THE GLOBE AND MAIL

TAX MATTERS

How to properly give the cottage to your kids

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The Victoria Day weekend has arrived, and for many Canadians, this means a trip to the cottage to enjoy the place – and perform some maintenance. My neighbour, Walter, is heading to his cottage in Muskoka to spend some time with his kids and grandchildren. Last year, his big maintenance project was to get rid of the old outhouse on the property. Everything went well until, later that evening in the dark, his grandson fell into the hole before it could be filled in. It was a crappy experience for sure.

This weekend, Walter is going to unveil a plan to transfer the cottage to his kids this summer. Walter is a widower, he's 78 years old, and wants to see the kids enjoy ownership of the cottage now. We talked about a few things he should keep in mind as he plans to give the kids the cottage. Here's the gist of the conversation we had.

THE TAX RULES

Any time you transfer an asset to someone other than your spouse, you'll be deemed to have sold it at fair market value. The result? You could face a taxable capital gain if the asset has appreciated in value. When Walter bought his cottage in 1985, he paid $120,000. He's added about $80,000 of capital improvements over time, so his cost amount for tax purposes is $200,000. Today, the cottage is worth $700,000. So, if he gifts the property to his kids, he'll trigger a $500,000 capital gain. The tax bill on this could be $130,500 since reporting this gain will push him into the highest tax bracket in Ontario.

THE STRATEGY

To eliminate the tax on the transfer, Walter should consider using his principal residence exemption (PRE) to shelter the gain on the cottage from tax. If he does this, he won't be able to designate his city home as his principal residence for the same years, so he could end up paying some tax on the city home.

In Walter's case, he wants to save his PRE for his city home (it has the bigger gain per year of ownership; but speak to a tax pro before deciding which property to shelter with the PRE). So, I suggested another idea to reduce the tax bill on the cottage: He could take advantage of the “capital gains reserve” in our tax law. This provision allows you to report a taxable capital gain over a period as long as five years. Sure, he’d still pay tax, but reporting the gain over five years allows him to keep that money in his pocket longer.

Further, in his case, reporting the gain over five years also results in a reduction of the overall tax bill because the amount of the capital gain reported each year will not push him into the highest tax bracket in any of those years, whereas reporting the capital gain in 2018 alone would do just that. In his case, Walter would save $10,575 in taxes by spreading the tax bill over five years.

How can he take advantage of the capital gains reserve? He’ll need to structure the transfer of the cottage as a sale at fair market value, not a gift. Further, he’ll have to ensure that he doesn’t have a legal right to the sale proceeds immediately (otherwise he’ll pay tax this year, the year of sale), but set this up so that he has a right to the proceeds only over the next five years – or longer.

So, Walter could sell the property for its value of $700,000 to the kids and take back a promissory note for that amount. The terms of the note will give him a right to demand payment of one-fifth of the sale proceeds each year for the next five years.

Walter doesn’t have to actually demand payment (so the kids don’t have to come up with the money to pay him if he so chooses), but he’ll pay tax over five years even if he doesn’t demand payment or collect the sale proceeds (five years is the longest our tax law will allow the reserve to be claimed).

Rather than taking back a promissory note, Walter could set up a mortgage on the property, which ensures that, if any of his kids’ marriages break up, he could call for payment on the mortgage. This could help to protect the cottage from becoming an asset that disappears through a divorce.

Further, Walter can forgive the promissory note or mortgage upon his death, with no tax consequences to his kids.

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