Tax Planning for Vacation Properties

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Welcome

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Tax Planning for Vacation Properties

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Tax Planning for Vacation Properties

- Can you claim the principal residence exemption on a vacation property?
- What are the issues surrounding adding someone on title?
- Should you gift your vacation property to your family during your lifetime?
- Should the vacation property go into a trust?
- What are the issues with rental use?

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Tax Planning for Vacation Properties

Can you claim the principal residence exemption on a vacation property?

Principal Residence Exemption

- Allows capital gain to be tax-free to the vendor of a principal residence
- Multiple properties may qualify as a principal residence
- Can only claim exemption on one property for a given year
- Post-1981, spouses and common-law partners must not claim exemption on any property other than that which is claimed by the spouse/common-law partner
- Property does NOT have to be in Canada

Principal Residence Exemption

- Types of properties that qualify:
  - *House*
  - *Apartment, duplex or condominium unit*
  - *Cottage*
  - *Mobile home*
  - *Trailer*
  - *Houseboat*
  - *Surrounding land, but with restrictions*

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Principal Residence Exemption

- Principal residence includes land upon which the dwelling stands and any portion of adjoining land that can reasonably be regarded as contributing to the use and enjoyment of the housing unit as a residence
- CRA says evidence to support this is not required for up to one half hectare of land (*approximately 1.24 acres*)
- Land over ½ hectare needs to be considered "*necessary*"
  - *E.g. Minimum lot size zoning*

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Principal Residence Exemption

- Principal residence must be:
  - *Capital property*
- *Capital gain vs business income*
  - *Beware house flippers, the sale of your residence could result in business income*
  - *IF you use your principal residence to run your business out of and having been claiming CCA*
  - *Rented it out and claimed CCA*

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Property Held on Account of Income

Some factors (not exclusive list) that the Courts have considered:

(a) the taxpayer's intention with respect to the real estate at the time of its purchase;

(b) feasibility of the taxpayer's intention;

(c) geographical location and zoned use of the real estate acquired;

(d) extent to which intention carried out by the taxpayer;

(e) evidence that the taxpayer's intention changed after purchase of the real estate;

(f) the nature of the business, profession, calling or trade of the taxpayer and associates;

(g) the extent to which borrowed money was used to finance the real estate acquisition and the terms of the financing, if any, arranged;

Property Held on Account of Income

Factor's Continued:

(h) the length of time throughout which the real estate was held by the taxpayer;

(i) the existence of persons other than the taxpayer who share interests in the real estate;

(j) the nature of the occupation of the other persons referred to in (i) above as well as their stated intentions and courses of conduct;

(k) factors which motivated the sale of the real estate;

(l) evidence that the taxpayer and/or associates had dealt extensively in real estate.

The more closely a taxpayer's business or occupation (e.g. a builder, a real estate agent) is related to real estate transactions, the more likely it is that any gain realized by the taxpayer from such a transaction will be considered to be business income rather than a capital gain (see (f) and (j) above).

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Principal Residence Exemption

- Principal residence must be:
  - *Owned legally (name on title) or beneficially (entitled to the use and benefit of the property whether or not legal ownership exists)*
  - *Mainly personal use*
    - *Income-producing less than 50% of the time*
  - "*ordinarily occupied*" in the year
    - *By the taxpayer, spouse/common-law partner, former spouse/common-law partner, or child*
    - *Fact-based test*
    - *Does not require significant use as long as its principal use is personal*

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Principal Residence Exemption

- Adjusted cost base is important to track
  - *Original purchase price*
  - *Legal fees*
  - *Land transfer tax*
  - *Improvements made, but not repairs and maintenance*
    - *Upgraded windows*
    - *Addition*
    - *Paved driveway*
  - *No addition to ACB for personal labour*
  - *Keep receipts for at least seven years AFTER <u>disposition</u> of the property*

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Principal Residence Exemption

- In the year of sale, the taxpayer must report the disposition on their personal tax return and designate the property as their principal residence for the years in which the exemption is to be claimed on form T2091IND
- Formula:
  - *(# of years designated + 1) / (# of years owned) x (Proceeds of disposition – adjusted cost base – expenses of disposition)*
  - *"+ 1" applies to Canadian resident at the time of purchase*
  - *Years owned includes whole and part years.*
    - *E.g. purchased in 2010, sold in 2020 = 11 years*

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Principal Residence Exemption

- Where multiple properties qualify, a choice needs to be made on which to claim the exemption, leaving the other as being taxable
- Generally, we prefer to claim the PRE on the higher gain per year property
- Consider taxation of non-Canadian jurisdiction if property is not in Canada
- Exception may be where lower gain per year property is sold much sooner than higher gain per year
  - *Rather pay low tax now or high tax later?*

