

THE TAX FACTOR

DON'T LET YOUR SUMMER GETAWAY BECOME A TAX TRAP: TAX SAVING STRATEGIES FOR COTTAGE OWNERS

The official start of summer is just days away and for many Canadians this means that the seemingly interminable wait for those lazy, hazy days spent at the cottage is almost over. Whether you refer to it as the cottage, the chalet, the cabin, the camp or the summer house, cherished memories of childhood summers spent lakeside with family and friends are often the inspiration for buying a summer getaway. But actually undertaking the purchase and maintenance of a cottage, as well as planning for its eventual sale or succession, can often bring you crashing back to reality. In this article, we will examine some of the key tax issues affecting cottage ownership.

Buying with selling in mind

Visions of summers spent unwinding and sharing quality time with family can make the allure of cottage ownership hard to resist. However, cottage properties can often be pricey, not only with the initial purchase cost, but a cottage also requires ongoing maintenance (like any property) and often needs costly repairs or renovations to keep it up. Bear in mind, what you spend on your cottage can have a huge impact on what you will ultimately pay in tax when you sell or dispose of it.

When you eventually dispose of your cottage, either during your lifetime or at death, and the value of the property has appreciated, then tax will become payable at that time on the difference between either the proceeds of sale or the fair market value of the cottage and the total of its "adjusted cost base" plus any selling costs (subject to the principal residence exemption discussed later). Adjusted cost base (ACB) refers to the aggregate of both the initial cost of the property plus any additional qualifying capital outlays made over the years you owned it. If you inherited your cottage from anyone except your spouse, then the initial cost will be the fair market value of the cottage at the time you inherited it.

There are additional considerations if you or your spouse owned your cottage prior to 1972, or if you or your spouse made an election in 1994 to increase the ACB of your cottage by using the \$100,000 capital gains exemption available back then. If either of these fact situations apply, contact your BDO advisor to discuss how to determine the ACB of your property.

The excess of the proceeds of disposition, whether deemed or realized, over the ACB (and any selling costs) is generally a capital gain for income tax purposes. Taxes will be assessed at an approximate rate of 22% of the gain. (The top rate of tax on capital

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gains for individuals in Canada varies from a low of 19.5% to a high of 25%, depending on the province or territory of residence. For simplicity, in this article we will cite an average rate of 22% as the top marginal rate for capital gains for individuals in Canada.) As a result, there's an incentive to minimize any gain by ensuring that the documented cost of the property is as complete as possible. Determining what types of costs are capital costs, and thus added to the ACB of the property, can be confusing. See the accompanying article "[Calculating cottage capital gains: have you accumulated all eligible costs?](#)" for more details about calculating the ACB of your cottage property.

Keeping accurate records of the cost of your cottage is crucial should the Canada Revenue Agency (CRA) ever ask for support for the ACB of the property. Proper records would include retaining the original purchase documentation you received when you bought the cottage, plus any invoices or receipts that support subsequent renovations or improvements.

Renting out your cottage

If you're not spending as much time at the cottage as you used to, or if the financial commitment of maintaining a second home is becoming burdensome, you may want to consider renting out your cottage. Whatever the reason, the ability to retain continued access to the cottage while also earning revenue to offset expenses can be appealing. Before renting out your cottage, you may first wish to consider some potential tax issues, particularly those surrounding a "change in use" and the recognition of rental losses.

When you commence the rental of a personal property, other than in an incidental manner, you are considered to have changed the use of the property for income tax purposes. When this happens, there is a disposition at fair market value. As a result, tax would need to be computed on the difference between the fair market value of the property at the time of the change in use and the property's ACB. Any resulting capital gain may be reduced by utilizing the principal residence exemption (discussed later).

An election can also be made to defer the deemed disposition on a change in use. When this election is made, it may also be possible to continue to designate the property as a qualifying principal residence for up to four years or longer in the appropriate circumstances. There are specific guidelines

for making this election and care must be taken to avoid inadvertently rescinding this election. Your BDO advisor can provide you with more information on this and other planning strategies should you decide to rent your cottage.

Revenues earned from renting your cottage will be taxable. However, you can claim applicable expenses to offset this income. Expenses can include a reasonable portion of the operating expenses for the cottage, as well as costs directly associated with renting the property (such as cleaning, advertising, commissions or fees paid to rental agents, and property management fees). You may also be eligible to claim depreciation, referred to as capital cost allowance (CCA) for income tax purposes, against the rental income.

