



Spring 2018

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Taxation *as a* Cottage Industry

As

the spring starts to ramp up and owners contemplate opening their cottages for the season, many decide to sell a recreational property instead of battling the mosquitoes. It may be the result of a natural progression, as the younger generation may not be interested or able to maintain the cottage tradition. Or it may be that owning two houses leaves just too little time for that all-important R&R. If the decision to sell is made, however, be aware that there will likely be some major tax consequences. Fortunately, there are some ways to mitigate these.



TAX consequences *of a sale*

Tax consequences of a sale

Basically, there is essentially a one-principal-residence-per-family rule (with some tax relief still potentially available for second properties owned prior to 1982). What this means is that if you sell or transfer the cottage, capital gains tax may be payable on your “home away from home.”

You should assume a tax rate on capital gains of about 26% of the appreciation in value. So, any sale of the cottage at today’s value will result in a capital gain equal to the sale price less the “adjusted cost base” of the property to you. Very simply, the “adjusted cost base” is the cost you paid to acquire the property plus all capital improvements you made to it over the years. If you inherited the cottage from previous generations by way of a will, your cost of the property will be equal to the fair-market value of the cottage at the time that you inherited it.

You should also ask yourself whether you have owned the cottage since before 1972. Why that far back? Well, if you owned property prior to December 31, 1971, you were able to take advantage of what is called “Valuation Day” or “V-day.” Since capital gains were only taxable from 1972 onwards, the increase in the value of your cottage prior to December 31, 1971 (i.e., V-day), is exempt from a capital gains tax.

Accordingly, you (or your parents or grandparents) were able to elect the fair-market value of the property as at December 31, 1971, to be your new cost base for future capital-gains calculation purposes. So, if you owned your cottage prior to V-day, you may want to check to

see what your V-day value is in order to determine what your effective cost base would be. Plus, if you made any capital improvements since V-day (presumably this would be the case, since your cottage likely would have required some work over the past 45 years), those improvements can be added to your V-day value in determining your adjusted cost base.

When it comes to selling the property, you have to designate either your principal home or your cottage as your principal residence in order to get the principal residence exemption. If you think that your capital gain on the sale of the cottage would heavily outweigh any possible gain on the principal home for those years that you owned both, then you may want to designate your cottage as your principal residence and claim the exemption. However, this becomes an exercise in numbers to determine where your biggest tax liability lies.

Transfer within the family

In many cases, you may want to rid yourself of the cottage but still keep it in the family by transferring it to a family member (i.e., your kids or grandkids) for estate planning or other reasons. However, our tax rules are clear: If you transfer a capital asset – be it a second home or otherwise – to a related person other than your spouse, there is a “deemed sale” of the property at its current market value at the time of transfer. This could then trigger a capital gains tax to you (even though you didn’t actually sell the property or receive any proceeds).

One of the most dangerous examples of this tax trap awaits Ontario taxpayers (and those in some other provinces as well) who change the title to their cottage from one person to joint tenancy in order to reduce probate fees. The Canada Revenue Agency will treat this as a deemed sale of the property at current values, to the extent that new co-tenants (other than a spouse) come into the picture.

Suppose, for example, that you decide to put your home in co-tenancy with your two kids. The CRA's position is that you will have sold two thirds of your property to your kids. Furthermore, since each child now owns a third of the home, the availability of the principal residence exemption for each one third interest will depend on the individual circumstances of yourself and each child.

On some occasions, taxpayers who have unwittingly fallen into a transfer/deemed sale trap have been able to convince the CRA that they held the property "in trust" for their kids, i.e., that their kids have been "beneficial owners" of the property all along. However, this can be an uphill battle and must be supported not only by the particular circumstances but also by proper documentation. For example, it is possible that statements listing ownership of assets provided to a financial institution could trip you up.

Renting out the second home

If you are concerned about triggering a capital gains tax by selling the cottage, you may want to consider a scenario where your second home doubles as a rental



property. While rental income is potentially taxable, you are entitled to claim applicable expenses (including any mortgage payments). Often, these expenses can really mount up and may put you into an overall loss position. If so, the losses are potentially available to shelter other sources of income, be it from your job, or whatever. If the second home is a farm, there are usually restrictions on the amount of annual losses that can be claimed, known as “restricted farm losses”.

