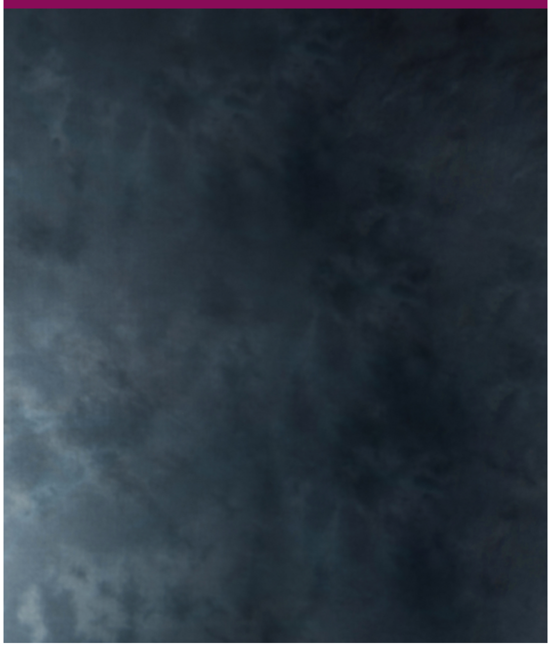
Education Library

Cottage Succession

ESTATE PLANNING



RICHARDSON Wealth

Keeping it in the family

An effective cottage succession plan is needed to ensure the most tax-efficient method of passing your assets onto your children. When a cottage is involved, additional issues are often encountered due to the emotional attachment. Memories of summers at the cottage, building and re-building the dock, sleep-overs with cousins and family dinners are all reasons to want to “keep it in the family”. With that said, additional complexities may arise when a cottage is to be shared among multiple family members.

Typical family issues

- Which, if any, of the children would be interested in future ownership/joint ownership?
- What is the impact of passing the cottage to certain children in the family?
- Are the children/spouses/grandchildren capable of jointly owning the cottage?
- Will family harmony be maintained?
- Where multiple children are interested in the family cottage, do they have the financial resources to maintain it? If not, consider transferring money or an insurance policy to a trust to provide the necessary financial resources.
- Does it make sense to pass on full or partial ownership prior to your death? Some tax and probate fee savings may be realized.
- Where you intend to pass the cottage to specific children, are there sufficient estate assets remaining to ensure an equal estate is passed on to the remaining children? If not, you may want to use life insurance to pay for the tax, or to plan for estate equalization for your remaining children.
- Are there sufficient liquid assets to sustain your lifestyle until your anticipated death, or would the sale of the cottage provide the resources to maintain your lifestyle?

While the list above may not be comprehensive, it helps outline issues that are most likely to cause conflict.

Many cottage owners have experienced a significant increase in cottage values over the last number of years and are concerned about their tax liability. To help you better understand the tax implications, we have provided a brief overview of the current tax rules. Since tax rules change frequently and each family's circumstances are unique, we recommend that you discuss your situation with your investment, legal and tax advisors to ensure that your cottage succession plan is appropriate in relation to your overall family wealth plan.

Important considerations for an effective cottage succession plan

Tax planning

- Tax deferral
- Principal residence exemption
- Probate fee savings

Using trusts

- Tax savings
- Creditor protection
- Maintaining control of assets
- Financial assistance to help maintain the cottage

Reducing family conflict

- Agreements
- Estate equalization opportunities

Taxation of your family cottage

Capital gains taxes and probate fees

Taxes are typically due whenever you dispose of property you own. You are also deemed to dispose of property for fair market value proceeds when you gift it. For most individuals when the cottage is disposed of at a value greater than its Adjusted Cost Base (ACB) a capital gain will be realized.

Currently, only 50% of the capital gain is included in your taxable income, unless you are able to claim the principal residence exemption. In some circumstances, you may also be subject to "Alternative Minimum Tax" on the capital gain, and your professional tax advisor should consider such tax when determining the overall cost of disposing of your property.

Deemed disposition on death

Upon your death, you are deemed to have disposed of your capital property at its Fair Market Value except where the property is left to a spouse or Spousal Trust in which case it passes at its ACB. In addition, certain provinces and territories in Canada impose a probate fee based on the value of a deceased's estate assets.

