

## Cottage Succession

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By Clinton Orr

Every spring and summer, many Manitobans head for the cottage. The cottage can be a great place to relax and enjoy time with friends and family. Unfortunately, if you intend to sell your cottage or pass it to the next generation, there could be some tax consequences. Let's cover a few ways to help minimize the tax hit.

First, what is the tax bill for the cottage? In Canada, there is a principal residence exemption. That means the home we deem as our principal residence can be sold without paying any tax. However, if we own two properties, say a house in town and a cottage, one of those properties will be taxed when it's sold. To be clear, the second property does not have to be a cottage - a second home, a condo, or a vacation property all fall into that category. The main tax on the second property is capital gains. The price you pay for the cottage and any major renovations are added together to form your adjusted cost base (ACB). The amount by which the sale of the property exceeds your ACB is your capital gain. Half your capital gain is tax free, the other half is added to your income and taxed at your marginal tax rate. So, if you paid \$100,000 for your property and you sell it for \$300,000, you have a \$200,000 capital gain. \$100,000 of that gain will be tax free, the other \$100,000 will be added to your income. So, if your income is usually \$40,000, the year you sell the cottage, your income will be \$140,000 and taxed accordingly. If you don't sell the cottage but decide to pass it down to the next generation, when you pass away there is a deemed disposition, which means even though you don't sell the cottage, the government is going to treat the change of ownership like a sale and tax you on it. So, your estate and beneficiaries will have to deal with the capital gains tax.

### **Boost your cost base**

So how do we minimize the tax on your cottage? One way is to boost your ACB. Any major renovations that materially upgrade or improve your cottage can be added to your ACB. The larger your ACB, the smaller the capital gain, which means you pay less tax. It is important to note that not all renovations can be added to your ACB. If your deck is old and you fix it up, that does not count. Regular maintenance and repairs cannot be added to your ACB.

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Only enhancements or additions to the property can be added. For example, if your cabin did not have a deck and you build one, that can be added to your ACB. As well if the cottage was only a seasonal cottage and you winterized it, that would count. It is a good idea to have some data to back up your numbers, so keep your receipts! It is also worthwhile to chat with your accountant to ensure you are only claiming appropriate expenses as part of your ACB.

### **Principal Residence Exemption**

Cottage properties have jumped in value recently. It is possible that your cottage now has a larger pending tax bill than your home. You do not have to live at a residence permanently for it to be your principal residence. You can designate your cottage as your principal residence. Typically, the calculation to determine which property should be designated your principal residence is based on the tax bill. Usually, we calculate the expected capital gain for each property and then average that amount based on how long you have owned the property. So, the property with the largest per year capital gain should be deemed your principal residence. That way your principal residence exemption will be used in a manner that saves you the most tax.

### **Using a promissory note**

This strategy is not for everyone. If you sell the cottage to your kids, it is possible to create a promissory note that allows your children to pay you over five years. So, instead of having to claim the capital gain as a lump in one year, it is broken up over five years. Spreading out the capital gain can lower your total income and lower your overall tax bill. This strategy is more complex, and it is a good idea to talk with your lawyer and accountant before implementing.

The above is barely the tip of the iceberg when it comes to cottage succession. What if you sell your home and then move to the cottage? What if you add one of your kid's names to the title now? If you have a corporation can you put the cottage in there? Can life insurance be used to ease the tax burden? There are lots of ways to structure a cottage succession plan. I believe the key is to talk to your family and ensure everyone is on the same page! Then, chat with your financial professionals and set up a plan that fits your situation.

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