The Broxterman Bulletin

Wealth Management Dominion Securities

Your quarterly financial planning newsletter

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Welcome and thank you

A warm welcome to the clients who have recently joined us and thank you to the clients who mentioned us.

We also want to thank our existing clients for your continued loyalty.

Perspectives on planning

Investment, tax and lifestyle perspectives from RBC Wealth Management Services

An overview of the principal residence exemption and how it may apply to Canadian secondary or vacation properties.

Your home. For many, it likely stands out as the largest purchase you've made as an individual or a family. And for some, depending on your circumstances, that may be followed by the purchase of a cottage or other type of Canadian vacation property.

When it comes to home or cottage ownership, the mindset is often buy it, enjoy it, maintain it (and potentially upgrade it over time), and then sell it or transfer it to the next generation. But what's important to remember is that these properties may significantly increase in value over time, which can create a large tax liability when they get sold or passed down. This is where it may be very helpful to understand how the principal residence exemption (PRE) works, when it applies and how to effectively use it, especially when you own more than one property in Canada.

Note: The following information is an overview of considerations and strategies and may not necessarily apply to your particular financial circumstances. To ensure that your own situation has been properly considered and that action is taken based on the latest information available, you should consult with your qualified tax and legal advisors.

Principal residence: What qualifies?

A principal residence can include your house, apartment, condominium, cottage, chalet, cabin, mobile home, trailer, houseboat or shares in a cooperative building.

For a property to qualify, you have to own it (solely or jointly with one or more individuals), and you or your spouse, former spouse or child must have "ordinarily inhabited" the residence during some part of the year. When it comes to what constitutes "ordinarily inhabited," the Canada Revenue Agency (CRA) has stated that the requirements can be met even where the owner, the spouse or the children live in the property only for a short period of time. Specifically for cottage or seasonal property owners, this means if you stay there even for a brief vacation, it may be considered ordinarily inhabited for the year.

What about rental properties?

Do you rent your cottage or other secondary property over the course of the year? If so, this may impact whether it qualifies as a principal residence. In general, property you purchase that's used mainly for earning income is not considered "ordinarily inhabited," even if you stay in the property for some period of time. However, it is possible to earn incidental income (e.g. rental income) from a property and still claim it as your principal residence.

Capital gains tax

Any principal residence, because it's owned primarily for your or your family's use or enjoyment, is considered a personal-use property. When you sell or are deemed to dispose of the property (e.g. when an individual passes away), if the property has increased in value during the time you've owned it, you'll realize a capital gain:

Note: The capital gain will be equal to your sale proceeds minus the adjusted cost base (ACB) of the property. The ACB is normally the purchase price plus any expenses to acquire it (e.g. commissions, legal fees). The ACB also includes capital expenditures, such as the cost of additions and improvements to the property.

In general, you're required to pay tax on the capital gain resulting from the sale (or deemed disposition) of a personal-use property, unless there's a specific exemption. That's where the PRE comes into play, because it can reduce or eliminate this capital gain.

The importance of 1981

When designating your principal residence for tax purposes, for years up to and including 1981, it is possible for each family member to designate a different property, and therefore you can make use of the exemption for each property. For ownership years from 1982 and onward, however, you can only designate one principal residence per family unit (spouses and minor children) in a particular year.

Another important year: 1994

In 1994, the government removed the then $100,000 capital gains exemption, but allowed you to file a special one-time election on your 1994 tax return to claim this exemption against capital gains accrued to that date. If you made this election and still own that property today, make sure the revised cost base is taken into consideration when you sell (or dispose of) it.

Applying the exemption

If your primary house and secondary property in Canada both qualify as principal residences, then for any period after 1981 where you owned both properties, you should determine which property, on average, has the largest annual increase in value.

You may be able to maximize the PRE if you designate this property as the family's principal residence for the maximum number of years. And remember, the maximum number of years a property needs to be designated is the number of years of ownership, minus one (because of the one-plus rule) to fully exempt the gain.

Keeping the family cottage in the family with insurance

Whether you call it a cottage, chalet, camp or cabin, it's your family's special place to relax and enjoy the great outdoors. For many families, it's a place filled with happy memories that's been in the family for generations, and will be for generations to come.

But keeping the cottage in the family from one generation to the next isn't always as easy as it might seem. There are many issues to consider, including how the taxes will be paid.

Consider ways to reduce taxes

When you pass along your cottage, you are also passing along a potentially large tax bill, which your beneficiaries may or may not be able to afford. Depending on their financial situation, your beneficiaries may be forced to sell the family cottage simply to cover the taxes.

There are two main types of tax to consider – capital gains taxes and probate taxes.

