the ADVISOR
RBC Wealth Management Services

April 22, 2010

Canadian Vacation Property Succession Planning

Vacation properties go by many names: cottage, chalet, camp, cabin or secondary home. Regardless of what they call it, many Canadians receive great personal enjoyment from their vacation property. Some owners feel it is important to keep the vacation property within the family and need help planning how to transfer ownership to younger family members. This article reviews various tax implications and strategies that can be used in passing ownership of the family vacation property to the next generation.

There are several tax and non-tax issues to consider when planning to transfer a vacation property to your beneficiaries, especially if more than one beneficiary is involved. From a tax perspective, there are two main items to consider: capital gains taxes and probate taxes. Note that probate is not generally a factor in Quebec and Alberta.

This article does not address the Goods and Services Tax (GST), Land Transfer Tax (LTT) or U.S. vacation properties. Usually sales of personal-use homes, by individuals or personal trusts, are exempt from GST/HST. Land Transfer Tax rules vary by province. If you own a vacation property in the U.S., we suggest you read our article entitled, *U.S. Estate Tax for Canadians: Estimating the Exposure and Strategies to Minimize or Eliminate the Tax.*

Capital Gains Tax

Calculating the Capital Gain

Consider the following scenario:

Several years after purchasing their home in the city, John and Mary purchased their cottage in 1965 at a price of $5,700. On December 31, 1971, its value was $11,250. Today it is worth $282,000. They decided in 1982 to upgrade their cottage and they spent $15,000 on an addition at that time. If they were to sell it today, the capital gain would be:

Sale Price	$282,000
Adjusted Cost Base (ACB)*	(26,250)
Capital Gain	$255,750

* ACB is made up of the December 31, 1971 value (or "V-Day" value) of ($11,250) plus the addition ($15,000).

Canadian Vacation Property Succession Planning

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. We will examine these strategies in the context of the most common methods of transferring ownership of the property.

Gifting the Property

A gift of capital property, such as a vacation property 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, is less than the market value of the property at the time of gifting, then there is a taxable capital gain in the year of the gift. If the vacation property 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.

Bequests

At the time of a property owner's death, the property 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 a spousal trust). A clause in the Will usually specifies the beneficiary, the individual who becomes the new owner of the property. Life insurance on the owner's life can be purchased to pay for the expected tax payable on the deemed disposition. 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.

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. Some of these issues will be addressed later in the article.

Principal Residence Exemption

Canadian tax rules allow any capital gain on the disposition of a "principal residence" to be exempt from income taxes. Due to the complexity of the rules for the principal residence designation, we recommend that you have your tax advisor compute and evaluate the different scenarios for you. In summary, it is possible for each family member 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 minor children) is only allowed to designate one property as being their principal residence. Note that even a vacation property that is occupied on a seasonal basis may be designated as a principal residence instead of the city home for purposes of the exemption.

Using the previous example, and assuming that the vacation property was worth $126,000 on December 31, 1981;

- The gain between December 31, 1971 and December 31, 1981 is $114,750 ($126,000 - $11,250). Since both John and Mary can each designate a property as their principal residence for these years, this gain can be sheltered from tax.

- The gain between January 1, 1982 and today is $141,000 ($282,000 – ($126,000 + $15,000)) or $5,222 per year. Since only one residence per family unit can be chosen as the principal residence after 1981, this figure should be compared against the gain per year on the city house. As a general rule, it is best to apply the principal residence exemption against the property that has the higher capital gain per year.

- Because the principal residence formula is based on the number of years owned plus one, at least one year can be allocated to the property with the lower capital gain per year.
- Assuming the city house has appreciated less per year since 1981 and therefore the full amount of the principal residence exemption is applied against the gain on the vacation property, the capital gain is fully exempted from taxation.

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 utilize 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 vacation property. The benefit of the election is that the cost base of the property is increased tax-free, thereby 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 vacation property, consideration could be given to gifting the property while you are alive. Unfortunately, when the property is transferred to a non-spouse recipient 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 gifting the property while alive to avoid probate taxes is worthwhile.

Other strategies to avoid probate on the vacation property asset upon death are as follows:

Joint Tenancy with Right of Survivorship (JTWROS)

It is possible to enter into a JTWROS agreement with an individual, other than a spouse, without incurring an immediate tax liability as well as avoid probate at death. In order to accomplish this you have to ensure that you do not transfer beneficial title, in the asset during your lifetime, to the joint tenant at the time of entering into the agreement. If you intend to implement this strategy it may be prudent that you stipulate your intentions in writing at the time you enter into the JTWROS agreement. You should seek legal advice before implementing to ensure that your intentions are properly documented. (However, in Ontario where an individual enters into a joint tenancy agreement with a tenant other than the individual's spouse, the joint tenancy will be severed immediately prior to death if the property was used as a family residence by both spouses and thereby deemed to be a matrimonial home).

A risk (other than in Ontario if the property is a matrimonial home) is that if JTWROS is initiated by you with two new joint tenants, and subsequently one of the joint tenants dies, the asset would pass to the surviving joint tenants and the estate of the deceased would not receive any interest in the property. For example, if initiated with a parent and two children, if one of the children were to die, the property would remain with the surviving parent and remaining child, but not pass to the children of the deceased child.