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Principal Residence Exemption

- Example:
  - Cottage owned 2008 to 2022 (POD = $1M, ACB = $350K)
    - *Assume no other principal residence owned between 2008 and 2014*
  - Home in city owned since 2015 (FMV = $1.8M, ACB = $1M)
    - *Assume no immediate plans to sell*
  - Cottage gain per year:
    - *$1,000,000 - $350,000 = $650,000 / 15 years = $43K*
  - Home gain per year:
    - *$1,800,000 - $1,000,000 = $800,000 / 8 years = $100K*

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Principal Residence Exemption

- Example:
  - Option 1 – PRE claim on cottage
    - *$650K capital gain = no tax now, but $800K capital gain on house now exposed as 2015 through 2022 years now claimed on cottage and not available for the house.*
    - *Let's say the house is ultimately owned for 25 years. 8/25ths of the total capital gain will not be sheltered using the PRE since the cottage used 8 of those years already*
      - *Note: this is NOT the same as the gain that accrued between 2015 and 2022 necessarily*
    - *House may appreciate more slowly or quickly in the future, so gain per year may change over time*

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Principal Residence Exemption

- Example:
  - Option 2 – Save 2015 to 2022 for the house, claim 2008 to 2014
    - *PRE = (# of years designated + 1) / (# of years owned) x (Proceeds of disposition – adjusted cost base – expenses of disposition)*
    - *PRE = (7 + 1) / (15) x ($1,000,000 - $350,000)*
    - *PRE = 8/15 x $650,000*
    - *PRE = $346,667*
    - *Capital gain of $650,000 less PRE of $346,667 = $303,333 capital gain subject to income tax*
    - *Note: There's no point in time valuation for 2014!*

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What are the issues surrounding adding someone on title?

Adding Someone On Title

- Common approach to avoid probate
  - *Ontario charges $15 per $1,000 in excess of $50,000 estate*
- May cause more problems than it solves!
- What is the intention?
  - *<u>Presumption of advancement</u> vs. <u>presumption of resulting trust</u>*
  - *Without other evidence:*
    - *Presumption of advancement (i.e. actual gift) between spouses/common-law partners and parents/minor children*
    - *Presumption of resulting trust (done for convenience and not actually intended as a gift) between parents/non-minor children*
- Need to document intentions!!!

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Adding Someone On Title

- Joint ownership:
  - Joint tenants vs. tenants-in-common
  - Potential issues:
    - *Control*
    - *Funding*
    - *Could be exposed to claims against joint owner*
      - *Family law, professional/commercial liability*
    - *May expose future gains to income tax if PRE isn't available*

Tax Planning for Vacation Properties

Should you gift your vacation property to your family during your lifetime?

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Gifting Property

- Gifting:
  - *Creates a deemed disposition at fair market value*
  - *Typical to get realtor to provide an opinion of value as third-party evidence of FMV*
  - *May cause income tax if gain isn't fully sheltered by PRE*
  - *ACB for recipient is FMV at time of gift*
  - *Need to consider issues of shared use if gifting to multiple people*
  - *Need to consider loss of capital for older generation*

Tax Planning for Vacation Properties

Should the vacation property go into a trust?