Capital gains taxes

If your cottage has been in the family for many years, its value has probably increased dramatically. The property your family bought for a few thousand dollars might be worth a few hundred thousand dollars today. Even property bought within your lifetime might have experienced this type of exponential growth.

This increase in value can result in a very large, taxable capital gain, which is triggered when you pass along the property to anyone other than your spouse, including your children. However, there are several ways you can address this tax bill, and even reduce or defer it.

Calculating capital gains tax

When you pass along your cottage to anyone other than your spouse, the government views it as having been sold at current market value – a "deemed disposition." The capital gain on this deemed disposition is taxable.

The following example shows how there can be a $95,625 tax bill in 2016 on a cottage purchased for only $75,000 in 1986.

Deemed disposition in 2016:	$500,000
Purchase price in 1986:	$ 75,000
Total capital gain:	$ 425,000
Capital gains taxable (50% of total):	$ 212,500
Taxes payable at 45% marginal rate:	$ 95,625

Most real estate values have substantially increased in recent years. When children inherit the family cottage the estate must pay the capital gains tax based on the appreciated value. There may not be sufficient liquid assets to pay the tax and provide a fair inheritance for children who will not inherit the cottage. For some this could mean selling their prized asset. There are options to satisfy the tax bill and avoid asset liquidation.

Gift the property ahead of time

Simply giving your cottage to your intended beneficiaries ahead of time is one way to defer future capital gains taxes. If you expect your cottage to significantly increase in value, consider giving it to your beneficiaries sooner rather than later since the tax is payable in the year the gift is made. This results in a much smaller capital gain than the one that would be triggered in the future, assuming the property increases in value. After the gift is made, any future gains will be taxed in the names of those beneficiaries receiving the gift, when they sell it or give it away at a much later date, and won't be included in your final tax return when your estate is settled.

Cover the tax bill with an insurance policy

The most common way for property to be passed on to the next generation is through a bequest made in your Will. When your property is bequeathed to anyone other than your spouse, it triggers a taxable capital gain, which your beneficiaries may not be able to afford. However, you can cover this tax bill through a life insurance policy, which provides a benefit that can be used to offset the expected tax bill when your estate is settled.

Family cottage case study – insurance solution

Sam and Susan (both age 60 and insurable) have two adult children, Jim and Jane. Jane lives nearby and will inherit their cottage. Jim lives in another province. Sam and Susan have arranged in their Wills that their assets are to be divided equally between Jim and Jane, with Jane's share to include the cottage. Today the cottage has a fair market value of $500,000 and was purchased in 1986 for $75,000.

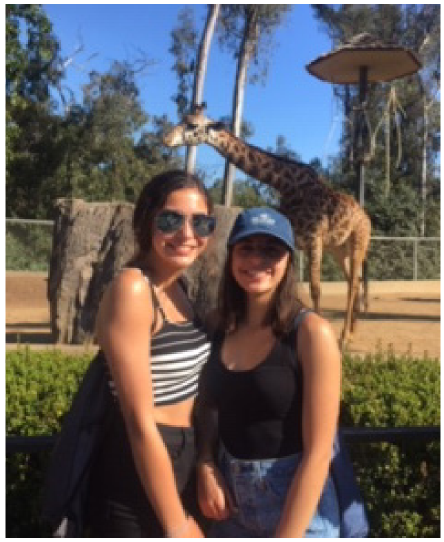
Should the cottage appreciate in value at 3% per year, the capital gains tax at Susan's age 90 is $256,192. As a result, Jane's share of the estate is reduced by the taxes payable on the cottage – thereby reducing her inheritance. This amount must be paid before Jim and Jane receive their inheritance. Sam and Susan wish to conserve their assets for their children and minimize the estate impact of the capital gains tax.

After considering three options (gift today, setting money aside in their investment portfolio, or purchase life insurance with guaranteed level premiums for ten years), Sam and Susan decided to purchase a joint life insurance policy where the insurance benefit will be paid upon the death of the survivor of Sam and Susan. In their situation this represented the least cost to them. It also allowed them to maintain control of the cottage and preserved more of their estate for their children.

To learn more, contact us today.

Personal notes

Brad trying on grandpa's goalie mask... future vezina winner?



Liz's daughters: Katelyn and Sara at the San Diego Zoo.

Family photo of PJ, Ryn and little Ren.

Carolyn and her husband Mike, with friends at Boots and Hearts this August.

Thank you for your ongoing loyalty to The Broxterman Group of RBC Dominion Securities. We would be pleased to provide a complimentary wealth management assessment or financial plan to any friend, family member or colleague you refer to us.