BEST TAX OPTIONS TO TRANSFER THE COTTAGE TO KIDS

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With spring upon us, many Canadians will soon be opening their cottages for the summer. The family cottage is a hot topic, especially when discussing options for transferring it to the next generation tax-efficiently. While there are several strategies to consider, there are also general pitfalls that could apply to these transfers.

WHY SELLING FOR LESS THAN FAIR MARKET VALUE ISN'T FAIR

In many cases, an adult child doesn't have the money required to buy the family cottage from the parents. In an effort to help the child—and where parents don't need the money to fund retirement—parents might consider selling the cottage to the child for nominal value, or an amount substantially lower than fair market value (FMV). This is problematic from a tax standpoint, however, as it may result in double taxation.

Here's why. For tax purposes, regardless of the purchase price when parents sell the cottage, they're required to pay tax on the capital gain, calculated as the difference between the property's adjusted cost base (ACB) and FMV. The child's ACB is determined by the purchase price, which may lead to the child paying tax on a capital gain when the child sells the property—tax the parents had already paid.

Let's assume the father, Michael, sold the family cottage to his daughter Jennifer for $1 when the cottage actually had an FMV of $1 million and an ACB of $500,000. Regardless of the purchase price, Michael's capital gain is the same: $133,825. See Table 1.

Table 1: Parent's tax liability on cottage sale

Calculation figures for capital gain	Values for Michael
FMV	$1,000,000
ACB	$ 500,000
Capital gain	$ 500,000
Taxable capital gain (50%)	$ 250,000
Capital gains tax payable (53.53%)*	$ 133,825

* Assumes top personal tax rate for Ontario and that Michael can't use the principal residence exemption

Selling the property to Jennifer for $1 results in her ACB being $1 rather than the property's FMV. If she sells the property in the future for $2 million, she'll have a substantial capital gain—more than half a million dollars. See Table 2.

Table 2: Child's tax liability on cottage sale

Calculation figures for capital gain	Values for Jennifer
FMV	$2,000,000
ACB	$1
Capital gain	$1,999,999
Taxable capital gain	$999,999.50
Capital gains tax payable (53.53%)*	$535,300

* Assumes top personal tax rate for Ontario and that Jennifer can't use the principal residence exemption

By selling the cottage to Jennifer for $1, Michael assumed he was helping her, but instead he has done her a disservice. If she were to sell the property for $2 million, she'll be subject to a capital gain of $1,999,999. Further, this results in double taxation on Michael's capital gain of $500,000.

What other options are available?

GIFTING THE COTTAGE

Michael can gift the cottage to Jennifer instead. He'll pay capital gains tax on the difference between the ACB and FMV of the cottage as he did above. The benefit is that Jennifer's ACB will now be the cottage's FMV. As a result, if she sells the cottage for $2 million, her capital gains tax will be substantially lower than if she bought the cottage for $1. See Table 3.

Table 3: Child's tax liability on gift received

Calculation figures for capital gain	Values for Jennifer
FMV	$2,000,000
ACB	$1,000,000
Capital gain	$1,000,000
Taxable capital gain	$500,000
Capital gains tax payable (53.53%)*	$267,650

* Assumes top personal tax rate for Ontario and that Jennifer can't use the principal residence exemption

USING THE CAPITAL GAINS RESERVE

Gifting the cottage is a better option for Jennifer, but Michael still must pay capital gains tax of $133,825, which is a substantial amount to pay in one year. Michael may want to consider using the capital gains reserve as a way of spreading the capital gain (and resulting tax liability) over time. As long as Michael doesn't receive (or become entitled to receive) the full proceeds of the cottage sale in any one year, the Income Tax Act allows him to spread the realized capital gain on the sale over a maximum of five years.

To accomplish this, Michael would sell the cottage at FMV, and Jennifer would pay for it with a promissory note (which can later be forgiven—more on that in a bit). The promissory note must be structured so that Michael isn't able to collect more than 20% of the sale proceeds each year over the next five years.

In this situation, Jennifer isn't required to come up with the money to purchase the cottage, and, since no money exchanges hands, Michael can spread the capital gain over a maximum of five years.

CRA's position is that a reasonable reserve may be determined by the following formula:

Reserve = (Capital gain ÷ Proceeds of disposition) × Amount payable after year's end

Reserve calculations for this case are shown in the table below:

Tax year	Reserve
2018	($500,000 ÷ $1,000,000) × $800,000 = **$400,000**
2019	($500,000 ÷ $1,000,000) × $600,000 = **$300,000**
2020	($500,000 ÷ $1,000,000) × $400,000 = **$200,000**
2021	($500,000 ÷ $1,000,000) × $200,000 = **$100,000**

Table 4 shows an example of how the capital gains reserve would work if Michael sold the property to Jennifer in 2018 and is able to take advantage of the capital gains reserve.

Table 4: Using capital gains reserve to spread tax liability over five years

Tax year	Capital gain left to report ($)	Reserve ($)	Maximum reserve	Capital gain reported ($)	Taxable capital gain ($)	Income tax ($)
2018	500,000	400,000	80%	100,000	50,000	26,765
2019	400,000	300,000	60%	100,000	50,000	26,765
2020	300,000	200,000	40%	100,000	50,000	26,765
2021	200,000	100,000	20%	100,000	50,000	26,765
2022	100,000	–	–	100,000	50,000	26,765
				$500,000	**$250,000**	**$133,825**

Instead of a tax liability in one year of $133,825, Michael has a tax liability of $26,765 over five years, which is more manageable and could also put him in a lower tax bracket.

It’s important to note that Michael will realize one-fifth of the capital gain each year over five years regardless of whether he collects the money from Jennifer or not. In his will, Michael can forgive the promissory note so Jennifer isn’t required to come up with the money to purchase the cottage. If Michael passes away before the full amount of the capital gain has been realized, the balance will be taxable in his terminal return.

So far we have talked about the capital gains reserve being used with a cottage, but it can also be used with other capital property where sale proceeds are collected over a maximum five-year period.

With cottage season fast approaching and clients considering how to pass the cottage to the next generation, now is a great time to speak with them about potentially using this strategy. Consult a tax professional who can assist with implementation.