Wealth Management
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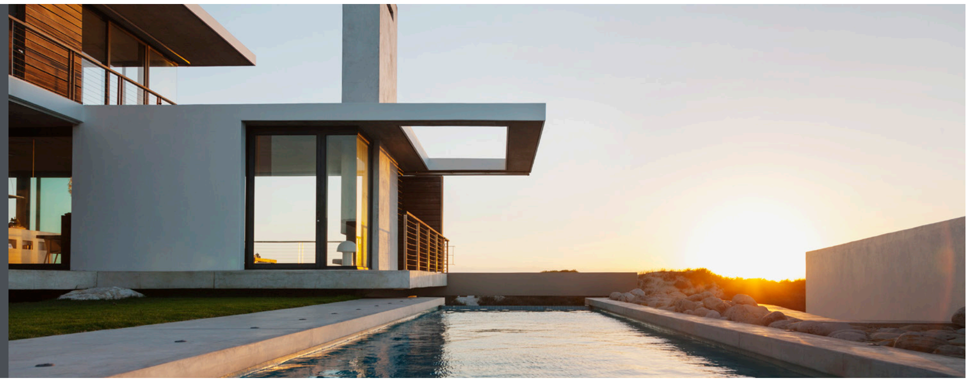

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Life events: Vacation home - succession

Financial checklist

1. Selling to a third party

Selling your Vacation Home (VH) to a third party is the most straightforward option for dealing with the family VH. Since it is a real estate transaction like any other, it should not involve the personal or emotional issues that can arise among family members. If you do not have any children to pass the VH down to, if your family members cannot come to an agreement as to how to share the VH, or if you would simply rather cash in the value of the property, then selling may be your preferred scenario. There are several tax issues that may come into play:

Capital gains/losses

When a VH is sold there will be a capital gain or loss, and half of that gain or loss must be considered for tax purposes. Two pieces of information are required to calculate a capital gain: the Fair Market Value (FMV) and the Adjusted Cost Base (ACB), with the difference between them being the capital gain or loss. Any costs relating to the purchase will increase the ACB, and any costs relating to the FMV will reduce the capital gain (or increase the capital loss).

Valuation day (V-Day)

Before 1972 there were no capital gains taxes, so if you are selling a VH that was bought in 1971 or earlier, special tax rules come into play. The tax cost or ACB of the property is determined in one of two ways: the Valuation Day Method or the Median (or Tax-Free Zone) Method. If the property has increased in value over the years, the Valuation Day Method typically has the most advantages; your Advisor can provide you with additional details and information. The Median Method is used mostly by corporations and takes the median of the original cost, Valuation Day value, and the disposition (sale) value.

The Principal Residence Exemption (PRE)

This is one of the more favourable tax advantages available to the average Canadian and can help reduce or eliminate the capital gains you would have to pay when you sell a 'Principal Residence'. The PRE is typically used when you sell your home, but it can also be used on the sale of a VH, and can offer advantages in certain situations. The PRE rules state that only one residence can be designated as a ‘Principal Residence’ by a family unit in a given tax year.

That means that you can use the tax advantage for either a primary home or VH, but not both—although the benefit can be shared between more than one property as long as both are not designated for the same tax year. You should study the relative unrealized capital gains on both properties (the capital gains you would have to pay if you sold both of the properties) to determine which prop-erty it makes the most sense to designate for your PRE. You may receive further tax advantages if you and your spouse owned both a cottage and a house before 1981. Your Advisor will have more information about the PRE.

2. Transferring to a family member

While selling a VH to a stranger or third party is fairly straightforward, handing down your property to family mem-bers raises some crucial issues. It may be important for you to pass on the VH to continue a family connection, but you should carefully consider your plans so that you avoid future complications. There will be tax issues, certainly, but typically more far-reaching and significant are the emotional and personal implications for your family. There are many true stories of families where disputes and misunderstandings about the future of the family VH have caused permanent rifts between family members. Planning ahead is extremely important and, ideally, all of the interested parties should be brought into the discussion upfront so that you can reach some sort of consensus together.

