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the newsletter of Prentice Yates & Clark

Considering a Vacation Property

Don't let vacation dreams become your financial nightmare.

Fantasy

The dog days of summer spent fishing off the dock, the sun sinking slowly behind the distant shore, the call of the loon, or cross-country skiing and a warm fire at the end of a winter day. Whether these are fond memories of childhood or an imagined future, the desire to own a vacation property for personal use or even for investment purposes may blind you to the real cost of owning a second home.

Reality

Year-round vacation properties are costly. For example, getting a mortgage may be a challenge, especially if you do not have at least 20% of the property's appraised value as a down payment. (Some banks offer financing for 95% of the property's value, but default insurance – often referred to as mortgage insurance – is required on any amount over 80% of the appraised value and, in some cases, on any amount over 65%. Canada Mortgage and Housing Corporation stopped providing second-home default insurance effective May 30, 2014.)

Cash Flow Needed

Assume, as an example, a purchase price of $300,000, and that you have 20% as a down payment (i.e., $60,000). A mortgage amortized over 25 years with an interest rate of 4% (the projected interest rate of 4% is simplified for the purpose of example only; however, it is important to anticipate changes – including possible increases – over time) will result in payments of about $1,260 per month. This means mortgage payments alone will be approximately $15,120 per year.

In addition to the capital outlay and mortgage payments, other costs should be recognized:

- furnishings
- municipal taxes, insurance, utilities and maintenance
- tools and household items (e.g., lawn mower, snow blower, dishes, bedding, etc.)
- monthly management fee (optional)
- transportation costs back and forth to the property.

Rental Income

To offset the cost of ownership, you may consider renting out the property for part of the year. But before doing so, consider the following:

Income Tax Consequences

Any rental income you receive must be reported to the Canada Revenue Agency (CRA) and added to your other income. Naturally, expenses incurred to earn rental income are deductible. Expenses can include a reasonable apportioning of costs incurred for renting out versus personal use. Costs that can be considered for vacation property are not dissimilar to those for any other rental property. It would be wise to maintain records of the times the property is rented in order to provide a mathematical means (e.g., a percentage of the days or weeks of the year) of assigning costs to the rental or personal-use periods. Capital cost allowance on depreciable property can be deducted against property income only to the point where the profit is zero. You cannot create an operating loss or increase a loss with capital cost allowance. Because there are other tax issues when utilizing capital cost allowance that occur "down the road," it is advisable to gain an understanding of tax consequences from your CPA to ensure the vacation property does not become an income tax nightmare.

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Three, Two, One

Backing up your files is a good habit to get into.

We have been inundated in the last decade with a plethora of devices to back up data. Most owner-managed businesses will have some form of relatively recent hardware for backups, whether it is burnable DVDs, ultra-portable USB flash drives or high-capacity hard drives (e.g., redundant, external, or network drives). Most recently, off-site backup services have become increasingly available via "The Cloud," with convenience extolled as a key selling feature.

So, what is the best backup solution for your business? The answer depends largely on the size of your business and the number of computers you need to back up. Regardless of how many employees or computers you have, one maxim holds true: at least three backups are required to protect business data. In addition, multiple physical locations should be used to store backup data.

The Cloud for Storage

Cloud data storage solutions have some inherent and appealing advantages, such as the ability to provide simultaneous access from multiple locations by multiple devices. Depending upon the service, backups may even happen in near-real time (i.e., after saving a file it may get immediately uploaded to the Cloud). There are also some services that assure the client has communication security and that the provider has redundancy and backups of their own in place. Provided the service is legitimate and reliable, a cloud server may be able to meet all the requisites for protecting your data.

Cloud backup and data storage can be expensive.

While cloud-based backup and data storage solutions may provide you and your business with many or all of your backup needs, there are some potential drawbacks worth considering. Online backup services operate over the Internet, which will tax your bandwidth and count towards your monthly data cap; if you have a lot of data to back up, this could be an issue. Additionally, while you will avoid the initial upfront capital cost of a physical backup and a data storage device, such as a hard drive, backup services generally require a monthly or annual fee, which can add up over time. Many services start at around $5-$10 per month per computer, although some companies charge based on data usage or data transmission. Internet-based services may also be susceptible to various outages and issues that can occur anywhere between (and including) your computer and the provider's servers, including all of the routers and servers along the way from your office and Internet provider.