But for those who are tempted to pile up the write-offs, a word of warning: the CRA has been known to carefully monitor taxpayers who consistently claim rental losses over a period of several years. It may well dispute your claim based on the premise that there must be a reasonable expectation of profit. However, this line of attack was generally shot down by the Supreme Court of

Canada in two landmark cases (*Stewart* and *Walls*), which drew an exception for properties that involve an element of personal use. Yet, the CRA can and will still attack.

Cottages south of the border

Other complications may arise if the second home is located outside of Canada, particularly in the U.S.:

- If you sell U.S. real estate, there is a U.S. withholding tax. The tax withheld may be offset against U.S. tax payable on the capital gain. Happily, there is no withholding if the sale price is less than US\$300,000 and the purchaser intends to use the property as a principal residence. However, the gain on the sale will still be taxable in the U.S. and you will have to file a U.S. tax return. (It is



also possible to go through certain procedures to reduce the withholding.)

- On a sale of your real estate, you will need to provide an Individual Taxpayer Identity Number (“ITIN”) to the transfer agent even if no withholding tax is due. The sale cannot close without both the vendor and purchaser providing an ITIN. In addition, the IRS will not issue a receipt for the withholding tax paid unless both the vendor and purchaser provide an ITIN. An ITIN can be obtained by filing Form W-7 with the IRA. This is at least a six-week process.
- If you sell your real estate, you will have to file a U.S. tax return to report the gain (a credit may be claimed for tax withheld under FIRPTA). This filing requirement is true even where there is no withholding tax due. The capital gains tax rate in the U.S. is currently 15% (if owned personally). If you have owned the property since before September 27, 1980, you can take advantage of the Canada/U.S. Tax Treaty to reduce the gain. In this case, you will have to pay tax only on the gain that accrued since January 1, 1985 (this does not apply to business properties that are part of a permanent establishment in the U.S.). To claim

this treaty benefit, you have to make the claim on your U.S. tax return and include specific information about the sale.

- Any U.S. tax paid on the sale of the property will generate a foreign tax credit, which you can use to reduce your Canadian tax on the sale. Note: This tax credit may be limited if you use your principal residence exemption to reduce your Canadian gain.

If you have any questions about the contents of this article, or on corporate, estate, or international tax planning, please contact Samantha Prasad at sprasad@mindengross.com or any member of our Tax Law Group.

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Samantha Prasad
sprasad@mindengross.com

Firm News

Minden Gross LLP welcomes **Gayle Greenbaum** to our Commercial Leasing Group as an Associate. Her practice focuses on commercial leasing law with a depth of experience developed as in-house legal counsel for a large retailer.

Minden Gross LLP was featured at Progress Place’s Taking Care of Business Breakfast on Mar. 1 as part of a video highlighting the firm’s participation in its Transitional Employment Program.



Gayle Greenbaum
ggreenbaum@mindengross.com

Professional Notes

Matt Maurer published two articles on *Slaw* and two on *Canada Cannabis Legal* including “Ontario to Open Door to Cannabis Tourism?” on Jan. 19. He was interviewed about cannabis tourism on *Newstalk1010* on Feb. 6. Matt was quoted in *Law Times* on Jan. 15 and Mar. 5, in *Ottawa Citizen* on Feb. 5 and Apr. 3, in *Cannabis Business Times* on Feb. 6, and in *Marijuana Business Daily* on Feb. 8. He was featured on *Business of Cannabis* for their “Week in Review” on Jan. 26. **Matt** and **Sasha Toten** spoke about buying or selling a cannabis business at an event hosted by the LSO on Mar. 5. **Matt** and **Whitney Abrams** published three articles in *Cannainvestor* including “Cannabis Retail Across Canada” in the Mar. edition.

Whitney Abrams posted “Six Licensed Producers will Supply Cannabis to Quebec’s SAQ” on *Canada Cannabis Legal* on Feb. 14.

The Tax Group’s **Joan Jung, Michael Goldberg, Samantha Prasad, Matthew Getzler,** and **Ryan Chua** participated in the “‘Trust Us’ - Trusts Can Get Complicated! - A Selection of Tax Issues” webinar on Mar. 6.