Transferring a VH to your spouse

Transferring a VH to your spouse through your estate is usually only a temporary solution since it doesn’t resolve the issue of who will get the VH in the next generation—but it can certainly be done. Under tax law, when one spouse transfers property to other spouse, there are no immediate tax consequences. This is also the case where the VH is jointly owned. For example:

Transferring a VH to your child or children

If there is no surviving spouse, then assets, including a cottage, are considered to be sold at their FMV at the time of death. In most cases, this results in a taxable capital gain to the deceased’s estate. The beneficiaries receive the property at the FMV and that is their ACB for future reference. Who the beneficiary or beneficiaries are is determined through the Will.

There are ways to reduce or eliminate the tax burden on your beneficiaries when passing down the VH. One valuable and flexible solution is to transfer the VH into a trust, either when you are still alive or after you pass. Speak to your Advisor about whether a trust can help you meet your overall financial planning and estate objectives.

3. Using a trust

A trust can be a very useful and flexible planning tool when it comes to passing on your VH to future generations. There are two ways that you can use a trust when transferring a VH:

Holding the VH in trust

Inter vivos trusts

An inter vivos trust is created when you transfer your VH (or any other assets you have) into a trust while you are still alive. The person you appoint trustee then becomes the legal owner of the property and will manage and deal with the trust assets (which would include the VH) as you have specified in the trust deed, for the benefit of the ben-eficiaries named in the trust—such as your children. By establishing a trust, you have some control over how the cottage is managed after you pass. This can ensure a transfer that is fair for all of your beneficiaries and hopefully avoids or reduces disagreements.

Testamentary trusts

A testamentary trust is established when you die, usually through your Will. In this situation, the VH is transferred to the trust after your death, according to your (the settlor of the trust) instructions. As with an inter vivos trust, you can establish the terms of the trust to ensure ongoing, equitable treatment for your beneficiaries.

When you transfer an asset such as a VH is transferred into an inter vivos or testamentary trust, it is considered for tax purposes to have been sold at Fair Market Value (except in the case of a spousal trust). This will most likely re-sult in a taxable capital gain. You may be able to use the Principal Residence Exemption (PRE) to reduce or eliminate the tax payable, but this will depend on your particular circumstances. Otherwise, some tax will have to be paid. Speak with your Advisor for more information on the PRE.

In the case of an inter vivos trust, as the VH owner you should be prepared to pay the resulting tax. With a testa-mentary trust, though, your estate will be responsible for paying any resulting tax—which will reduce the final value of the assets your beneficiaries receive. If you want avoid this situation, you should plan to have enough cash in the estate to pay for the resulting taxes. You can do this, for example, by taking out life insurance and naming the es-tate as the beneficiary.

Maintenance trusts

Instead of transferring your VH into a trust, you might instead transfer the VH directly to your children and then es-tablish a trust that contains money to pay for the ongoing maintenance of the VH. This arrangement should avoid many of the problems that can surface when co-owners of a VH are faced with sharing the maintenance costs.

Alter ego and joint partner trusts

Alter Ego and Joint Partner Trusts are both a type of inter vivos trust into which you transfer your VH while you are still alive. An alter ego trust is an inter vivos trust established for your (the VH owner's) personal benefit. A joint partner trust is an inter vivos trust established for the benefit of both you and your spouse or common law partner. The main advantage of these trusts is that, if they are properly structured and maintained, the trans-fer of the VH into the trust is not considered a "deemed disposition", or a sale at its Fair Market Value. This means that you can defer any capital gains on the trust (resulting from the "sale" of the VH) until your death. There are specific rules regarding these trusts and they should only be established with the help of a qualified professional.

Probate

Probate fees are, essentially, death taxes and are applied to the assets in your estate. All of the provinces except Quebec have probate taxes. One way to avoid probate fees on a VH is by using an inter vivos trust, since the VH will not form part of your estate. You should keep in mind that probate taxes are generally not that high when compared to income taxes, so consider whether establishing a trust to avoid probate fees makes sense in the context of your overall financial plan and objectives.

Professional assistance

Trusts are very useful and flexible but it is important that you seek qualified legal and tax advice before attempting to establish the trust(s).