The unfair cottage tax

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By Jim Poling Sr.

The campaigning has yet to hit full stride, but federal election day is just over a month away with plenty of serious issues to debate. There is one issue that will not see any debate, probably because it does not impact large swaths of voters.

That issue is the unfairness of the capital gains tax on cottages. It is an issue that causes much grief among older folks wanting to pass the family cottage on to the next generations.

Capital gains tax applies when a capital asset is sold for more than the purchase price. For instance, if you bought a stock for $1,000 and sold it for $10,000, capital gains tax applies to 50 per cent of the $9,000 gain. So you pay tax on $4,500 at your marginal tax rate.

Seems fair enough. Make a profit, pay tax.

It's not when it comes to trying to keep a cottage in the family.

Here's the unfairness: You built a modest cottage on a lake 35 years ago. It cost $35,000 to acquire the lot and to get the bare bones basics built.

The children grew up enjoying the place, swimming, paddling, hiking, nightly campfires and all the other fun things children do at cottages. Suddenly they are adults with their own children and the cottage, which has undergone various renovations and additions, is being enjoyed by three generations.

People don't last forever so the time arrives when the parents who built the place pass away, leaving the cottage to one or more children.

Improvements over the years added some value to the cottage. But basically it's the same place, on the same lake, providing the same family enjoyment.

The improvements over the decades might have raised the total cost of the place to say, $100,000. However, when the children inherit it, they are shocked to find the market value is $600,000.

So federal tax law says that the market value of $600,000, minus the $100,000 total cost of the place, means there has been a capital gain of $500,000. The inheritors then are stuck with paying capital gains tax on one half of that gain, which could be a $100,000 or more tax bill depending on their marginal tax rates.

The children don't have the money to pay the tax so they sell the cottage and pay the tax from the sale price. They now have a nice bundle of cash but the cottage that was a family treasure for 35 years is gone.

There no doubt are people who build or buy cottages to fix up and sell for profit. Their goal was to turn a profit, so it seems fair that they pay capital gains tax on the profit.

However, the family cottage enjoyed by three generations is different. The parents built it for pleasure, with no thought of financial gain. In fact, most family cottages are a financial drain ? the price paid for the family's enjoyment.

Improvements increased the cottage value. But they were made to accommodate the growing family. There was no expectation of financial gain or that the value one day would be $600,000.

A chunk of the increased value came from inflation. So part of the capital gains tax payable on the cottage is simply for inflation.

Look at it another way. You bought stocks in 2008 for $100,000. Over the 10-year period ended June 2018 inflation was roughly 16 per cent. So the $100,000 of stocks bought in 2008 now are worth $116,000 in 2018 dollars.

That $16,000 of inflation is a gain that is taxable if the stock is sold. Yet the $116,000 in 2018 dollars has no more purchasing power than the $100,000 in 2008 dollars. It is a larger number but because of inflation cannot buy more goods or services.

There are ways to reduce capital gains tax on a cottage passed to family members. However, finding the best ways involves hiring lawyers, accountants and realtors to work out the details.

I failed high school math twice so I'm not a reliable source on details of capital gains taxes. However, my rudimentary understanding tells me it is an unfair tax in legitimate cases of parents wanting to pass along the family heritage cottage to their children.