Determining your Adjusted Cost Base

When calculating your ACB you should include the cost paid to acquire/build the cottage, including any costs of improvements. Where you purchased the cottage prior to 1972 special rules apply, but typically the Fair Market Value at December 31, 1971 will be deemed to be the cost for tax purposes. In addition, you may have increased your ACB in 1994 when you had the ability to bump up your ACB by electing to realize up to $100,000 of unrealized capital gains on your property. You should review your 1994 tax return, contact your accountant or Canada Revenue Agency (CRA) to determine whether you made this election.

Principal residence exemption

Ownership

In order for a cottage to qualify as your principal residence, the first requirement is that you must own the property.

Ordinarily inhabited

In addition, the cottage must be "ordinarily inhabited" by you, your spouse (or common-law partner), former spouse (or former common-law partner), or child during the year. You do not have to live in the cottage more than your other residence or live in the cottage for any specific period of time. However you should have lived in the cottage at some time during the year. The CRA has provided Income Tax Folio S1-F3-C2, Principal Residence, which details the principal residence requirements.

Multiple exemptions

For purposes of the exemption, you can designate only one property as your principal residence for a taxation year. Furthermore, for taxation years after 1981, only one property per family unit can be designated. If you own property purchased prior to 1982, you may be able to claim more than one property as your principal residence. You should contact your tax professional to ensure that you maximize your entitlement to the exemption.

Excess land

If the land is not in excess of one-half hectare (1.24 acres), it usually qualifies as part of your principal residence. However, where land is in excess of one-half hectare, you will need to prove that the excess was necessary for the use and enjoyment. While it is beyond the scope of this article, generally if items such as the waterfront, docks, gardens and septic fields are placed strategically around the property, the entire land may constitute land necessary for the use and enjoyment of the cottage.

Principal residence exemption

One of the most commonly misunderstood provisions of the Income Tax Act is the Principal Residence Exemption. This is a special exemption that shelters all or a portion of the capital gain realized on the disposition of a property that meets the definition of "principal residence".

Some of the typical **misconceptions** regarding your principal residence for purposes of the exemption are:

- Your principal residence must be the same residence to where your mail is sent
- You need to file your personal tax return in the province of your principal residence
- Your principal residence must be in the same location as your office or place of employment
- You must register your vehicle in the same location as your principal residence

Claiming the exemption

To claim your principal residence exemption, you should report the disposition (including transfers to children) in your personal income tax return in the year the property is disposed of, or in the year of death, as applicable. You should note that you may have already inadvertently used up the exemption if you had disposed of a property with a capital gain and not reported it for tax purposes. Where this is the case, CRA will deem you to have claimed the exemption on the property disposed of. Therefore, we highly recommend that you review your personal circumstances any time you own more than one property.

Ways to dispose of your cottage

Sell the cottage

Probably the last thing you could imagine is selling your cottage after all the years of hard work and great memories. However, selling the cottage and dividing the proceeds among your family may maintain harmony. You could sell to a third party, directly to your children or provide them with a right of first refusal. Selling the cottage prior to death will also have the added benefit of avoiding probate fees and settling up the capital gains taxes that would otherwise be payable upon your death.

Use of a trust

Another option is transferring your cottage to either a Lifetime (inter-vivos) or Testamentary Trust. A Lifetime Trust could be created by transferring your cottage to a trust whereby trustees would administer the property, within the terms of a trust agreement, for the benefit of certain beneficiaries. A Testamentary Trust would work in a similar manner except the trust would be created upon the death of the cottage owner in accordance with their will. Where a cottage is transferred to a trust you will be deemed to have disposed of the cottage at its Fair Market Value.

