



CESTNICK

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TAX MATTERS

## Tax tips and traps you should know about if you own a cottage

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Finally, cottage season is here. Last year, my wife's sister and her husband – Janice and Peter – came to visit our cottage on Victoria Day weekend. I said to them “We're glad you're here! Our cottage is your cottage – make yourself at home!” Peter said “Thanks! In that case, it would be great if you guys could pack up and leave. We don't really want visitors.”

Okay, the truth is that we love having friends and family visit. As for the taxman, we don't really want him showing up – but he does. Today I want to share some tax tips and traps that come up when you own a cottage. Let's jump to it.

### Renting the cottage

Renting the cottage to others can make good sense for a couple of reasons. First, given how much you can earn a week by renting it, the idea is tempting. Cottages can commonly fetch between \$1,500 and \$3,000 a week – and much more for some places. This can go a long way to help pay for cottage-related costs.

Second, you'll have to report your rental income, but you can deduct a portion of all kinds of costs you're paying for anyway – such as property taxes, insurance, utilities, repairs and maintenance, and mortgage interest. And don't forget vehicle costs to visit the cottage during rental periods, cleaning costs and management fees.

Depreciation on the cottage – called capital cost allowance (CCA) – is technically deductible, but it's not smart to claim it. This can jeopardize use of the principal residence exemption (PRE) to shelter tax on the sale or transfer of the cottage later.

Finally, make sure you don't rent the place more than half the time, since this could limit your ability to claim the PRE, and before listing on Airbnb, Vrbo or another short-term rental site, check your municipality's rules. Some places require an annual licence and may have rules around minimum stays and occupancy limits. And if you don't follow local rules, Canada's tax law can deny you deductions against your rental income.

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## Transferring the cottage

When you transfer your cottage – whether by selling it, gifting it today or passing it along at death – you’ll be deemed to have sold it at fair market value (there’s an exception if you transfer it to a spouse). This can trigger a capital gain, half of which is taxable.

Suppose, for example, that you bought your cottage for \$150,000 in 1995 and added \$50,000 of capital improvements over time so that your adjusted cost base (ACB) is \$200,000, and it’s worth \$900,000 today. Transferring it or selling will trigger a \$700,000 capital gain, and \$350,000 of that is taxable. Apart from planning, your tax bill would be \$187,355 if you’re in the top tax bracket in Ontario, \$190,050 in Newfoundland (the highest), \$155,750 in Nunavut (the lowest) and between these extremes everywhere else.

There’s one potential lifesaver: the PRE. Your cottage can qualify as a principal residence for years you or a family member “ordinarily inhabited” it – which includes even brief stays during the summer. You can use the PRE to fully shelter the cottage from tax, or your city home, or partly shelter both. But you can’t fully shelter more than one residence using the PRE.

Make sure you keep your ACB records in good shape. Every capital improvement over the years – a new deck, roof, dock extension, septic upgrade, bunkie and more – can increase your ACB and reduce your eventual capital gain.

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## Double taxing the cottage

If you’re determined to transfer the cottage to the kids during your lifetime, do it properly – otherwise you could face double-tax on the place.

Back to our example above. Suppose you sell the cottage to the kids for \$300,000, well below its fair market value of \$900,000. The CRA will deem you to have sold it at \$900,000, triggering a \$700,000 capital gain. But your kids will have an ACB of only \$300,000, which means that they’ll face another large capital gain on the same property if they sell later. Double taxation on the same asset.

A better idea? You could gift the property outright, which still triggers a capital gain, but gives the kids a full \$900,000 ACB, which eliminates the double tax problem. Or consider selling to them at fair market value and take back a promissory note for the purchase price. The kids can pay some of it down over time, and you can forgive the balance at death with no negative tax consequences.

Better still, this last idea lets you spread your capital gain over up to five years using the capital gains reserve in our tax law because you’re not collecting the full price up front. It’s better than absorbing the full tax hit in a single tax year. Speak to a tax pro to get the details right.

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