



How to keep the family cottage in the family

The tranquility of the cottage and the memories of sun-kissed summers past can easily turn into headaches and even all-out feuds when a proper cottage succession plan is not in place.

Cottage succession planning

Studies show that cottages hold a deep and emotional bond for Canadians—not to mention a financial one.

The main goals of cottage succession planning are to establish a legal arrangement that keeps a cottage in the family over multiple generations as well as maintain family harmony. A good plan will allow you to pass the cottage on to your children without passing on a huge emotional and financial burden.

Unwelcome guests

Relaxation and memories aside, there are two main items to consider when planning to pass on the family cottage: capital gains taxes and probate taxes. Note that probate is not generally a factor in Quebec and Alberta.

Capital gains tax

For many people, one of the main goals in estate planning is to reduce or defer capital gains taxes payable upon death. Several strategies to help reduce or defer the capital gains taxes payable are available.

Gifting the property

A gift of capital property (such as a cottage) to someone other than a spouse is deemed to be a disposition at market value. If the original cost of the property plus any additions during the period of ownership are less than the market value of the property at the time of gifting, then there is a capital gain in the year of the gift. If the cottage value is expected to appreciate significantly in the future, a gift to your intended beneficiaries now may be advantageous so that the future gain is taxed in their names. If the donor does not want to give the beneficiaries outright control of the cottage, transferring the cottage to a family trust may be the solution.

Bequests

At the time of a cottage owner's death, the cottage is deemed to be sold at market value and tax owing on any capital appreciation is payable by the deceased's estate (other than when transferred to a spouse or special trust). At this point, a clause in the Will usually specifies who becomes the new owner

Abby Hall, PFP

Manager, Self-Publishing System

Royal Mutual Funds Inc.

200 Bay Street, Royal Bank Plaza
7th Floor, North Tower
Toronto, ON M5V 3C8

Tel: 416-974-6962

Fax: 416-955-3033

Cel: 416-000-0000

abby.hall@rbc.com

or beneficiary of the property.. In order to pay the tax on a bequest such as this, life insurance on the owner's life can be purchased to pay for the expected tax payable on the deemed disposition. A common strategy is to have the beneficiaries pay the premiums since they will ultimately benefit when they receive the full value of the property.

Principal Residence Exemption

Canadian tax rules allow any capital gain on the disposition of a "principal residence" to be exempt from income taxes. In summary, it is possible for each family member, even minor children, to designate an eligible capital property as a principal residence for years up to and including 1981. Beginning in 1982, the family unit (husband, wife and children under 18) is only allowed to designate one property as being their principal residence. Note that even a cottage that is occupied on a seasonal basis may be designated as a principal residence instead of the city home for purposes of the exemption. Generally the dwelling with the largest gain per year is designated as the principal residence to maximize the tax savings. Due to the complexity of the rules for the principal residence designation, it is a good idea to have your tax advisor evaluate the different scenarios available to you.

Capital Gains Exemption

In 1994, the federal government eliminated the \$100,000 lifetime capital gains exemption. However, taxpayers were allowed the opportunity to file a special tax election to "crystallize" previously unrealized gains on capital property in order to make use of any remaining capital gains exemption. The election was a one-time opportunity and although you cannot claim the exemption now, it would be prudent to check if the election was filed with respect to your cottage. The benefit of the election is that the cost base of the property is increased tax-free, reducing future capital gains when the property is sold.

Probate taxes

To reduce the amount of probate taxes you would otherwise be required to pay relating to your cottage, you may want to consider gifting the property while you are alive. Unfortunately, when the cottage is transferred to a non-spouse beneficiary there would be a disposition at market value triggering any accrued gains for tax purposes. In addition, there could be land transfer taxes, legal and other professional fees related to changing the ownership of the property. Therefore, a cost/benefit analysis must be undertaken to determine if the strategy is in your best interest. Other strategies worth looking into are Joint Tenancy with Right of Survivorship (JTWROS) ownership and Family Living Trusts. Ask your advisor for more details.

Avoiding upset by planning ahead

Here are some quick points to think about now that may save you and your loved ones a lot of hassle in the future:

- Begin discussing your intentions with your family early to avoid stress when you're gone.
- Set up a cottage trust fund. Because siblings may have widely varying financial resources, some may find it difficult to share expenses equally. A trust fund that generates income can be used to help pay expenses.
- Siblings should consider a written cottage co-ownership agreement with a lawyer if the cottage is to be shared in order to avoid disagreements and disappointment. Work out a plan for sharing time at the cottage, dividing responsibilities and expenses, such as opening and closing the cottage, routine maintenance and expenses such as upkeep and taxes.

Where to go for help

Cottage succession planning is important if you wish to keep one of your most important family assets—your cottage—in the family for generations to come. That's where we can help.

For more information about cottage succession planning or for answers to any other estate-planning questions you may have, please give me a call.

02/2004

The material in this newsletter is intended as a general source of information only, and should not be construed as offering specific tax or investment advice. Every effort has been made to ensure that the material is correct at time of publication, but we cannot guarantee its accuracy or completeness. Interest rates, market conditions, tax rulings and other investment factors are subject to rapid change. Individuals should consult with their personal tax advisor, accountant, or legal professional before taking any action based upon the information contained in this newsletter.

Financial planning services and investment advice are provided by Royal Mutual Funds Inc., a member company under RBC Investments. Royal Mutual Funds Inc., Royal Bank of Canada, Royal Trust Corporation of Canada and The Royal Trust Company are separate corporate entities, which are affiliated. Royal Mutual Funds Inc. is licensed as a financial services firm in the province of Quebec.

TM Trademark of Royal Bank of Canada. RBC Investments is a registered trademark of Royal Bank of Canada. Used under licence. © Royal Bank of Canada, 2005