

Cottage FINANCIAL DISASTERS Can Be Prevented

Rule #1:

Talk to lawyers and accountants that are knowledgeable in tax before selling any property

In Canadian tax discussions, PRE usually stands for Principal Residence Exemption. The Principal Residence Exemption allows you to avoid paying capital gains tax on all or part of the increase in value of your principal residence when you sell it.

For example:

- You buy a home for \$300,000.
- Years later, you sell it for \$600,000.
- The gain is \$300,000.

If the home qualifies as your principal residence for all the years you owned it, the entire \$300,000 gain may be exempt from tax.

Bob and Tanya were gifted the family cottage from Bob's parents at West Hawk Lake in 1972. Its value when they inherited it was \$50,000 and it is currently valued



at \$850,000. Ten years ago, they sold their jointly owned, modest condo in Winnipeg and did not report the gain. They are deemed to have used their Principal Residence Exemption (PRE) on that condo. The condo only had a capital gain of \$100,000, which would have caused tax, at most, of \$12,500 each. They should have paid tax on the condo and saved the PRE for their cottage, but they didn't talk to a lawyer or accountant

knowledgeable in tax.

They had the common misconception that the PRE was only available on their primary residence. They thought you must live in the cottage full-time to claim the PRE. This is incorrect — you just have to own it for two years and stay there one day per year. The Principal Residence can be a residence in Florida, a condo in British Columbia, a cottage on Lake of the Woods, or even an affixed trailer!

Bob and Tanya want to transfer the cottage to their two children. Bob and Tanya didn't keep receipts for their capital expenses and repairs on the cottage so the capital gain on the cottage may be more than it should be. Assuming the survivor of Bob and Tanya dies in 2028, capital gains tax will have to be paid (over \$165,000 in tax) and that may cause their children to have to sell the cottage. Had they saved their PRE for the cottage and paid tax on their condo, they could have saved over \$140,000 of tax!

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What should they have done differently?

- 1** Talk to lawyers and accountants that are knowledgeable in tax before selling ANY property.
- 2** Keep ALL receipts for everything you do for all your properties including house, vacation home, cottage, condo, etc.
- 3** Categorize your receipts into those that are capital in nature and those that are not.
Examples of things that ARE capital in nature: roof, landscaping, dock, road, siding, decks, built in appliances, boathouse, garage, wall to wall carpet
Examples of things that are NOT capital in nature: boats, water toys, moveable appliances, lawnmowers, snowblowers, furniture
- 4** Be aware that you are deemed to have sold all your assets on death at fair market value with the exception of a tax-free rollover to a spouse (or some farmland to children). Thus, capital gains tax will have to be paid on the death of the surviving spouse.
It often makes a lot of sense to transfer one property sooner – either by gift or sale to a child or children – in order to halt this ever-mounting increase in capital gain accrued on the cottage. You can keep control during your lifetime by retaining a life estate which is a very simple concept and not expensive to implement.
- 5** Make sure your will is updated and specifically deals with the cottage if you decide not to transfer sooner.
Consult your children – do they want the cottage? Can they share it with the other siblings? What will the rules be? Don't transfer to those that won't use it as that never works. Consider setting up a cottage repair and "tax fund" in your will.

Be proactive and plan today — you will save yourself and your family significant grief and potential strife and may save a lot of money that would otherwise go to the CRA.

Mona Brown has been practising vacation home planning since 1980. 

Contact Mona Brown and/or Stéphane Warnock at PKF Lawyers today to start your cottage planning process:

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