The Navigator

RBC WEALTH MANAGEMENT SERVICES

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)/ Harmonized Sales Tax (HST), 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 titled, Owning and Renting Property in the U.S.

The content in this article is for information purposes only and should not be taken as tax or legal advice. Prior to implementing any strategy, it is essential that you discuss your situation with a qualified tax or legal professional.

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).

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 on death 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

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other than a spouse, is deemed to be a disposition at fair market value. If the original cost of the property, plus any additions during the period of ownership, is less than the fair 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 disposed of at fair market value and tax owing on any capital appreciation is payable by the deceased's estate at his or her marginal tax rate. An exception to the deemed disposition rules occurs when the property is transferred to a spouse or spousal trust. In such a case, the property is deemed to automatically "roll over" to the other spouse at its adjusted cost base and no gain will be immediately reportable. Generally, the deceased's Will will specify the beneficiary/(ies) and thereby new owner(s) of the property. Life insurance on the owner's life can be purchased to pay for the expected taxes 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 are addressed in this article.

Principal Residence Exemption

Canadian tax rules allow any capital gain on the disposition of a "principal residence" to be exempt from income taxes. A vacation property that is occupied on a seasonal basis may be designated as a principal residence. 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 a property as a principal residence for years up to and including 1981. Since 1982, the family unit (husband, wife and minor children) is allowed to designate only one property as being their principal residence.

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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 about $4,548 per year. Since only one residence per family unit can be designated 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 principal residence exemption is entirely applied against the gain on the vacation property, the capital gain is fully exempted from taxation.

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.

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 deemed disposition at fair 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 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)

Transferring title to a vacation property into JTWROS is one method of avoiding probate fees payable on death. JTWROS means that upon the death of one joint tenant, the property is transferred directly to the surviving joint tenant, bypassing the estate. It is therefore not subject to probate. The transfer of the vacation property into joint tenancy may trigger a capital gain through the disposition of half the property. This tax consequence would occur where both beneficial and legal ownership of the property was transferred to someone other than a spouse. It could be significant if the property being transferred has appreciated significantly.

It is also possible to transfer the vacation property into JTWROS with an individual, other than a spouse, without incurring an immediate tax liability and still avoid probate at death. In order to accomplish this you must retain beneficial interest in the property and only transfer the right of survivorship to the joint tenant. On death, there will be a deemed disposition at fair market value of your 100% interest in the property, and any accrued gains on the property will be taxable on your terminal tax return. Your interest in the property will pass by right of survivorship to the surviving joint owner. 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. It is essential that you seek legal advice before implementing this strategy to ensure that your intentions are properly documented.

It should be noted that there are some pitfalls to transferring title to a property into joint tenancy. Aside from the potential tax consequences, transferring your property into joint tenancy could mean a loss of control over the property and decisions relating to it. There is also the risk that the property could be exposed to the creditors of the joint tenant.

In Ontario, one thing to be aware of is that where an individual enters into a joint tenancy agreement with a third person other than the individual's spouse, the joint tenancy will be deemed to be severed immediately prior to his death if the property was used as a family residence by the individual and his spouse and is deemed to be a matrimonial home. The joint tenant's interest will fall into his estate and be distributed in accordance with the terms of his Will or the rules of intestacy. The property may end up benefiting someone the original owner did not intend, such as the deceased joint tenant's spouse.

Another risk is that if ownership of the asset is transferred into joint tenancy 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 joint tenant would not receive any interest in the property. For example, if a parent transferred ownership into joint tenancy with his two children and one of the children were to die first, the property would remain with the surviving parent and child, but not pass to the children of the deceased child.

Family Living Trust

The use of a trust to hold a vacation property can help avoid probate fees payable on death since property inside the trust is not included in the value of your estate. When the vacation property is transferred to an inter-vivos trust for the benefit of your beneficiaries there is a deemed disposition of the property at fair market value. Any accrued gains on the property are taxable at that time to the transferor. In addition, every 21 years, there is a deemed disposition of the property at fair market value within the trust, at which time taxes 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 or joint partner trust. In order to be an alter ego or joint partner trust, no one other than you (or you and your spouse, in the case of a joint partner trust) can be entitled to the income and capital of the trust during your lifetime. There is no deemed disposition at the time the property is transferred to an alter ego or joint partner trust nor upon the 21st anniversary of the trust. However, there is a deemed disposition of the vacation property on the death of the settlor of the alter ego trust or on the death of the last spouse to die in the case of a joint partner trust, which is subject to tax at the top marginal tax rate.

Other issues to keep in mind when creating the trust may include: rules regarding the 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); the maintenance and upkeep of the property, such as how any maintenance expenses will be funded.

Continuing with the earlier example, if John and Mary should pass away this year, probate fees could amount to $4,230 (($15/$1,000) x $282,000)**. These fees could be avoided using the strategies 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.

** 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.

Non profit organizations

Another strategy that people have used in the past is to hold a vacation property in a non profit organization (NPO). CRA has recently commented that NPOs should not be used for personal or tax planning purposes and has been auditing NPOs they believe may have been established for such purposes. It is therefore important to obtain professional advice prior to implementing this strategy.

Non-Tax Issues

If you own a vacation property, you may wish to consider several non-tax issues as well, including the following:

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 a 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 visions for the use of 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 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 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 and Quebec, 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.

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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;

iv) If you live in Ontario, Manitoba or Quebec, 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; and

v) If you anticipate a significant capital gains tax, arising as a result of the deemed disposition of the property at your death, 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.

Conclusion

Parents who are beginning the estate planning process should consider that their adult children may have varying priorities and wishes. As such, parents are advised to sit down with their children at the beginning of the planning process to discuss these issues. 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.

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