Family Living Trust

Transfer of the vacation property to a trust for the benefit of your beneficiaries results in a disposition at market value. In addition, every 21 years, there is a deemed disposition at market value of the property within the trust at which time tax on any accrued gains must be paid.

An exception to these "deemed disposition rules" at the time assets are transferred to a trust is when you are at least 65 year of age and you transfer property to an alter ego trust. In such a case, a deemed disposition neither occurs at the time the property is transferred to the trust nor upon its 21st anniversary. However, there is a deemed disposition at the time the trust/parents transfer the property to the children, which could be problematic as there may be significant accrued capital gains on the property at that time.

Other issues to keep in mind when creating the trust may include: rules regarding use of the property; how each beneficiary's interest in the trust is treated upon death (e.g., automatically passes to remaining beneficiaries of the trust or allows for it to be passed on to others); and ensuring proper maintenance occurs and how any expenses related to the upkeep of the property will be funded.

Continuing with the above example, if John and Mary should pass away this year, probate taxes could amount to $4,230 (($15/$1,000) x $282,000)**.

** The top marginal probate tax rate of $15 per $1,000 of probatable assets (for Ontario) is used on the assumption that there are other assets in addition to the vacation property that would be subject to probate and benefit from the lower probate rate.

As previously mentioned, a cost/benefit analysis must be undertaken to determine the best course of action and you should consult your tax and legal advisors prior to finalizing any decisions.

Non-Tax Issues

If you own a vacation property, you may wish to consider several non-tax issues as well.

Your children may not "get along" with each other after you die

Many people who own a vacation property become very emotionally attached to it; the property represents warm memories of family gatherings. If you own vacation property, you may have a desire to transfer the property to your adult children so that they too can continue to enjoy the property after you die. However, there is often a significant difference between being an invited guest and co-owning property with adult siblings. For example, your daughter might be delighted to stay in a basement bedroom in your cottage for a week in the summer as she would likely consider it to be a fun and inexpensive vacation. However, after you die, she may not be as thrilled when her older sister stays in the enormous master suite with the Jacuzzi tub. And even if all your children get along with each other, their respective spouses may, for example, have significantly different standards of cleanliness and tidiness in regard to the cottage, and this may be a source of conflict and tension.

Your children are not identical to each other

Some of your children may be less wealthy than others which may make it challenging to contribute to the maintenance and periodic capital improvements of the vacation property. Also, some of your children may live relatively far from the property, thus making it more difficult to visit it frequently or regularly in comparison to some of your other children.

Matrimonial Property Law

Matrimonial property laws vary from province to province in Canada. In most provinces, gifts/inheritances are excluded from property subject to division on marriage breakdown. (Note that in British Columbia inheritances are not automatically excluded, and in some provinces the application of this rule is dependent on the manner in which the property is used.) However in most, but not all, provinces in Canada, the growth on such gifts/inheritances is subject to division unless a marriage contract (e.g., prenuptial agreement) indicates otherwise. Also some provinces, such as Ontario, Manitoba, Quebec and Saskatchewan, allow a donor or testator (by deed of gift or will) to state/declare, pursuant to the relevant provincial matrimonial property legislation, that the growth on the gift/inheritance provided to the adult child (who resides in that province) shall not be divisible on marriage breakdown. It is important that you consult with a lawyer in your own province or territory to confirm the exact matrimonial property rules that apply in your jurisdiction.

Some Solutions

i) Consider providing each of your children with an equivalent-sized inheritance, and include a power for your executor to distribute assets in kind. This will give any child the opportunity to purchase the vacation property to the exclusion of the other children.

ii) It may be helpful for the co-owner children to enter into a “usage agreement”. Such an agreement may be especially helpful in setting out the manner in which the share of an outgoing owner can or will be “bought out”. However, one of the problems with these agreements is that if a party breaches the agreement, it will be difficult to force him/her to comply without jeopardizing family relations.

iii) If the children become co-owners of the property, you may wish to fund a trust, the purpose of which will be to finance ongoing maintenance of the property and to provide for periodic capital improvements to it.

iv) If you live in Ontario, Manitoba, Quebec or Saskatchewan, include a matrimonial property legislation statement/declaration in your will to ensure that your child’s interest in the property that he/she received from you as a gift/inheritance, specifically including any growth on such property, is not subject to a claim from an ex-spouse.

v) If you anticipate that the capital gains tax, arising as a result of the deemed disposition of the property at your death, is likely to be significant, particularly if your children have expressed to you a desire to retain the property rather than sell it, you may wish to consider purchasing life insurance. You may also wish to consider buying life insurance as a means of ensuring that each of your children receives an equivalent inheritance in the event that only one of them inherits the property.

Canadian Vacation Property Succession Planning

Family Meeting

A family meeting with your adult children will give you and your children an opportunity to share your thoughts with each other, and this will reduce the likelihood of making false assumptions about the wishes of your children.