There are a few issues to be aware of if you decide to claim CCA on your rental property. First, you may not claim CCA if doing so would either create or increase a rental loss. As a result, you may only claim enough CCA to bring your net rental income down to zero, irrespective of the amount of CCA that is available to be claimed in the year. Second, you should be mindful that claiming CCA during the years that you rent your property could result in an income inclusion in the year the property is sold. This income inclusion is referred to as a "recapture of CCA" and it would be in addition to any capital gain realized on the sale of the property. One final point to note — if you elect to defer the deemed disposition on a change in use, you cannot claim CCA. Doing so will rescind the election and cause the deemed disposition rules to apply in the tax year that CCA is claimed. Speak to your BDO advisor about the possible tax implications of claiming CCA on your rental property.

It is possible that the costs you are allowed to deduct could amount to more than the revenue earned, in which case you may find yourself in an overall loss position. The ability to utilize rental losses to shelter other sources of income will rest heavily on the individual facts. Case law suggests that the ability to claim a rental loss depends on the amount of personal use and whether the rental of the property is conducted in a commercial manner. In this regard, the CRA will view the occasional rental of your cottage as significantly different from purchasing a cottage specifically as an investment with the intent to earn income by renting it out. Your BDO advisor will be able to provide you more specific guidance on the deductibility of rental losses.

In this issue, we refer exclusively to a summer vacation property, such as a cottage. However, the issues discussed apply equally to any type of vacation property owned in addition to a primary residence. The planning tips discussed here pertain solely to a vacation property situated within Canada, and not one located in the U.S. or another country. If you own, or are contemplating the purchase of, a property outside of Canada, contact your BDO advisor to discuss the tax issues that specifically affect international vacation properties.

Selling your cottage

As with the decision to rent, there may be a host of reasons why you may choose to put your cottage up for sale. The sale of your cottage property will result in the realization of a capital gain if the value of your cottage increased while you owned it. As discussed above, this gain will be taxed at an approximate rate of 22%.

The principal residence exemption may be available to shelter the gain on a cottage from tax. A cottage can be designated as a principal residence, even if you don't use it as your primary residence, as long as it is "ordinarily inhabited" at some point during the year. Ordinarily inhabited would include living at the cottage for only a short period of time, as long as the main reason for owning it was not for the purposes of earning income. The CRA does not consider incidental or occasional rental of a property sufficient to prevent it from qualifying as a principal residence. Also as mentioned above, if you decide to rent out your cottage regularly, the years that you rent out your cottage can be considered qualifying years for purposes of the principal residence exemption if you elected to defer the change in use when you began renting your cottage and if you meet certain other tests.

A couple may designate only one of their residences as their principal residence for each year that they own multiple residential properties. Prior to 1982, it was possible for each spouse to own a property and designate it as his or her principal residence, allowing a tax-free disposition of more than one residence per couple. For property purchased after 1981, this is not possible and a choice has to be made upon the sale of the first property as to which of the properties should be designated as a principal residence for each year. Many factors will need to be considered, including predictions as to whether the remaining residence will increase or decrease in value in the future. For properties purchased prior to 1982, the ability to make separate principal residence designations between you and your spouse still applies, but only for the years of ownership prior to 1982, and only where the properties are owned wholly by you or your spouse at the time of disposition. Your BDO advisor can help you make the decision on how to best utilize your principal residence exemption.

Often, cottages can be located on a sizeable piece of property. As a result, it's not unusual for a cottage owner to consider subdividing a cottage property to sell off a portion of land as a means of realizing some value. The sale of land can create a capital gain, or where such land is considered inventory or an adventure in the nature of trade, the sale of land can create fully taxable income. Where a capital gain arises on a disposition of a vacant parcel of land that was attached to a cottage property, it may also be possible to shelter this gain by utilizing the principal residence exemption.



Essentially, a principal residence is defined as the actual building plus any surrounding land that can reasonably be regarded as "contributing to the use and enjoyment" of the residence. Generally, the surrounding land in excess of a half-hectare (approximately 1.24 acres) is deemed not to qualify as part of the principal residence unless the taxpayer can prove that its use is necessary to the continued use and enjoyment of the residence. Interpretation and case law appear to support a taxpayer's ability to claim the principal residence exemption on the sale of excess land, as long as that land can be shown to be necessary to the continued use and enjoyment of the property up to the time of its subdivision. Whether a parcel of land meets this criteria will rest on the facts, but the CRA has explicitly stated that land that was subject to specific zoning laws prohibiting it from being subdivided would qualify as part of the principal residence during that relevant time.