Multiple Storage Locations

Why do you need more than one backup medium and multiple locations?

Consider that the following could occur at any time:

1. Computer components, such as the hard drive, can fail.
2. Power surges can fry your computer. (A good surge protector or UPS could prevent this.)
3. Your power can falter, or fail, for an unpredictable length of time.
4. Your Internet can also fail during an outage, after exceeding your bandwidth cap or for other reasons.
5. Computers and/or external storage drives can be stolen.
6. Physical damage can occur to the laptop, desktop or server.
7. Your computer can be infected by a virus or Trojan.
8. Your backup device could fail, leaving your data unrecoverable.
9. Critical data can be erased or overwritten, either maliciously or in error.
10. Your Cloud provider could have an outage.

The Three-Two-One Rule

If you're backing something up, you should have:

3. at least three copies,
2. in two different formats,
1. with one of those copies off-site.

Murphy Said It Best

Murphy's law states: "If anything can go wrong, it will." Keep in mind that at any moment, any of the 10 items listed above could stop your business cold. Your very ability to keep your business running could depend on having multiple copies of your data in a number of secure locations. Whether you choose to have multiple computers backing each other up, external physical drives, or a Cloud-based solution, the most important thing is to keep your data safe and secure.

Consider backup a part of your regular routine. When disaster strikes, your ability to recover quickly will make you smile with the knowledge that in the face of diversity you came through unscathed. There is wisdom in not putting all of your eggs in one basket.

Taxation—The Deciding Factor

A six-figure earned income may not have as much spending power as expected after taxes.

Wages, salaries and all other forms of earned income have increased dramatically for those with the required skills who are willing to move to the parts of the country where such skills are in demand. Indeed, it is not unusual to see T4s at year end in excess of $100,000.

The satisfaction of earning a six-figure income is quickly tarnished, however, after the amount of federal and provincial tax has been calculated.

A $160,000 annual salary income, for instance, is equal to $13,333 per month. Based on 2013 personal tax calculations, however, a single person living and working in Ontario, for example, would pay $56,481 in combined deductions from federal and provincial income tax, Canada Pension Plan (CPP) and Employment Insurance (EI).

Effect of Deductions

Given these figures, anyone in Ontario who earns $160,000 is going to take home $103,519 if salaried. On a monthly basis, this amounts to $8,627, a far cry from the $13,333 that appears on the payslip. For those who earn or aspire to earn in the six-figure range, consider the tax brackets in the following table.

T4 Income $	Total Withholding Taxes $	Average Tax Rate %	Net Income $	Monthly Take-Home Pay $	Marginal Tax Rate* %
100,000	29,627	29.7	70,313	5,859	43.4
120,000	38,368	32.0	81,632	6,803	44.2
140,000	47,199	33.7	92,801	7,733	46.4
160,000	56,481	35.3	103,519	8,627	46.4
180,000	65,763	36.5	114,237	9,520	46.4

*The marginal tax rate represents the average additional income tax on the next $20,000 of income.

It is also important to note that, as marginal tax rates rise with additional income, there are fewer disposable dollars left until the maximum marginal rate is reached.

Base spending decisions on disposable income not gross income.

Gross Income vs. Disposable Income

The realization that gross income *must not* be construed as disposable income should be factored into any spending decisions. Financial decisions should be calculated on the basis of take-home, i.e., *not gross*, income. The following questions should guide any spending and saving decisions:

1. How much are my monthly mortgage payments and utility bills?
2. How much does it cost per month to service my student loans or other debts?
3. If mortgage rates increase will I be able to meet the additional cash-flow drain?
4. What is the price of mortgage insurance?
5. How much are my property taxes?
6. How much do I spend on rental accommodations, condominium or common-cost fees?
7. How much do I need to put aside to accumulate the 20% down payment on a home?
8. How much do I spend per month on food, clothing, repairs and maintenance, entertainment and other leisure activities?
9. Should I purchase an expensive vehicle with payments spread over 84 months?
10. What is the minimum after-tax dollar requirement to support my current lifestyle in the event I lose my job?
11. How much do I need to put aside to cover a short-term layoff?
12. If I need to borrow for an emergency, will I be able to pay down the line of credit?
13. In the event of downsizing, will I be able to quickly find a new position with the same pay scale?
14. Is it worth moving to take a new job that pays more?
15. In the event I am ill, what is the cost of insurance to cover the cost of staying in my home?
16. Can I afford to open an RRSP? What is my contribution limit? Can I afford to contribute?
17. What is the cost of medical and dental insurance?
18. What is the cost of going to and from the job site?
19. Will I be able to help my parents if the need arises?
20. Will increased earnings offset increases in the cost of living?
21. How long will I continue to earn six figures?

