



Planning for a family cottage

Few things in life bring families closer than the time they spend at the cottage. Whether it's for weekends throughout the year, a couple of weeks in the summer or an annual Thanksgiving or holiday dinner, the memories created for many families are rich and enduring. Unfortunately, these memories can be tarnished without proper tax and estate planning, as a second property can trigger tough financial issues for children upon the death of its owners. To help ensure a tax-efficient transfer of the family cottage to heirs, the following has been developed, which provides useful background information on the topic and up-to-date tax and estate planning strategies for vacation properties.

Background

Prior to 1972, there was no capital gains tax in Canada and a principal residence or a second vacation property could be sold without any capital gains tax. With the introduction of the capital gains tax regime in 1972, it became more important to plan around the ultimate disposition of property. Planning for a second property didn't really become an issue, however, until the beginning of 1982 when the government changed the rules governing the principal residence exemption. Prior to 1982, it was possible for each spouse to own a property and designate it as his or her own principal residence. Beginning in 1982 this was no longer possible. A couple may only designate one property between them as their principal residence for years of ownership after 1981.

Before March 1992, the \$100,000 lifetime capital gains exemption was available on all property and would have been available to shelter a gain on the sale of a second property (or on the deemed disposition of the property upon death of the last surviving spouse before a transfer of the property to the next generation). However, in February 1992, the capital gains exemption was modified to exclude gains on most real property and, in February 1994, the \$100,000 exemption was repealed completely for all property. This led estate practitioners to come up with strategies to pass the vacation property to the next generation in the most tax-efficient manner.





Strategies

Although numerous planning ideas have been suggested over the last number of years to reduce or defer the tax liability on the transfer of the cottage, probably the most common are the use of life insurance and the transfer of the property to a trust.

Life insurance. A life insurance policy can be purchased on the life of the owner of the cottage or, more commonly, on the last-to-die of the owner and his or her spouse or partner. In some cases, children (or grandchildren) who stand to inherit the property may be willing to pay the premiums on the policy. Practically, however, this may not be feasible. If the cottage owner is in his or her 60s or older, he or she may be uninsurable or, if he or she is insurable, the premiums could be prohibitively expensive. That's why it may be worth exploring other solutions.

Trust. Another strategy may involve the transfer of the property into an inter-vivos trust to avoid the deemed disposition of the property on the death of the original owner (or his or her spouse or partner). The biggest hesitation with transferring the property to a trust is that unless certain conditions are met (i.e., the new alter ego or joint partner trust rules), then a transfer to such a trust currently will trigger immediate capital gains tax.

If, on the other hand, you own a vacation property that has very little or no accrued capital gain currently, you may wish to transfer the property to a trust today so that any future capital gains tax that arises on the property may be passed on to your children. In addition, you may be unsure of whom to leave the property to because each child may have a different level of interest in the ultimate use or enjoyment of the property (discussed further below). By setting up a discretionary trust, the property can be transferred to the trust today. You can be the trustee of that trust and, therefore, control who gets the property at a later time.

The trust deed would normally specify that you have exclusive use of the property during your lifetime and have unlimited access to, as well as full control of the property. Later on, perhaps upon retirement, you may no longer use the property substantially, so you may wish to distribute it to the appropriate beneficiaries. The property could be rolled out of the trust to the children at the original cost base and thus tax would be deferred further until the property was ultimately sold.



Who should inherit?

Of more concern than the future tax liability for some is to whom to leave the property. It is not necessarily in the best interest of parents (or more importantly, their children) to leave the cottage equally to all kids. For example, a parent with three children may have one child who may be very interested in using the cottage in future years while the other two children may have less of an interest. Perhaps the other two children may be satisfied with a particular cash legacy to be received from the estate from the liquidation of other assets, such as open investments, life insurance, or the after-tax values of RRSPs or RRIFs. In this case, it would be simpler to leave the cottage to the child who truly wants it, as opposed to dividing the property into one-third interests

You may engage in an open and frank discussion with your children or grandchildren as to whether or not they actually wish to accept the “burden” that a cottage represents. Children may not have the wherewithal to finance the annual upkeep and maintenance (property taxes, landscaping, etc.) that ownership requires. This will help to ensure that planning today is not wasted in situations where certain children have no real interest in inheriting the property and the inherent costs associated with its upkeep. Both tax and estate planning considerations need to be discussed thoroughly before undertaking any type of plan with regard to a second property.

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5140 Yonge Street, Suite 900, Toronto, Ontario M2N 6X7

Tax & Estate InfoService

Telephone: 416.590.9855 or 1.800.874.6275

Facsimile: 416.590.9868 or 1.800.631.7008

inquiries@aimtrimark.com **www.aimtrimark.com**



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