

Tax issues of owning and selling a cottage or second home

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For tax years after 2015, you must report the disposition of your residential property in the year of sale, transfer or gift, whether you are claiming the principal residence exemption or not. It, therefore, becomes more important than ever to understand the tax issues surrounding owning a second home.

Perhaps the biggest tax issue associated with a vacation property is the potential for capital gains tax upon either the sale, or gift of the property, or upon the death of the owner.

As a general rule, if you sell or gift the property while you are alive, you will be taxed on the difference between the amount you receive (the “proceeds of disposition”) and the tax cost (the “adjusted cost base” or ACB) of the property.

As you make improvements or additions to your vacation property, be sure to keep all receipts as these expenditures can be added to the ACB of the property, thus potentially reducing the amount of future capital gains.

Possible solutions

If you simply gift or leave your vacation property to a spouse or common-law partner either during your lifetime or upon death,, the property is deemed to automatically “roll over” (i.e., transfer) at its ACB and no gain will be immediately reportable.

On the other hand, parents may wish to give the vacation property to their kids. Doing so will result in an immediate capital gain if the property has gone up in value since the date of acquisition.

The best tax planning opportunity, of course, is to shelter the capital gain on the vacation home by using the principal residence exemption (PRE).

A principal residence can include your vacation property, even if it's not where you primarily live during the year as long as you, your spouse or common-law partner, or your child, ordinarily inhabit it at some point during the year.

Your cottage can be considered to be ordinarily inhabited by someone even if that person lives in that property for only a short period of time during the year (say, during the summer months) as long as the main reason for owning the property is not for the purpose of earning income.

Even if you occasionally rent it out, the Canada Revenue Agency (CRA) has stated that incidental rental income won't prevent a cottage from qualifying as a principal residence.

International homes

Note that the home does not have to be located in Canada to qualify as a principal residence. The only requirement is that the individual who claims the PRE must be a resident of Canada for each year of claim.

For example, a U.S vacation property owned by a Canadian resident may be eligible for designation as a principal residence for the purposes of claiming the PRE. Of course, whether or not that's advisable will depend on both the income and estate tax considerations of the other country.

Before 1982 it was possible for each spouse (or partner) to own a property and designate it as his or her principal residence, with any resulting capital gains being tax free upon disposition.

Since then, a couple can only designate one property between them as their principal residence for any particular calendar year. This becomes a challenge when a couple owns more than one home and is forced to choose, upon ultimate sale of one property, which one will be designated

the principal residence for each year during the period of multi-home ownership.

As a result, a conscious decision needs to be made when you sell one of your personal residential properties as to whether that property should be designated your principal residence to shelter the capital gain from tax.

Doing so will preclude you from using the PRE in the future on the sale of your other property, at least during the overlapping years.

Property values

Generally, the decision to claim the PRE when you sell your vacation property — as opposed to saving it for the disposition of, perhaps, your city home — will depend on a number of factors, including: the average annual gain on each property (the gain on each property divided by the number of years each was held), the potential for future increases or decreases in the value of the unsold property, and the anticipated holding period of the unsold property.

Non-economic factors may also come into play as you may be more concerned about a current, immediate tax liability today versus a tax liability payable later (say, upon death, by your estate) on the sale of your other property.

In the past, the CRA stated that you didn't have to report the sale of your home or vacation property if the entire gain was exempt as a result of the PRE. But the rules were changed in 2016 to require you to report the disposition of a residence on *Schedule 3, Capital Gains* and on *Form T2091(IND), Designation of a Property as a Principal Residence by an Individual* of your tax return, whether or not you intend to claim the PRE.

This means that the gift, transfer or sale of your cottage, even if fully tax exempt, will now be on

the CRA's radar, should it choose to take a closer look at the transaction.

Bottom line? Be sure to keep good records of your ACB and, in the case of transfer or gift, it may be useful to have a proper appraisal of your cottage property handy as of the date of transfer/gift to

help establish its fair market value should the CRA come knocking at your door.

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