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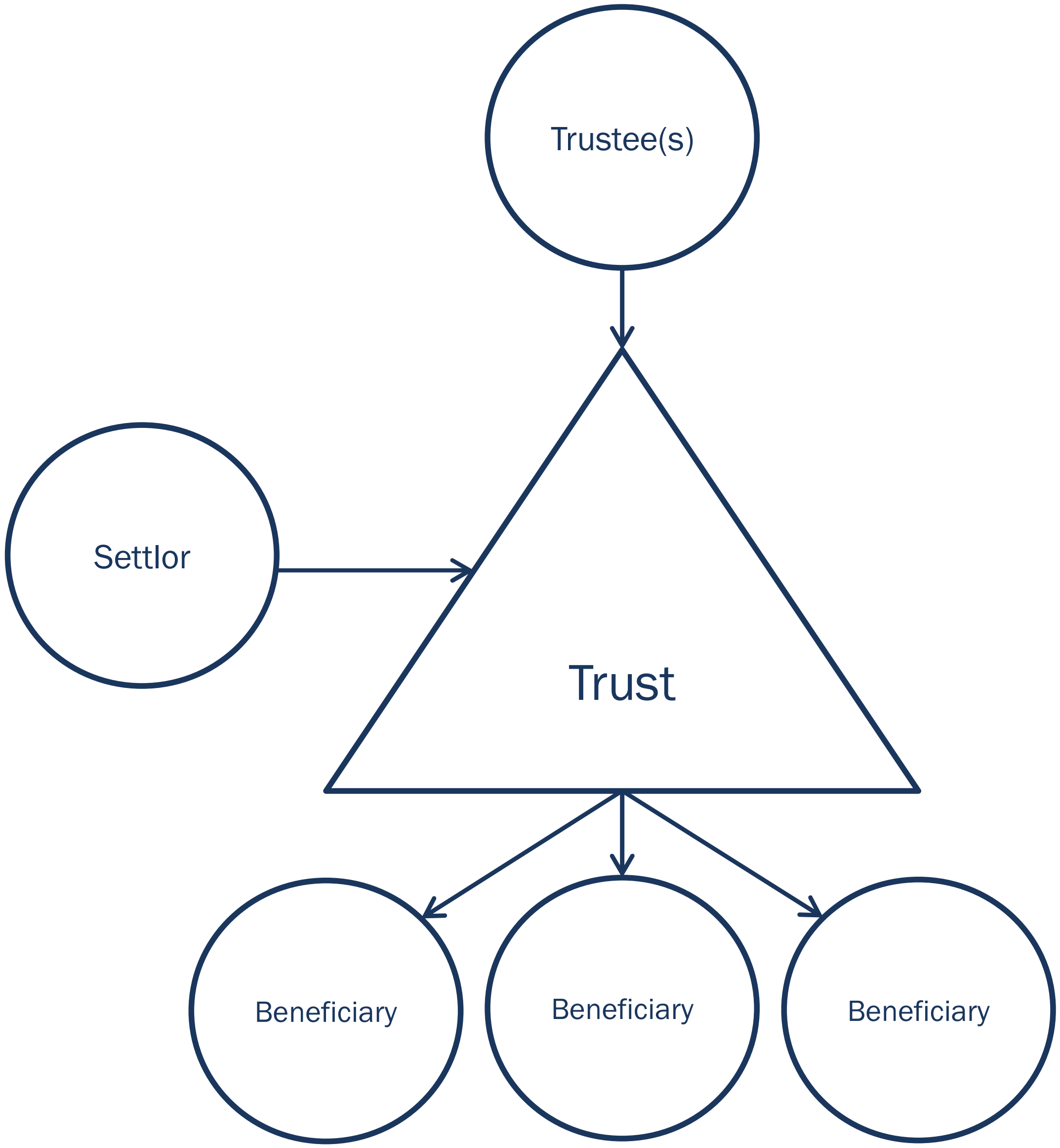
Use of a Trust to Hold Vacation Property



- Settlor passes property to trustee(s) to create trust
- Trustee(s) look(s) after trust property for the benefit of the beneficiaries
- Beneficiaries receive economic benefits of trust property
- Relationship for legal purposes
- Entity for tax purposes

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Vacation Property Held In Trust

- Trustee(s) retain control
- Avoids probate as trust document dictates subsequent owner(s)
- Consider funding the trust in addition to contributing cottage?
- FMV disposition when the cottage is contributed unless an alter-ego or joint partner trust
- 21-year rule is a concern
  - *Every 21 years, the trust is deemed to dispose of its capital property at FMV*
- Non-resident beneficiaries are a concern
  - *Property transfers out of the trust at FMV if distributed to a non-resident beneficiary*
- T3 trust income tax returns must be filed

Vacation Property Held In Trust

- Trust can designate a property as its principal residence for one or more years for the purpose of the *Principal Residence Exemption*, just like individuals
- Trustee must file form T1079
- Trust must specify each individual who was beneficially interested in the trust, and ordinarily inhabited the housing unit (spouse/CLP, former spouse/CLP, or child)
- No beneficiary of the trust can designate another property as their principal residence for each year

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What are the issues with rental use?

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Rental Use of a Vacation Property

- Significant difference if <50% vs >50% rental use
  - *Availability of PRE*
- Claim rental revenue and deduct rental portion of expenses on form T776 on personal tax return
  - *What constitutes "rental portion"?*
  - *What if days rented + days used personally doesn't add up to 365?*
  - *Should you claim Capital Cost Allowance?*
- HST issues:
  - *No GST/HST on long-term rents (more than one month)*
  - *HST on short-term rents unless less than $30K revenue*

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Rental Use of a Vacation Property

- Change of use = deemed disposition at FMV
  - *Capital gain?*
  - *Recapture?*
  - *45(2) election – personal use to income producing*
  - *45(3) election – income producing to personal use*
  - *45(2) and 45(3) elections:*
    - *Cause the deemed disposition not to occur*
    - *Allow the property to qualify as a principal residence for up to four additional years while being rented*
    - *Cannot claim CCA!*

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Tax Planning for Vacation Properties

- *Many financial and non-financial planning considerations*
- *Income tax and HST rules need to be considered before decisions are made and actions are taken*
- *Be proactive & get professional advice!!!*

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Question and Answer Period

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