Matthew Getzler presented a “Tax Update” at the OBA Trusts & Estates Law Program on Mar. 27. He posted “Tax Law Update: Income Splitting Isn’t Dead: Prescribed Rate Loan Planning” on Feb. 1.

Michael Goldberg hosted the third session of Tax Talk: Season 5 on Feb. 7.

Samantha Prasad published two articles in *The Fund Library* including “How to Leave a Bigger Legacy” on Feb. 22. She spoke on “The Estate Freeze and Income Splitting in 2018” at RBC Wealth Management on Jan. 25. *The TaxLetter*

published three of her articles including “The 2018 Budget - A Relief” in Mar.

Joan Jung spoke at a joint STEP Canada/STEP US webcast about US tax reform on Jan. 19. She is also a member of the planning committee for the 2018 Ontario Tax Conference of the Canadian Tax Foundation.

Tracy Kay participated in the “Not Up in Smoke: Employer Rights in the Face of Legalized Marijuana” webinar hosted by Meritas on Mar. 29.

Melissa Muskat spoke on “Property Assessment and Taxes” at the Institute of Law Clerks of Ontario’s 2018 Advanced Real Estate Law CLE Program on Mar. 7.

Danna Fichtenbaum was quoted in “Judge calls for culture shift on consent motions” in *Law Times* on Feb. 26. She spoke at the OBA’s Institute 2018 on “Clarifying the ‘Minimal Evidentiary Threshold’: What Does *Seepa v. Seepa* Mean for Estates Practitioners?” on Feb. 8.

Irvin Schein published “The Uber Powerful Impact of Arbitration Clauses” on *irvinschein.com* on Mar. 9. *Canadian Employment Law Today* republished this article on Mar. 16.

Ken Kallish won an award for his contribution to the Meritas Financial Services and Creditors Rights and Bankruptcy Section on Jan. 26.

Hartley R. Nathan, QC, and **Jessica Thrower** published “Do You Have to Follow Proper Corporate Procedures?” in *The Directors Briefing* for January 2018.

The Commercial Leasing Group attended the ICSC Whistler Conference from January 28-30. **Stephen Messinger** was on the program

planning committee. He spoke at the session “Do You Have the Appetite for Change? Industry Leaders Discuss Why You Should” and moderated for the Next Generation Session “Mentorship Program”. **Adam Perzow**, **Boris Zayachkowski**, and **Christina Kobi** were also in attendance. **Christina** and **Adam** participated in a legal roundtable discussion on “Trends and Tips in Mixed-Use Development” on Jan. 29. **Stephen Messinger**, **Christina**, and **Melodie Eng** were listed in the Jan./Feb. 2018 edition of *Lexpert Magazine’s* “Top 10 Deals” on the due diligence work they completed for the SmartREIT and Strathallen Acquisition of OneREIT.

Christina Kobi was listed in “Top Female Leaders in the Canadian CRE Industry” by *The Behar Group Buzz* on Mar. 8. She spoke on “Risk Allocation in Leases: An Update on *Deslaurier Custom Cabinets v. 1728106 Ontario Inc.*” at The Six-Minute Commercial Leasing

Lawyer on Feb. 15. **Christina** was quoted in “Condo, townhome developers and brokers seek retailers” in the *Vancouver Sun* on Jan. 30. She posted her article “Risk Allocation in Leases - An Update on *Deslaurier Custom Cabinets v. 1728106 Ontario Inc.*” in February.

Minden Gross LLP was listed in the Jan./Feb. 2018 edition of *Lexpert Magazine’s* “Big Deals” as acting for The Shotgun Fund in Gen-therm’s acquisition of Etratech Enterprises, Inc. The team included **Brian Temins**, **Benjamin Bloom**, **Sasha Toten**, **Jessica Thrower**, **Samantha Prasad**, and **Tracy Kay**.

Retired **Senator Jerry Grafstein** was awarded the Senate 150th Anniversary Medal on Feb. 6.

Andrew Elbaz and **Alexander Katznelson** (student) posted three articles on blockchain technology including “SEC Issues Warning on Unregulated Cryptocurrency Exchange Platforms” on Mar. 8.

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