Also, a recent Federal Court of Appeal case (*Cassidy v. R*) has ruled that the determination of whether subjacent land meets the criteria for principal residence must be applied on a year-by-year basis, with only those years in which the land can be shown to be necessary to the use and enjoyment of the property being eligible for the purposes of designating the property as a principal residence. The principal residence exemption rules can be complex. Speak to your BDO advisor if you are considering subdividing your cottage property for the purposes of selling a portion of the land.

Your future plans may not be to sell your cottage but rather to transfer the ownership of the cottage to your children, either during your lifetime or after your death. In the next article, we will examine some of the issues surrounding the transfer of your cottage to your children or family members.

► Summertime is a great time to escape the demands of city life by retreating to the cottage. But whether it's a cottage, cabin or chalet, a vacation property is supposed to be a tiny piece of paradise to call your own, not a money-pit that costs you more than you bargained for. Much like applying sunscreen, tax planning to mitigate potential pitfalls when buying, renting or selling a cottage can help you minimize additional outlays and protect you from getting "burned".

THE FAMILY COTTAGE: TIPS FOR SUCCESSION PLANNING

Any cottage owner will tell you that a cottage is more than just a house by a lake. There is a sort of magic that happens when a family comes together up at the cottage. Precious memories forged over the years spent at the cottage can create a strong sentimental bond to that physical place, and as a result cottage owners will often want to take measures to strengthen this bond by ensuring that the cottage is kept within the family after they are gone. Unfortunately, all too often the transfer or gift of a cottage to children or family members has both unplanned financial and personal results.

There may be many factors that influence your own desire to keep your cottage in the family. But before making the decision to transfer or gift the property to your children, you may want to first reflect on what inheriting the cottage could mean to them. Ask yourself whether your children have shown an interest in owning the property or whether they are indifferent. Also, consider whether you anticipate future conflict between siblings when they eventually share not just the cottage, but also its upkeep. An open discussion with your children in advance of undertaking any financial planning may be needed to ensure that the cottage will not become a source of family disputes.

If you do decide to transfer the cottage to your children, there are several ways to accomplish this:

Use of a personal trust

A popular option for dealing with succession is through the use of a trust. A trust allows you to separate the control and management of an asset from its ownership. An inter-vivos trust can allow you to gift ownership of your cottage to your beneficiaries, most often your children, while still allowing you to enjoy the continued use of the cottage. When you transfer your cottage to a trust for the benefit of your children (or other beneficiaries), there is a deemed disposition at fair market value. As discussed in the earlier article, you may decide to shelter any gain by using your principal residence exemption. As well, every 21 years there will be a deemed disposition of the trust property at fair market value. Taxes will have to be

paid on the accrued gain at that time if the trust still owns the property. An exception to both of these deemed dispositions is a transfer to either an "alter ego" or a "joint partner" trust. More information on these types of trusts and issues surrounding establishing and administering a trust can be found in our Tax Bulletin titled [Understanding Trusts](#).

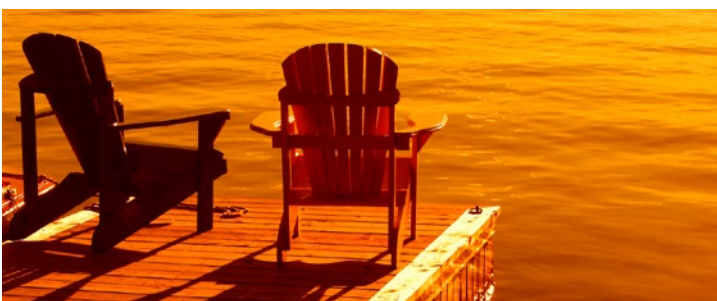
If the cottage is sold by the trust, rather than distributed to the beneficiaries, there will be a disposition for income tax purposes and taxes will become payable. The trust can claim the principal residence exemption to shelter any gains, but bear in mind that in doing so, this may cause problems for the beneficiaries of the trust. The trust's designation of the cottage as a principal residence for a given year may preclude each beneficiary from designating his or her own home for that year. This could affect how your children will be able to shelter future gains on their own houses. Conversely, if a beneficiary already designated another property for any of the relevant years, this may prevent the trust from designating the cottage as a principal residence for those years.

