FINANCIAL PLANNING

Dealing with Cottage Succession

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Spring is here and many of us are thinking of opening the family cottage and looking forward to those long lazy days of summer. Whether you call it a cottage, chalet, camp or cabin, it is your family's special place to relax and enjoy the great outdoors.

For many families, it is a place filled with happy memories, has been in the family for generations, and will be for generations to come. But keeping the cottage in the family from one generation to the next isn't always as easy as it might seem. There are many issues to consider, including how the taxes will be paid when it passes from one family member to the next.

REDUCE THE TAX BITE

When you bequeath your cottage, you are also passing along a potentially large tax bill. Depending on their financial situation, your beneficiaries may be forced to sell the family cottage simply to cover the taxes. There are two main types of tax involved here - capital gains and probate taxes.

In 1994, the federal government eliminated the $100,000 capital gains exemption but taxpayers were allowed to crystallize previously unrealised gains on property in order to utilize any remaining capital gains exemption. It would be prudent to check to see if this election was been filed on your cottage property.

If your cottage has been in the family for many years, its value has probably increased dramatically. The property your family bought years ago, for a few thousand dollars might now be worth a few hundred thousand today. Even properties within your lifetime might have experienced this type of exponential growth.

This increase in the value can result in a very large capital gain tax, which is triggered when you pass along the property to anyone - other than your spouse - including your children. However, there are several ways you can address this tax bill - even reduce or defer it.

CALCULATING CAPITAL GAINS

When you pass along your cottage to anyone other than your spouse, the CRA views it as having been sold at current market value – a deemed disposition. The capital gain on the deemed disposition may be taxable if you are unable to claim a principle residence exemption. The following example shows how there can be a $68,512.50 tax bill owing in 2014, on a cottage purchased for $5500 in 1981.

DEEDING PROPERTY AHEAD OF TIME

Simply giving your cottage to your intended beneficiaries ahead of time is one way to reduce future taxes upon your death. If you expect your cottage to significantly increase in value, consider giving it to your beneficiaries sooner rather than later. This will trigger a taxable capital gain from the appreciation of the property to date. The tax payable in the year the gift is made.

It should be a much smaller capital gain than the one that would be triggered in the future, assuming the property increases significantly in value. Any future gains will be taxed in the names of your beneficiaries, when they sell or give it away at a much later date. It will not be included in your final tax return when your estate is settled.

The capital gains on the disposition of a principle residence are exempt from income taxes.

Deemed Disposition, in 2014:	**$310,000**
Minus purchase price in 1981:	**$5,500**
Total Capital Gain:	**$304,500**
Capital gains taxable (50%of total):	**$152,250**
Taxes payable at 45% marginal tax rate:	**$68,512.50**

If you choose to make an outright bequest to more than one person, consider issues that may jeopardize the long term sharing of the property; such as disputes over use of the property, expenses, maintenance, divorce, or creditor action against one of the beneficiaries.

Probate taxes are generally calculated on all property in an estate other than those that are in Joint Ownership with Right of Survivorship.

PAY TAXES WITH INSURANCE

The most common way for property to be passed on to the next generation is through a bequest made in your will. When you property is bequeathed to anyone - other than your spouse - it triggers a taxable capital gain, which your beneficiaries may not be able to afford. You can cover this tax bill with a life insurance policy, which provides a sum equal to the expected tax bill when your estate is settled.

Although the premiums on an insurance policy purchased later in life can be expensive, 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.

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