How to pay less tax when you sell your cottage

You may have to pay capital gains tax on the sale of a second home. Here's how you can keep more of that money in your pocket.

Every spring, people across Canada either make plans to go to their cottages or are reminded that they never use it and should probably sell it to someone who will. If you fall into the latter category, then you might as well put it up for sale soon so that you can stop paying property taxes and maintenance fees on a building that doesn't get any attention.

However, there is one thing to keep in mind as you sell your second home: the Canada Revenue Agency (CRA). When you sell a primary residence, the proceeds from the sale are not taxed—you get it all, minus the real estate agent fees. With a second home, though, the increase in the value of the property is considered a taxable capital gain at the time of sale.

Depending on your income, province of residence, and how long you've owned the property, that capital gain could result in thousands of dollars in additional taxes.

Capital gains taxes are based on 50% of the increase in value of the asset you sell. The gain gets added to your taxable income. What you end up paying in tax depends on what tax bracket you're in. It's also important to note that if your cottage falls in value, you can't use the capital loss to offset gains in other areas because losses on personal-use property are not deductible.

Fortunately, there are ways to mitigate the tax hit on the sale of a cottage. Here are a few strategies you may be able to employ.

Make your cottage your principal residence

In some provinces, lake-related real estate has skyrocketed over the years to the point where it's possible that a person's cottage could be worth more than their city home. If that's the case, then you may want to consider making your cottage your principal residence. A principal residence is a home that's "ordinarily inhabited in the year," according to the CRA. You don't need to use it for a specific amount of time, but you must be able to say that you do use it during the year. (Earning rental income off that property could complicate this strategy, with some cottages potentially being subject to capital gains.)

This strategy may still result in capital gains taxes as you will have to pay gains on your cottage for every year that it wasn't designated as your principal residence. So, if you owned your cottage for 15 years and you only made it your principal residence for the last five, you will have to pay gains on the first 10.

Once your cottage is sold, you can then move back your principal residence to your regular home and not pay gains on the sale of that home, but you may have to pay tax on any gains made during the years that your city abode was not considered your main home. This strategy can get complicated, so you should consult with a tax expert before making any changes to your principle residence if your personal situation allows you to do so.

Boost your cost base

Capital gains on the sale of a property are calculated by subtracting the adjusted cost base (ACB), which is what you paid for the cottage plus any closing costs from the proceeds of the sale. The larger the ACB, the smaller the capital gains. While most of your ACB is based on the original purchase price, it is possible to increase that number. How? By adding up any renovations you made to the property over the years. If you spent $10,000 redoing your cottage's kitchen, then you can add $10,000 to the ACB, and, ultimately, pay less in tax.

You will need receipts to back up your renovation claims, but in general, any enhancements or additions made to the property such as installing new windows or floors, adding a new well or septic tank, or upgrading wood siding to aluminum or brick will qualify. Regular maintenance costs, like painting a sunroom or fixing a deck, cannot be added to the ACB (though building a new deck qualifies). Again, it's a good idea to consult a tax expert.

Use the 1994 capital gains exemption

This strategy won't apply to everyone, but if you owned your cottage prior to 1994 and opted to claim the $100,000 lifetime capital gains exemption on that year's tax return, then you can add that amount to your ACB, which will lower the amount of your capital gains.

Spread the tax over five years

If your plan is to sell the cottage to your kids, you'll still need to pay capital gains. However, there is a way to spread those gains out over time. It's a good idea to talk to a lawyer and a tax expert before implementing this strategy, but when you sell, you can create a promissory note that stipulates that your children will pay you over a five-year period. If they do that, then you can spread the capital gains out over that same time frame. If your tax rate is lower in one of those years, then you'll pay less tax in that year than you might otherwise.

While paying the CRA can sting, remember that having to pay tax on multiple properties that have increased in value is a good problem to have. At the same time, it's important to pay only as much tax as you need to. So, start digging up those old renovation bills, talk to your kids to see if they might want to buy the cottage, and speak to a financial professional to see if there are other ways to keep more money in your pocket.