Wealth Management

the Navigator

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC FAMILY OFFICE SERVICES

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Planning considerations for your Canadian vacation property before June 25, 2024

Many Canadians who own vacation properties have a deep connection with these secondary homes, as they are often well-loved places of leisure and a source of fond memories and experiences with family and friends. Whether you're planning to sell or pass the property on to future generations, there can be strong emotions tied to the decision.

With many vacation properties in Canada increasing in value, and the 2024 federal budget proposal to increase the inclusion rate from 50% to 66.67% for capital gains realized that are above $250,000 for individuals, it's important to consider your options and potential planning opportunities. This proposed change will apply to capital gains realized on or after June 25, 2024. Any capital gain realized by an individual before June 25 will be subject to a 50% inclusion rate. If you own a Canadian vacation property, such as a cottage, and it has a large accrued capital gain, you may wish to consider whether it would make sense to sell or transfer this property before June 25 to benefit from the lower inclusion rate. This article discusses some of the tax-related and other aspects to consider before making your decision.

For the purposes of this article, it's assumed the capital gain from a disposition of your vacation property would not be excluded by your principal residence exemption.

Should you sell or transfer your vacation property now?

If you were planning on selling your vacation property or transferring it to your intended beneficiaries in the near to medium term, you may want to consider whether you should accelerate the timing of this transaction and complete this sale or transfer before June 25, 2024. Disposing of your vacation property prior to June 25 may result in some tax savings to you.

To illustrate this point, let's consider an example of an individual who transfers their vacation property to their intended beneficiaries before June 25 at the 50% inclusion rate, versus transferring their property on or after June 25 when the inclusion rate is increased to 66.67% for capital gains above $250,000.

Let's assume:

- The fair market value (FMV) of the vacation property is $1,300,000.
- The adjusted cost base (ACB) of the vacation property is $300,000.
- The individual's marginal tax rate is 50%.

	Before June 25	On or after June 25
Realized capital gain	$1,000,000	$1,000,000
Capital gains inclusion rate	50%	50% on the first $250,000 66.67% above $250,000
Taxable capital gain	$500,000	$625,025
Taxes payable	$250,000	$312,512.50
Increased taxes payable if transfer on or after June 25		**$62,512.50**

If the individual transfers their property to their beneficiary prior to June 25, they will save 62,512.50 in taxes.

Planning options

Transferring your vacation property to your intended beneficiary

Gifting your vacation property to a beneficiary, other than your spouse or common-law partner, will trigger a disposition of the property at FMV. If the ACB of your property is less than the FMV of the property at the time of the transfer, you'll realize a taxable capital gain in the year of transfer.

If your beneficiaries don't have sufficient funds to pay you for your vacation property, you can take back a note or mortgage for the balance owing. This would allow you to claim a capital gains reserve and spread out the recognition of the capital gains over up to five years.

If you decide to sell the property to your intended beneficiary, you'll also trigger a capital gain based on the difference between the ACB and the greater of the FMV of the property or the proceeds received. It's important to set the sale price at least equal to the FMV of your vacation property, not a reduced or nominal price. The Canada Revenue Agency (CRA) will consider the property to have been sold at the FMV, so reducing the price will not reduce the capital gains tax to you. Also, when your beneficiary eventually sells or passes on the property, they will be required to report the reduced purchase price as their cost base, possibly resulting in double taxation.

If your beneficiaries don't have sufficient funds to pay you for your vacation property, you can take back a note or mortgage for the balance owing. This would allow you to claim a capital gains reserve and spread out the recognition of the capital gains over up to five years. Until detailed draft legislation is released, it's not known how capital gains recognized before June 25 will be treated when the capital gains reserve is claimed, and whether the future reserve brought into income each year will be subject to the 50% or 66.67% inclusion rate if the capital gain for that year exceeds $250,000. If you structure the sale in this manner, you may consider forgiving the note or mortgage in your Will so that your beneficiaries will receive the property free of any debt.

Transferring your vacation property to a trust

Another potential option would be to transfer your vacation property to a trust for the benefit of your intended beneficiaries. This may be desirable where you're looking to maintain a degree of control over the vacation property. In general, when you transfer a vacation property to a trust during your lifetime, there will be a deemed sale of the property at FMV, triggering the unrealized capital gains.