Agreements to reduce conflict

While setting up an agreement will not eliminate conflict, a well thought out agreement can go a long way in reducing disagreements and ensuring summers at the cottage continue to provide memorable moments. When setting up an agreement the following points should be considered:

- **Scheduling** – where families share the cottage you should set up a fair and equitable schedule that outlines how the prime cottage time (typically long weekends in the summer) will be shared. You should also consider allocating the responsibility for performing the annual opening and closing of the cottage.
- **Financial contributions** – outlining the annual costs associated with running a cottage may help children assess whether they have the funds necessary to own/share a cottage. Annual contributions, even in years where capital improvements are not necessary, may help with cash flow. The funds can be invested until the funds are required for annual maintenance, property taxes, capital improvements, road assessments, etc. Where one family is expected to use the cottage more frequently than others, consider alternative cost-sharing arrangements.
- **Decision making** – outlining how decisions are to be made (majority rules, tie-breaking mechanisms, etc.) may eliminate the concern that certain parties to the agreement (such as overly aggressive siblings/spouses) may overstep their bounds without such an agreement.
- **Future sale of property** – while a parent may wish for their children to own the cottage, circumstances may change (i.e., children move, get divorced, die prematurely, children require funds, etc.) such that a child may need to sell their portion of the cottage. An agreement that would resolve this decision such as right of first refusal to other family members could avoid conflict among the children. You may also want to consider having an agreement signed by spouses that the cottage will not form part of a marital property claim, if allowed under matrimonial law. Family law lawyers need to be involved in advising on such an agreement to increase likelihood of enforceability.

Alternative ownership arrangements (not applicable in Quebec)

Joint tenancy vs. tenancy in common

In certain instances a parent may wish to sell or gift only a portion of the cottage to the children. Typically there are two common ways that property may be held, Joint Tenants with Right of Survivorship (JTWROS) and Tenants in Common. The manner in which title is held will impact the treatment of the property at death.

The most common way to hold real estate is JTWROS. This means that all of the owners of the property share an interest in the property. On the death of any of the owners, the property automatically transfers to the surviving owners and does not form part of the estate of the deceased. Probate fees would be avoided because the fees only relate to assets that form part of the estate.

If a cottage is held as Tenants in Common, each party owns an undivided interest in the cottage. This interest does not terminate on death and that interest passes to the estate of the deceased. The result would be a new “owner” of the interest, either the estate or the beneficiary of the estate. In contrast to JTWROS, the portion of the cottage held as Tenants in Common would be subject to probate fees.

Once you have determined that you are ready to transfer ownership of the cottage, you need to consider the various options available to you.

Summary

Identifying those issues that may cause conflict, discussing these issues with your children and acting on opportunities available to you to reduce taxes are all key aspects of a successful cottage succession plan. Tax savings, creditor protection and other estate planning opportunities are all part of the issues your Advisor can discuss with you as part of your family wealth plan. For further information or other articles on family wealth management issues please consult your Richardson Wealth Advisor.

Effective use of a trust

Using a trust to hold the family cottage may be appropriate in certain circumstances including the following:

A. Where parents would like continued access to the cottage throughout their lives but would like to pass on the increase in value, as well as the related tax liability, to future generations. The trust agreement should contemplate the ongoing management of the property and who will be responsible for any costs. As part of the trust, the parents may also choose to include a sum of money for the upkeep of the cottage. This contribution to the trust could make up for any of the children who may not be able to pay their share of expenses.

B. Where parents feel the children are not able to handle the financial responsibilities, or have concerns over existing or potential creditors. Where a trust is considered discretionary, no single beneficiary will own the cottage and therefore does not have the ability to sell the cottage. Creditor protection may also become particularly important where any of the children have marital difficulties. If properly structured, the trust may prevent the cottage from being considered a marital property asset.

C. Decision making can be simplified by having the trust in place and having the trustee make the decisions as to use, upkeep and eventual disposal. This would simplify the process of having consensus on sensitive issues.

As a general rule, note that for tax purposes a trust is considered to dispose of all of its property at Fair Market Value on its 21st anniversary and pay all taxes relating to the disposition. However, prior to the 21st anniversary, a trust may "wind-up" by transferring the property directly to its beneficiaries on a tax-deferred basis. The individual beneficiaries will then own the property. Probate fees will be avoided on death of the original owner because the cottage will be owned by the trust and not the deceased.

Tax & Estate Planning

As an individual investor or a business owner you have unique objectives and priorities that need to be considered. At Richardson Wealth, your Investment Advisor collaborates with our in-house Tax & Estate Planning professionals to deliver customized wealth management solutions designed to address tax, estate, insurance, philanthropic and succession needs.

Our approach. Our expertise. Our experience. **Our difference.**