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TAX MATTERS

Selling a cottage will take more careful planning under new tax rules

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Ah, yes – cottage season. My neighbour, Richard, was at his cottage fishing last weekend. His wife, Wendy told me that, "If you give a man a fish you'll feed him for a day. If you teach a man to fish, you'll get rid of him for the whole weekend." But as much as they enjoy the cottage, they're planning to sell it in two or three years. Given the proposed changes to the capital gains inclusion rate, there's lots for them to consider. Let me explain.

The Issues

Wendy and Richard own their city home worth $1.5-million (which cost them $500,000 15 years ago), and the cottage worth $1-million (which Wendy inherited 10 years ago when it had a value of $400,000 – which is her adjusted cost base).

They can designate either property as their principal residence, and claim the principal residence exemption, or PRE, to shelter from tax the capital gain on the property designated. Normally, it makes sense to save the PRE for the property with the largest capital gain per year of ownership – which would be their city home.

When Wendy sells the cottage, she could pay tax on the $600,000 capital gain. If she sells on or after June 25 – which is the plan – part of her capital gain (the amount in excess of $250,000) will be two-thirds taxable. The first $250,000 of the gain will be one-half taxable (see my article from April 17 for more details).

Under the current rules, she'd owe $160,590 in taxes on the sale of the cottage (assuming the highest marginal tax rate in Ontario). If she sells on or after June 25, she'll face a tax bill of $191,816 – a full $31,226 more. As an aside, it can make sense to pay taxes earlier at a lower rate than later at a higher rate if you're likely to sell in the next three to four years anyway. (You can do that by actually selling, or by gifting or transferring the asset, most commonly to another person, corporation, or trust.) So, what should Wendy do?

The Options

Wendy has a few options to consider:

- **Use the PRE:** Wendy could sell the cottage in a couple of years and shelter the full capital gain using her PRE. She'd pay no tax, so the two-thirds inclusion rate won't hurt her. The problem? When they sell their city home, they wouldn't be able to shelter the full capital gain from tax because they would have already designated the cottage as their principal residence for many of the years where the city home and cottage ownership overlapped. They'd be wise to save the PRE for the city home.

- **Sell before June 25:** Wendy could sell the cottage before June 25, so that she faces tax at the lower 50-per-cent inclusion rate on the entire capital gain. But they're not ready to sell today. Besides, the short time frame between now and June 25 would make it tough to sell the property at an amount above a fire-sale price.
- **Transfer before June 25:** Wendy could transfer the cottage to Richard as a gift before June 25, and elect for the transfer to take place at fair market value, which could trigger the unrealized capital gain before the change in the inclusion rate. The couple would still have use of the property, but Wendy would have to come up with $160,590 by next April to pay the taxes for 2024.
- **Transfer over time:** Wendy could also wait until after June 25, and gift half the cottage to Richard early next year, elect to realize a $300,000 capital gain, and then gift him the other half the following year, realizing the other $300,000. Most of the capital gain each year ($250,000 worth) would be eligible for the lower 50-per-cent inclusion rate. The $50,000 balance of the capital gain each year would be subject to the higher inclusion rate. She could simply pay the extra tax ($8,922 in total over two years) on that $50,000 annual gain if she chooses.
- **Transfer and PRE:** Finally, she could transfer the cottage to Richard as in the last option, but could reduce the $300,000 capital gain each year to under $250,000 by using the PRE for just part of the capital gain on the cottage (I won't get into the mechanics, but doing this will effectively preserve the PRE for the city home later since she'll only need to designate the cottage as her principal residence for one year). This option will allow her to take advantage of the 50-per-cent inclusion rate on the current capital gain without having to do anything before June 25.

As you can see, the interplay between the PRE and the new capital gains inclusion rate will complicate your tax planning, but there are still opportunities to take advantage of the current 50-per-cent inclusion rate if you plan properly.

Tim Cestnick, FCPA, FCA, CPA(IL), CFP, TEP, is an author, and co-founder and CEO of Our Family Office Inc.
He can be reached at tim@ourfamilyoffice.ca