THE GLOBE AND MAIL

CESTNICK

TAX MATTERS

How to make cottage life more affordable and save tax dollars too

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I've always taught my sons that they should give up their seat for a lady, even at the outhouse at the cottage. We had an outhouse there long ago, but I never once saw a lady enter it. It might have been the décor. We had soap on a rope as an air freshener, a can of raid on the floor and a toilet seat hanging on the wall framing a picture of Johnny Cash. I miss that place.

Like many Canadians who own a cottage or cabin, we've made improvements to the property over time (including removing the outhouse.) Making improvements today and covering the annual costs of ownership has become a financial burden for many families. Today, I want to share some ideas to help you cover your costs and save tax if you eventually sell.

While you're an owner

1. Rent out the cottage. If you rent your cottage for even a couple of weeks each year, you might be surprised at how much money you can make to help cover costs. Keep in mind: You'll have to report your rents, but you'll also be entitled to a deduction for a portion of your costs of upkeep (don't claim depreciation – capital cost allowance – if you hope to preserve the ability to fully use the principal residence exemption on the property later). Second, if you rent out the cottage more than just occasionally – that is, if the property becomes primarily income-producing – then you'll be deemed to have disposed of your cottage at fair market value upon the change in use. This can trigger a tax bill on any capital gain. You may be able to reduce or eliminate the tax by using your principal residence exemption (PRE). The rules are complex, so speak to a tax pro.

2. Sell off excess land. A friend owns a cottage with much more property than he needs to enjoy the place. Given the big increase in value, he's decided to subdivide and sell part of the property. This will provide cash for some renovations and to buy a new dock. It may be possible to sell a portion of the land and use the PRE to avoid tax on the sale. A principal residence is defined as the actual building on the property plus the surrounding land that's considered necessary for the use and enjoyment of the cottage as a residence. Generally, land in excess of half a hectare (about 1.24 acres) is not considered eligible for the PRE, but where it can be shown that the land was necessary for the use and enjoyment of the cottage (perhaps the property was subject to zoning laws that previously prevented it from being subdivided, for example), then the land may qualify to be sheltered from tax using the PRE.

When you sell

If you eventually sell the property, consider reducing the taxes in the following ways:

3. Use your principal residence exemption. The PRE is, of course, the exemption that allows you to sell a residence on a fully or partially tax-free basis. To qualify as a principal residence, you (or your spouse, common-law partner or child) need to "ordinarily inhabit" the cottage. There's no definition in our tax law for what it means to ordinarily inhabit a place, but if you live in the cottage for a "short time" each year the Canada Revenue Agency will generally accept it as a principal residence. Renting out the cottage so that this activity is ancillary to the primary use of the cottage as a residence won't jeopardize your PRE. This generally means that you should avoid renting the cottage for more than half the time that it's available for use.

4. Track your adjusted cost base. A capital gain on the sale of your cottage is calculated as its fair market value less your adjusted cost base (ACB). If you aren't going to fully shelter from tax a capital gain using your PRE, you'll want to maximize your ACB to reduce the capital gain subject to tax. You can do this by keeping records of your original acquisition costs including the purchase price (or the value at the time you received the property as a gift or inheritance), land transfer taxes, utility connection costs, real estate commissions and inspection costs, legal fees, cost of a survey or title insurance and other purchase agreement disbursements. Also, keep records for any improvements or renovations. These might include things like a new septic system, well, water system, building a driveway, correcting drainage problems, building a deck or dock, changes to the structure of the cottage itself or other costs that are not related to simply maintaining existing items.

See my article from last week on how the PRE interacts with the new proposed capital gains tax changes.

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