

The Cottage & the Cost

By Tracy Broeze, CFP

It sounds like the title of one of Aesop's Fables. How can the idyllic summer retreat that our parents worked so hard for, the cottage that the whole family has enjoyed for so many years, be a cause concern?

As we all know, there are two certainties in life: 'death and taxes'. The cost that I refer to in the title is triggered by both of these inevitable events. If a couple own a cottage and one spouse passes away, the cottage may roll tax free to the survivor. At the second death, the family cottage could become a huge tax liability to the estate. This liability is also present if the cottage is sold or gifted. There's no avoiding the tax man.

The amount of the tax liability at any of these events is determined by the difference between the amount received for the cottage or the current market value and the adjusted cost base (ACB). The adjusted cost base is established by a combination of the amount actually paid for the property when originally purchased plus the value of all improvements and renovations made to the property. Because these expenses trim down the tax bill, make sure that copies of all receipts are kept on file. This amount is then subject to capital gains tax. Essentially 50% of the amount of the capital gain is taxed at the effective tax rate of the seller, giftor, or the estate, whichever the case may be.

There are several ways to address this looming tax liability. The capital gain on a cottage can be reduced in some cases by strategic use of the principle residence exemption, but only with careful planning. Comparisons must be made to properly evaluate how to most advantageously apply the exemption. There is also the added complexity of the amount of land surrounding the cottage since the principle residence exemption is not extended to land over ½ hectare, (about 1.2 acres). This is why it's often difficult to predict the final tax bill.

The option of selling or gifting the cottage to the kids brings with it a few drawbacks. If the cottage is sold or gifted, the taxes will be due the following April. This may be manageable if the amount received from the property is sufficient, but what if the kids, as much as they would love to keep the cottage in the family, can't afford to buy it? Gifting the cottage will still cause the tax bill but won't provide capital to cover it. The other consideration is the cost of upkeep: can the kids afford to maintain the property? Probably even more important is control of the asset: are Mom and Dad ready to let the kids have control of their summer haven?

Another option is to defer taxes until absolutely unavoidable. As mentioned, the ownership of the cottage can be rolled on a tax free basis to the surviving spouse. The capital gains tax is payable at second death. Will there be enough left in the estate of the survivor to cover the tax bill or will the cottage have to be sold out of the family to cover the tax? If there are several children, there may be differing ideas on this. Perhaps there are some members of the family who don't use the cottage and want it sold. This can be greatly complicated by family dynamics. Many are in their second marriages with children from their first. What if the heirs divorce their spouses? Ownership of the cottage can become fragmented beyond reason and maneuverability.

Many of these problems can be addressed in advance by frank and open discussion with sound financial planning. Everyone needs to be involved in the decision-making early. If paying the tax bill is a worry and your health is good, insurance may be the perfect solution, perhaps even providing enough for maintenance of the cottage for a few years as well. If you don't need the added cash or your health isn't good, there are other ways to manage but it's clear that this isn't something that can be put off indefinitely. It's also clear that the best and most appropriate planning can only be done after much thought and discussion with assistance. Advance planning with an experienced professional is the only way to minimize tax and, perhaps more importantly, stress.

And isn't reducing stress the reason the cottage was bought in the first place?