A significant benefit of holding a cottage in an inter-vivos trust is that probate fees can be avoided on your death, in provinces where they apply. This is because property held within a trust is not considered to be part of your estate. For more information on trust and estate planning, speak to your BDO advisor.

A testamentary trust, or a trust that is set up in your will and comes into effect on your death, can be used to pass ownership of the cottage to your children after you die. At the time of your death, your cottage will be deemed to be disposed of for fair market value consideration and your estate will pay tax on the accrued gain. (An exception to the deemed disposition rules would be if your assets transfer directly to your spouse or to a spousal trust, as this transfer would occur on a tax-free basis). Should there be a taxable gain, the principal residence exemption may be used to shelter all or a portion of that gain, if available. After death, the cottage will be an asset of the testamentary trust.

A benefit of a testamentary trust is that it is treated as an individual for income tax purposes, and thus enjoys access to graduated tax rates. Note, however, that the 2013 federal budget announced the government's intention to consult on the possibility of eliminating this benefit. The anticipated changes to the taxation of testamentary trusts are discussed in our 2013-05 *Tax Factor* article titled "[Death and taxes: potential changes to the taxation of testamentary trusts](#)".

If you decide to bequeath the cottage to your beneficiaries after you die, you may wish to consider purchasing a life insurance



policy to pay for the taxes that will become payable on the deemed disposition at death. For further discussion on post-mortem planning strategies, speak to your BDO advisor.

Joint tenancy with the right of survivorship

Another option to consider is transferring ownership of the cottage directly to your children during your lifetime. You can accomplish this by transferring title into joint ownership with the right of survivorship. This means that on the death of one owner, the cottage simply transfers into the hands of the joint owner, thereby bypassing the estate and avoiding probate. In Québec, the concept of undivided co-ownership, usufruct or right of use could be used. Please note that usufruct and right of use are treated like trusts for tax purposes. The transfer of a cottage into joint tenancy or in Québec, in co-ownership, will constitute a partial disposition for tax purposes, and will generally trigger the realization of a capital gain if the property has increased in value. An exception to this would be if you transfer joint tenancy to your spouse.

Note that there may be future implications to claiming the principal residence exemption when this option is used. In addition, there will be legal and other implications to entering into a joint tenancy agreement with your children since you will no longer be the sole owner of the property. Speak to your BDO advisor and seek legal counsel before transferring title of your cottage into joint tenancy to prevent any unintended results.

Sell the cottage to your children in your lifetime

You could also consider the outright sale of your cottage to your children. Again, there will be a disposition for income tax purposes at the time that you sell the property. The capital

gain will be computed based on the fair market value of the property regardless of the price you actually sold the property to your children for, since the sale is considered to take place between “non-arm’s length” parties. Note that if you sell your cottage to your children for less than fair market value, not only will you still pay tax as though you received fair market value, but your children will have an ACB equal to the amount they paid, possibly resulting in double taxation.

Another planning strategy to keep in mind may be spreading out the gain on a sale to your children over five years. By receiving proceeds for the sale over this period, you may be able to utilize the capital gains reserve. In this way, you can spread out the taxation of the capital gain over time rather than having to pay tax on it all in one year. For more information on using a reserve for capital gains, speak to your BDO advisor.

A final word

A cottage is more than just a sum of its parts. There is that intangible element — the little bit of enchantment that transforms the cottage into a special place. It’s not surprising then that cottage owners want to see that magic extend beyond them to future generations. There are many ways in which to accomplish this goal. Bear in mind that the decision to transfer or gift a cottage to future generations is not always easy, and successfully doing so requires a commitment to consider both the emotional and financial aspects of the decision making process.

► Your BDO advisor can help you ensure that passing on the cottage doesn’t turn the place that brings your family together into the place that potentially tears them apart.

CALCULATING COTTAGE CAPITAL GAINS: HAVE YOU ACCUMULATED ALL ELIGIBLE COSTS?

If you have an ownership interest in more than one residence, you will likely have a taxable capital gain on one of your properties when you dispose of it. For many individuals that own a cottage or other vacation property, it will often be the gain on that property that is not sheltered by the principal residence exemption since the gain on their primary residence may be higher. Where the principal residence exemption is not available, the capital gain will be calculated in the usual manner — the gross gain is equal to the proceeds less selling costs and the adjusted cost base (ACB). One-half of this amount is taxable.

