policy that also allows for the tax-free accumulation of investments inside the policy.

Tim Cestnick, FCPA, FCA, CPA(IL), CFP, TEP, is an author, and co-founder and CEO of Our Family Office Inc.
He can be reached
at tim@ourfamilyoffice.ca