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TAX MATTERS

This cottage story comes with a potpourri of tax issues

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Chris and Jennifer are neighbours of mine who own a cottage two hours north of Toronto. Last summer, they built a new cottage at the lake because, the summer before, Chris had fallen through the floor of the outhouse on the property. Not a pleasant experience.

Let's rewind: They bought the property back in 1985 when it had no buildings on it – just the outhouse. In 1988, they built a small cabin on the property which they had intended on replacing with a bigger cottage anyway (the outhouse incident accelerated those plans). This year, they're renting out the smaller cabin on the property for some income, which they plan to do every year now.

Now, another opportunity has come up. The property next door at the lake is up for sale and Chris and Jennifer would like to buy it. They want to keep their current cottage and give it to the kids in the next few years, and use the property next door for themselves. Chris just sold a business and has come into some money that can be used to buy that next-door cottage. All of this raises the question: Will any of this affect their taxes? Yup. There's a potpourri of tax issues here. Let me share the highlights.

Principal residence: First, it's possible to designate a second property – such as a cottage or cabin – as your principal residence if you ordinarily inhabited the place. This will allow use of the principal residence exemption (PRE) to shelter all or part of any gain on the property from tax. In this case, Chris and Jennifer owned the property for three years (1985 to 1988) while it was vacant land. The result? They won't be able to designate the property as a principal residence for those years, so if they ever sell or transfer the property and there's a capital gain, they will not be able to shelter the full gain from tax.

Change in use: This year, they started renting out the smaller cabin on the property. Any time you change the use of a property from personal use to an income-producing use, you'll be deemed to have sold the property at fair market value and to have reacquired the property at that same value on the date of the change. Since the property has appreciated in value, there will be a capital gain for Chris and Jennifer. They can use their PRE to shelter some of the gain, but not all of it, for the reasons I mentioned above.

Taxable transfer to the kids: They want to give the kids ownership of the cottage in the next few years. Transferring ownership to someone other than a spouse creates a disposition at fair market value. So, there could be tax to pay on a gain at the time of the transfer. They might consider waiting until they pass away to have the transfer made (to defer the tax). If they insist on transferring ownership during their lifetimes, there's a way to spread the tax bill, if any, over five years. Here's how: They can sell (not gift) the property to the kids at fair market value. The kids can pay for the cottage by way of promissory notes (not cash) that will be due upon demand, but over a five-year period of time. Since Chris and Jennifer won't have the legal right to collect payment except over five years, they can spread the tax liability over five years using something called the "capital gains reserve" in our tax law. In reality, they'll probably choose not to demand payment on the notes (but they'll still pay tax over five years) and those notes will be forgiven upon the death of the second of Chris and Jennifer. So, the transfer is effectively a gift to the kids.

Buying the new place: The money to purchase the new cottage is currently in Chris's holding company. He thought about buying the cottage in the corporation, but doing this would preclude use of the PRE to ever shelter gains on the property from tax. It may be better to either (1) borrow the money from his corporation (with bona fide terms of repayment), (2) extract the money from his corporation tax-efficiently to use for the purchase (perhaps by way of a tax-free capital dividend; more on this another time), or (3) borrow the money personally to make the purchase and pull money from the corporation over time to make the payments on the debt.

In all of this, advice from a tax pro is critical.

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