Budget Strategically

"I've been rich and I've been poor. Believe me, rich is better."

This pithy remark, often attributed to Sophie Tucker, Mae West and others is certainly true, regardless of who said it first. Earning more *is* better than earning less. But the principal factor in determining the amount of money available for lifestyle expenditure remains taxation. Those who already have six-figure incomes should carefully analyze the long-term impacts of a high debt load, future increases in the cost of living, and the risk of layoff in order to determine the best means of managing after-tax income wisely.

Inside PYC

The annual conference of the Co-operative Housing Federation of Canada will be held in Charlottetown P.E.I. from June 3 to 6. J.J. Pauze, Charlie Petralito, Paul Jaroszko and Viola Bardhoshi plan to attend.

We would like to welcome the following additions to our professional staff:

Aria Nassiri Afshar
Charlene Bi
Sviato Romaniuk
Arthur Urtan
Guru Sivapalan

You may have already met or will meet them as they become an integral part of our audit team.

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Renting your vacation property to help with costs could trigger a "change in use" to the CRA.

Change in Use

Renting the property more than occasionally could trigger a "change in use" in the judgment of the CRA. Once a change in use is determined, the property is considered to have been disposed of at fair market value and a calculation of the gain or loss between the original cost and the "deemed disposition" price may trigger a capital gain on the difference. There are, however, other elections that can be made to defer the deemed disposition. Make sure to get the advice of a qualified tax advisor if you plan to rent the property for more than occasional use.

Multiple Residential Properties

There is nothing to prevent a taxpayer from owning more than one residential property; however, the *Income Tax Act* allows only one principal residence. Thus, if you already own your primary residence and subsequently purchase a vacation property, it will be necessary to consider the tax consequences of selling one of the properties in the future. In a nutshell, at the time the first residence is to be sold you must decide to either elect this property as your designated principal residence or defer the election until the sale of the second residence. When the designated principal residence is sold, any gain in value throughout the period of ownership is not considered to be a capital gain and is therefore not subject to capital gains tax. However, any gain on the sale of the property not elected as the principal residence will be regarded as a capital gain and taxed accordingly. Whichever property has the greater gain at the time of sale should probably be deemed your principal residence.

Something to Think About

Assume for a moment that two taxpayers decide to enter a common-law relationship or marry. Under CRA rules, if one person owns a traditional home and the other a vacation property and both properties are carried into the new relationship, tax laws dictate that only one property can be considered a principal residence. From the CRA's point of view, it does not matter that as single persons each owned a principal residence that would not have been subject to capital gains tax if it had been sold before the parties entered into their new relationship.

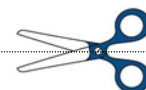
A Final Perspective

The total cost of ownership of a vacation property over the 25-year amortization period can be substantial. To the original $300,000 price of the property, you have to add in the $140,000 (rounded for simplicity) interest cost to carry the $240,000 mortgage at 4% over 25 years. Add to that a conservatively estimated $5,000 per year for taxes, utilities, insurance and maintenance and you have an additional $125,000. This gives a total ownership cost of $565,000 ($300,000 + $140,000 + $125,000). Assume also that the property is sold after 25 years for $600,000. Because only half of any capital gain is taxed, you would be taxed on $150,000 in the year the property is sold. Assuming a 40% tax rate, the tax liability on the taxable portion of the capital gain will be $60,000. As a result, the actual cost of owning a $300,000 cottage for 25 years will be $625,000 ($565,000 + $60,000) or $25,000 per year.

Certainly the overall cost of (approximately) $625,000 can be reduced by renting the property but, as suggested above, exercise care to ensure the property does not become redefined by the CRA as an income-producing property with all its potential tax consequences.

Calculate the Best and the Worst

No one can accurately predict interest rates, tax rates or property values 25 years into the future. In the final analysis, purchasing a vacation property as a long-term investment should be tempered with a measured look at the real cost of holding the property and the return that may eventually be realized when the property is sold. Prudence would suggest running the best and worst case scenarios to determine whether such a long-term investment meshes with your current lifestyle and risk profile.



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