You'd want to consider the costs of setting up the trust and administering the trust, as well as the enhanced income tax reporting requirements that now apply to trusts. Consideration would also need to be given to how the trust will be funded to pay for ongoing expenses and maintenance of the property.

Most trusts are subject to a 21-year deemed disposition rule. On the 21st anniversary of the trust, and every 21 years thereafter, there's a deemed disposition of the trust property which could trigger capital gains if the vacation property has appreciated in value. These capital gains may be taxable in the trust and would potentially be subject to the proposed 66.67% inclusion rate for capital gains earned by trusts on or after June 25. When creating this trust, consider how you want to deal with the property prior to the 21st anniversary of the trust. If the trust is properly structured, the trustee may be able to roll out the property on a tax-deferred basis to a Canadian resident beneficiary.

If the vacation property is sold while held by the trust, the future appreciation might also be subject to the proposed 66.67% capital gains inclusion rate for trusts. As a result, you may wish to provide your trustee with the flexibility to allocate out capital gains to a beneficiary to potentially benefit from their 50% inclusion rate on the first $250,000 of capital gains.

Transferring your vacation property to your spouse

If you own your vacation property in sole name, you could consider transferring the property to your spouse or common-law partner. The default tax treatment is that the property would be transferred at your ACB. However, it's possible to elect out of this rollover and transfer the property at FMV to your spouse, triggering the unrealized capital gain. The deadline to file the election (there's no prescribed form) is the income tax return deadline, generally April 30, 2025. Note that capital gains realized on a future sale of this property would attribute to you and be taxed in your hands unless your spouse uses their own funds to pay for the property.

Funding the tax liability

For any of these planning options, you'll need to consider how you're going to fund the tax liability, as well as whether any land transfer taxes or other fees will be payable as a result of the gift or sale.

Paying the tax liability from your own funds may result in a domino effect if assets need to be liquidated, thus triggering additional taxes. Another option may be to have your beneficiaries (to whom you've sold or gifted the property) pay the tax liability.

Alternative minimum tax (AMT)

In addition to your regular income tax liability, you may want to consider whether triggering capital gains on the disposition of your vacation property may result in AMT. For more information on AMT, ask your RBC advisor for an article on this topic.

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Other considerations

If you choose to transfer your vacation property during your lifetime, either by gift or sale, it's important to keep in mind that you're giving up control over the property, as well as the security of owning that property. In addition, you're possibly exposing the property to your beneficiaries' creditors, including matrimonial creditors. If your beneficiary is currently married or in a common-law relationship or will enter one of these relationships in the future, the vacation property may form part of their family property and be subject to division on relationship breakdown. To protect this property from potential division on relationship breakdown, your beneficiary may wish to sign a domestic contract regarding the treatment of this property should their relationship come to an end.

If you transfer the vacation property to more than one person, keep in mind that certain issues may jeopardize the long-term sharing of the property (for example, disputes over the use of the property and who's responsible for the expenses related to its maintenance). You may want to encourage the new owners to enter into a co-ownership agreement. A co-ownership agreement may include terms dealing with the use of the property and how expenses and property improvements are to be handled. It may provide a decision-making process for the transfer or sale of the property on an owner's death, incapacity or relationship breakdown, and it may specify the individuals whom the property can be transferred to, both during the owner's lifetime and on death.

Continuing to hold your vacation property

If your intention is to hold onto the vacation property for the long term, you'll want to consider how the proposed change to the inclusion rate will impact you when you ultimately dispose of, or are deemed to dispose of, your property.

If your plan is to hold onto the property until your death, you'll need to consider whether your estate will have enough liquid assets or cash on hand to pay the tax obligation. Life insurance may be the least costly method of compensating for the taxes payable at that time.

Conclusion

If you own a Canadian vacation property with a substantial unrealized gain, it's important that you speak with a qualified tax and legal advisor about whether you should take steps to realize this gain before June 25. For a more robust discussion of the impact of the proposed changes to the capital gains inclusion rate for individuals, corporations, estates and trusts, please refer to the article titled "2024 Federal Budget – Planning for the proposed increase to the capital gains inclusion rate."

This article may contain strategies, not all of which will apply to your particular financial circumstances. The information in this article is not intended to provide legal, tax or insurance advice. To ensure that your own circumstances have been properly considered and that action is taken based on the latest information available, you should obtain professional advice from a qualified tax, legal and/or insurance advisor before acting on any of the information in this article.

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NAV0316 (04/2024)