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TAX MATTERS

Strategies to consider when buying a second property

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My friend Joel has been looking to buy a second property. Something he can use when he wants to but can rent out when he's not at the place.

"Tim, I'm looking for a property with at least 30 acres, with rolling hills, a stream and pond but within walking distance of theatres, shops, great restaurants and night life."

"Sure Joel, and I'd like my car to fly and make me breakfast," I replied.

"I think they're working on that," he said. I've been writing these past two weeks about buying real estate. Today, I want to finish the conversation with some ideas about three common types of second properties: cottages, income properties and U.S. real estate.

COTTAGE PROPERTIES

If you've been looking to buy a property in cottage country in the past 18 months, you'll know that prices have risen dramatically. I've spoken with several

people who are intent to find a place away from the city.

My first observation is that cottages and cabins are an emotional thing. Sometimes, emotional decisions trump financial ones. If you're looking to buy a place, I understand that the memories and experiences attached to a cottage, or the prospect of these, may outweigh the financial considerations of buying today. And that may be okay – as long as you're not putting yourself on difficult financial footing.

If you're going to keep a cottage in the family for many years, you'd be wise to create a cottage agreement that, once ownership transfers to the kids, will guide the sharing of the cottage among family members. This type of agreement is to cottage owners what a shareholder's agreement is to business owners. It will guide decisions around costs of maintenance, responsibility for upkeep, use by visitors, when to sell the property and more. (Check out my article, "[A cottage agreement can make sharing a summer home simple](#)," dated May 21, 2020.)

The vacation retreat generally can qualify as a principal residence, so you may be able to shelter any gains on the property from tax when you sell, transfer the property or pass away. But you should visit a tax professional to talk this over.

If you want to own a property, consider these strategies first

This is how the principal residence rule works for Canadian homeowners

INCOME PROPERTIES

Perhaps you've heard that income-producing properties are an "IDEAL" investment. The acronym IDEAL stands for:

- **Income:** A rental property can produce income that can fully replace or simply supplement other sources of income – and this income opens the door to claiming many types of tax deductions.
- **Depreciation:** If you own an income property, you can shelter part of the income by claiming capital cost allowance (CCA, or depreciation) for tax purposes – a sizable deduction amounting to between 4 per cent and 10 per cent of the undepreciated cost of your property each year. If you sell the property for a sizable profit later, you might have to recapture (include in your income) some of the CCA claimed in the past, so talk to a tax pro about it.
- **Equity:** If you borrow money to buy a property, it's sort of like a forced savings plan. With every

mortgage payment you make, the amount you owe to the bank declines, and therefore your equity in the property increases.

- **Appreciation:** It's expected that a property will appreciate in value over the long term. There's no doubt that some years will be better than others, and some years may see price declines, but over the long run, it's fair to expect your net worth to improve as real estate prices rise.
- **Leverage:** There aren't many assets that you can purchase with borrowed money to the same extent you can with real estate. It's not uncommon to borrow 75 per cent of the cost when investing in an income property. This allows you to use OPM (other people's money) to create wealth for yourself over time.

U.S. PROPERTIES

If you want to buy a property in the United States, you should get some tax advice. You'll want to avoid U.S. estate taxes at the time of your passing, so it could make sense to set up a trust to acquire the property.

You should also educate yourself on the "substantial presence test" in the U.S., which could complicate your life by requiring you to file tax returns south of the border if you spend too much time in the U.S. – although in most cases you won't have to file more than one U.S. tax form – Form 8840, "Closer Connection Exception Statement for Aliens" – which simply confirms to the U.S. Internal Revenue Service that you have a closer

connection to Canada and are not required to file a full U.S. tax return.

Finally, if you're going to be renting out your U.S. home for any part of the year, this opens up a number of other tax filing requirements on both sides of the border that you should speak to a tax pro about.

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