TAX MATTERS

Ten tax issues and opportunities with your cottage to watch out for

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Family cottages can present surprises sometimes. I recall a few years ago that some thieves stole a steel bridge that connected an isolated cottage to the main road nearby. It's not exactly the kind of surprise you want to experience when you arrive at the lake for the weekend. You probably also want to avoid surprises when it comes to your cottage and taxation. Here are 10 tax issues and opportunities that cottage owners should be aware of.

1. Designate a principal residence. If both your city home and cottage appreciate in value, you'll have to eventually make a decision about which property to shelter from tax using the principal residence exemption. Normally you'd shelter the property with the biggest capital gain per year of ownership. But speak to a tax pro before making a final decision.

2. Track your capital improvements. Since you may face tax on the cottage when you sell, gift, or change the use of the property, or pass away, you should track all of the major improvements you make. Keep your receipts. You can add capital improvements to the adjusted cost base (ACB) of the property, which can reduce a taxable capital gain later. Do the same for your city home.

3. Remember the $100,000 exemption. Before February, 1994, there was a $100,000 capital gains exemption available to shelter gains on many assets, including the cottage. Before repealing that exemption, the taxman allowed Canadians to make an election on their 1994 tax returns to "bump up" the ACB of those assets by $100,000. If you did this in respect of your cottage, make note of it (get a copy of your 1994 tax return from Canada Revenue Agency at 1-800-959-8281) and let your executor know about this, too.

4. Shelter certain gains on two properties. A family unit (spouses and unmarried minors) can only claim one principal residence exemption. But prior to 1982, each individual was entitled to an exemption. Today, it's still possible to shelter pre-1982 gains on more than one property – including the cottage. Speak to a tax pro about how to do this properly.

5. Defer tax on a transfer. If you give the cottage to the kids, you'll be deemed to have sold the property at fair market value. This could trigger a tax bill. But it's possible to spread the tax over five years. How? By selling the cottage to the kids at fair market value and taking back a promissory note for the value, with terms that spread the requirement to pay over a five-year time frame. You don't have to actually collect the proceeds (you can forgive the note, or part of it, on death with no tax consequences), but you'll face tax over five years rather than one year. Get the help of a tax pro here.

6. Changing the use of the property. If you change the use of a property from personal use to income-producing (turning it into a rental property, for example) or vice versa, you're deemed to have sold the property at fair market value. This could trigger tax. If you turn the cottage fully into a rental, visit a tax pro to talk about minimizing the tax hit.

7. Selling the cottage below fair value. Selling the cottage to the kids for less than fair market value is a bad idea. You'll be deemed to have sold it for fair market value anyway, but your kids will have an ACB that is equal to the lower price they actually pay. The result will be double tax on the difference between those two amounts. Instead, sell it at fair market value, then take back a promissory note (that the kids never have to pay, and you can forgive on death) for part of the purchase price, to effectively give them a price break.

8. Writing off some maintenance costs. You can't normally deduct mortgage interest, property taxes, insurance, utilities, and routine repairs and maintenance costs on the cottage. But if you choose to rent out the cottage for part of the summer, then you'll be able to claim a portion of these costs against that income. You won't run into a problem under the "change in use rules" (see above) if the property is still primarily for your own use and benefit.

9. Watch for U.S. estate taxes. If your cottage is located in the United States, you may have U.S. estate tax exposure if your worldwide estate is greater than $11.4-million (in 2019). This threshold could be reduced after 2025 when the current rules are scheduled to change.

10. Donate ecologically sensitive land. If you're interested in conservation efforts, or for those with no apparent heirs, you can gain special tax breaks by donating the cottage if the property is considered to be ecologically sensitive land. Speak to a tax pro for more.

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