As there is usually good documentation for the proceeds you will receive and the selling costs if the disposition arises from a sale, the key to minimizing your gain is often related to ensuring that all eligible costs have been included in the

property’s ACB and that you have proper documentation for these costs. The chart on the next page can be used as a checklist to identify the key elements to consider when determining the ACB.

Documentation is a key element, as the Canada Revenue Agency (CRA) has been known to audit gains on second residences. Their enquiries will typically focus on the ACB calculation and the value of the proceeds where the disposition is something other than an arm’s length sale (i.e. a gift or a disposition on death). On ACB additions, the CRA will be looking for proof of the expense and why it is not a regular repair or maintenance cost.

If you have any questions on calculating a gain on your cottage, contact your BDO advisor.

CHECKLIST OF COTTAGE ACB COMPONENTS AND REQUIRED DOCUMENTATION

Original acquisition of the property

Elements from the Purchase Agreement and other costs (documented by invoices, statements and proof of payment) include:

- Purchase price of the cottage, if purchased after 1971 (contact your BDO advisor for properties owned on December 31, 1971, or if you made an election in 1994 to increase the ACB)
- If inherited or received as a gift, evidence of the value at the time of the gift or inheritance such as a valuation
- Land transfer taxes on acquisition
- Utility connection costs
- Real estate commissions
- Real estate inspections
- Legal fees
- Cost of a survey or title insurance
- Other purchase agreement disbursements, other than reimbursements to the former owner for annual costs such as property taxes and utilities that were paid before closing
- Repairs and maintenance related to properties acquired in a state of disrepair. Generally speaking, it may be possible to include costs that wouldn't ordinarily qualify in the opening ACB such as costs related to replacing a roof, buying new fixtures and plumbing, replacing flooring, etc. The key is that the state of disrepair was factored into the purchase price (i.e. the price would have been higher if the cottage was in better shape and these costs were incurred for that reason).

Improvements not directly related to the building

Make sure you include any improvements to the land that are not related to maintaining current elements. Costs could include a new septic system, a new well, a water system etc. Also, ensure that you include any improvements to the land such as correcting drainage problems, building a driveway or right of way, pathways or fixed decks and docks. Moveable items will generally not qualify (although the definition of moveable should be carefully considered from a practical perspective). Documentation needed includes invoices and proof of payment.

Renovations

Any change to the structure of a cottage that creates something that wasn't present before will generally qualify as an addition to ACB. Documentation will include invoices (including details on the nature of the work as an improvement) and proof of payment. Examples include:

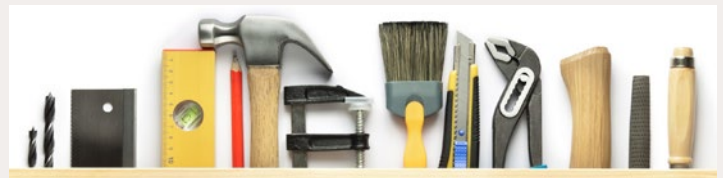
- Adding new rooms or finishing a basement
- Building a new deck or replacing an old deck with a larger deck
- Moving walls or partitions inside the structure
- Creating a new bathroom, including the cost of fixtures

Ongoing maintenance vs. building improvements

Probably the most difficult task is deciding whether repairs and maintenance costs are an ACB addition or just an ongoing expense that cannot be included in ACB. Generally, the test is whether the structure has been improved vs. just returned to a previous state of repair during your period of ownership. A good example is a new roof. If the cottage's roof was in good shape when you acquired the cottage, then there is a strong argument that just replacing the shingles is an ongoing cost. However, if you replace a roof with a different and higher quality type of roofing, then that cost could be an ACB addition. A key element to consider, in addition to having documentation similar to that described so far, will be whether the documentation highlights why an improvement was made. Other examples where an improvement may have been made include:

- New windows and doors
- New flooring and paneling
- Replacing bathroom or kitchen fixtures

A final note for those do-it-yourself (DIY) cottagers — you can't capitalize the imputed cost of your own labour for a DIY improvement, but you can capitalize the cost of the materials you used for the improvement.



The information in this publication is current as of June 1, 2013.

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