



CESTNICK

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TAX MATTERS

# Clever planning can make a cottage transfer tax-smart

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Every summer my kids try to convince me to try some new extreme sport. Kite surfing is on their list this summer. I suggested cheese rolling instead (an activity dating back to 15th-century England where participants run down a steep hill chasing a wheel of cheese). Getting their father to take part in an extreme sport is a game they call “Let’s see if we can get our inheritance early.”

And speaking of early inheritances, my friend Mark has decided to transfer ownership of his cottage to his kids very soon. Both of his children use the cottage and the plan is to keep the property in the family long-term. He wants to see them learn to co-own and share the cottage while he’s around. His initial thought was to sell the cottage to his children for a very low price. We talked about the best way to structure all of this.

## The issues

A few things come to mind here. First, there are tax issues around the transfer of the cottage to the kids. Mark wants to sell the cottage to his kids at a price of just \$100,000. It’s an amount the two kids

can afford – just \$50,000 each. The problem is that our tax law will deem Mark to have sold the cottage to the kids at fair market value – which is \$1.5-million. He paid \$300,000 for the place years ago. This will trigger a \$1.2-million capital gain on the sale to the kids.

As you’re probably aware, the capital gains inclusion rate increased on June 25 for gains over \$250,000 for individuals. So, if Mark sells the cottage to the kids, the first \$250,000 of the capital gain will be subject to a 50 per cent inclusion rate, while the balance will be two-thirds taxable.

To make matters worse, the adjusted cost base to the children will be just \$100,000 – the selling price. So, if the kids were to sell the property later, they’d pay tax on any proceeds over \$100,000. This is a double tax problem, because Mark will have already paid tax on the gain in value from his cost of \$300,000 to the fair market value of \$1.5-million.

Finally, there’s a non-tax, or governance, issue to consider. The kids will need to agree on how to share everything from

time at the cottage, to maintenance costs, and will need to have a mechanism for making decisions around the cottage if they can't agree on things. Just as there's a solution to the tax issues I've raised above, there's also a solution for the governance issue.

### **The solutions**

Mark can structure the transfer to the kids differently. One option is to give – not sell – the cottage to the kids. This will still trigger a capital gain in the year of the transfer, but the adjusted cost base for the kids when they sell it at some future point will be the current fair market value of \$1.5-million. This would prevent the double tax problem I mentioned. But there is still the problem of Mark having to pay tax on most of the capital gain at the two-thirds inclusion rate. That can be solved too.

Mark could, instead, sell – not give – the cottage to the kids for the full fair market value of \$1.5-million. He could take back promissory notes, or a mortgage, from the kids for the balance owing. Mark could then forgive all or a portion of the balance owing on the cottage at the time of his death, with no negative tax consequences.

I like this last alternative best because Mark can choose to be paid some cash – or no cash – for the sale to the kids, with the balance being forgiven on his death. Further, since he's not collecting the full \$1.5-million in sale proceeds in the year of the sale, he'll be able to claim a capital gains reserve under our tax law. This allows a taxpayer to pay tax on a capital gain over a period as long as five years when the sale proceeds are not fully collected in the first year.

If Mark were to pay tax on his capital gain over a five-year period of time, this would be \$240,000 per year for five years (\$1.2-million divided by five years is \$240,000 per year). Since the first \$250,000 of capital gains each year is subject to an inclusion rate of just 50 per cent, Mark would be able to take advantage of this lower rate on the entire capital gain resulting from the sale to the kids.

Finally, Mark is going to work with the kids to create a cottage agreement, which will address the governance issues around how the property will be shared (see my [article](#) from May 21, 2020, for more).

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