

Cottage Succession Planning

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Many individuals have cottage properties they use for their personal enjoyment. Planning what to do with the cottage in the future may include thoughts of transferring the cottage to younger family members. This article reviews various tax implications and strategies of passing ownership of the family cottage to the next generation.

There are several issues to consider when planning to transfer the family cottage to your beneficiaries, especially if more than one beneficiary is involved. However, 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.

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)*	<u>(26,250)</u>
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).

One of the main goals in Estate Planning for many people 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 a cottage.

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 taxable 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.

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 a spousal trust). At this point, a clause in the Will usually specifies who becomes the new owner of the property, or beneficiary. 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.

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 available to you. In summary though, 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 minor children) 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.

Using the previous example, and assuming that the cottage 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 in 2003 is \$141,000 (\$282,000 - (\$126,000 + \$15,000)) or \$6,714 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 cottage, the capital gain is reduced to \$0 from \$255,750.

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 cottage. 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 cottage, consideration could be given to 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 gifting the property while alive to avoid probate taxes is worthwhile.

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

JOINT TENANCY WITH RIGHT OF SURVIVORSHIP

Joint Tenancy with Right of Survivorship (JTWROS) ownership. Note that entering into a JTWROS agreement with anyone other than a spouse, results in a deemed disposition at market value of a prorated share of the asset at the time of the agreement.

A risk is that if JTWROS is initiated by you with two new "tenants", and subsequently one tenant were to die, the asset would pass to the other remaining 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 tenant(s), but not pass to the grandchildren (children of the deceased tenant).

FAMILY LIVING TRUSTS.

Transfer of the cottage 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 cottage within the trust and tax on any accrued gains must be paid.

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

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

** The top marginal probate tax rate of \$15 per \$1,000 of probateable assets (for Ontario) is used on the assumption that there are other assets in addition to the cottage 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.

Note: The above information is based on the tax law in effect as of the date of this article. The article is for informational purposes only and should not be construed as offering tax advice. Individuals should consult with a qualified tax advisor before taking any action based upon the information contained in this article.

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