Wealth Management

the Navigator

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC FAMILY OFFICE SERVICES

Succession planning for your Canadian vacation property

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Vacation properties go by many names: cottage, chalet, camp, cabin or secondary home, for example. For many Canadians, regardless of what you call it, these types of vacation properties are a source of great personal enjoyment. Some owners may feel strongly about passing their vacation property to the next generation; if that's the case, it's important to consider how best to transfer ownership to other family members. This article reviews various tax implications and strategies that can be used in passing ownership of your 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, the two main aspects to consider are capital gains tax and probate fees (note that probate fees are not generally a factor in Quebec, Manitoba and Alberta).

This article does not address Goods and Services Tax (GST)/ Harmonized Sales Tax (HST), Land Transfer Tax (LTT), or U.S. vacation properties. LTT rules vary by jurisdiction. If you own a vacation property in the U.S., please ask your RBC advisor for the article on owning and renting property in the U.S.

Any reference to a spouse in this article also includes a common-law partner.

Tax considerations

Capital gains tax

One of the main considerations when estate planning for your vacation property is the income tax liability that may arise on death with respect to the property. This may be a concern if your vacation property has appreciated in value since the date you acquired the property. In

general, when you pass away, you are deemed to dispose of your capital property, including your vacation property, at fair market value (FMV). The amount by which the FMV of the property exceeds the adjusted cost base (ACB) of the property on the date of death is the capital gain. Of that gain, 50% is taxable on your final tax return at your marginal tax rate. An exception to the rules applies when the property is transferred to a spouse or a qualified spousal trust. When this is the case, the property is deemed to automatically “roll over” to the surviving spouse or qualified spousal trust at its ACB and no gain will be immediately reportable. If you realize a capital loss on personal-use property, such as a vacation property, you cannot claim that loss for tax purposes.

In reviewing different planning options for the transfer of ownership of your vacation property, you may want to consider strategies that may defer or reduce the capital gains tax liability on death.

Determine the ACB of your vacation property

To get a better sense of the potential capital gains tax exposure on the sale, transfer or deemed disposition on death of your vacation property, you must first determine the ACB of the property.

The ACB of your vacation property will normally be the purchase price plus any expenses to acquire it, such as real estate commissions and legal fees. If you acquired the property by gift or inheritance, the ACB of your vacation property will generally be the FMV on the date you acquired the property (or the date of death of the person you inherited the property from).

The ACB of a property also includes capital expenditures, such as the cost of additions and capital improvements to the property. It’s important that you keep documentation to substantiate the costs for capital improvements and renovations made to the property.

There are also some unique tax events that may impact the calculation of your ACB. Capital gains only became taxable in Canada from 1972 onwards. As such, if you owned your vacation property before 1972, the starting point for calculating your ACB is generally the FMV of the property on December 31, 1971.

Starting in 1986, Canadian taxpayers had an opportunity to claim a capital gains exemption against capital gains realized on capital property, including real property. By 1994, the exemption was $100,000 when the federal government decided to restrict the application of the capital gains exemption only to capital gains realized from the disposition of qualified small business corporation shares and qualified farm properties. In 1994, taxpayers had the opportunity to file a one-time special tax election to “crystallize” unrealized

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gains on capital property to utilize any remaining capital gains exemption. The election allowed you to bump the ACB of certain capital property, such as real estate, to a maximum of its FMV at the end of February 22, 1994, to claim the $100,000 capital gains exemption. While you can’t claim the exemption now, it’s a good idea to check if the election was filed with respect to your vacation property.

Principal residence exemption

Canadian tax rules allow you to reduce or eliminate the capital gains realized on the disposition of a “principal residence” by claiming the principal residence exemption (PRE). A principal residence for a particular year may include a vacation property if you “ordinarily inhabit” the property at some time during the year.

The PRE is calculated using the following formula:

$$\frac{1 + \text{Number of years designated as principal residence}^{*}}{\text{Number of years the property is owned after 1971}} \times \text{Capital gain} = \text{PRE}$$

Prior to 1982, each member of your family unit (which includes you, your spouse and unmarried minor children) was allowed to designate a separate property as their principal residence for each tax year. Since 1982, your family unit is allowed to designate only one property as their principal residence for each tax year. As such, if you own more than one property that may qualify as your principal residence after 1981, you will need to decide, at the time of sale or transfer of one of those properties or on your death, which property to designate as your principal residence during the period of multi-home ownership.

You will want to determine which property has the greatest average annual increase and consider designating that property as the family’s principal residence for the maximum number of years. Note that the maximum number of years a property needs to be designated as the principal residence is the number of years of ownership minus one (due to the one-plus rule) to fully exempt the gain.

Due to the complexity of the rules for the PRE, it’s recommended to have a qualified tax advisor compute and evaluate the different scenarios for you. For a more

* The taxpayer must have been resident in Canada during these years to qualify for inclusion in the formula.

detailed discussion of the rules relating to the principal residence exemption, ask your RBC advisor for the article on this topic.

Probate fees

Generally, if you own your vacation property in sole name, it will form part of your estate on death and may be subject to probate fees. Probate fees vary in each province and territory, and in many cases the fees are based on a percentage of the value of the estate. There are different strategies that can be used to reduce probate fees with respect to your vacation property. These strategies will be discussed later in this article. The key element of all of the strategies is to transfer title of the vacation property out of your name so the property will not form part of your estate when you pass away and will therefore not be subject to probate fees.

Although minimizing probate fees may be one of your objectives in planning for the transfer of your vacation property, there are other considerations. For example, there may be additional costs to consider when using any of these strategies, such as capital gains tax, land transfer tax, and legal and other professional fees related to changing the ownership of the property. To determine if any of these strategies to minimize probate fees are worthwhile, it's important to complete a cost/benefit analysis.

Non-tax issues

If you own a vacation property, you may want to consider several non-tax issues, such as family dynamics and legal matters that may impact the planning choices you make.

Family disputes after your death

Many people who own a vacation property become very emotionally attached to it; the property often represents warm memories of family gatherings and enjoyment. If you own a vacation property, you may have a desire to transfer the property to your family members so they can continue to enjoy the property after your lifetime.

When considering your vacation property as part of your estate plan, keep in mind that there's often a significant difference between being an invited guest and co-owning property with family members. For example, your daughter might be delighted to stay in a basement bedroom in your vacation property for a week in the summer, as she may likely consider it to be a fun and inexpensive vacation. However, after your passing, she may not be as thrilled with the basement bedroom when her older sister stays in the enormous master suite with the jacuzzi tub. Even if all of your family members get along with each other, their respective spouses may, for example, have significantly different visions for the use of the vacation property, and this may be a source of conflict and tension.

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Some of your family members may also be in a different financial position than others, which may make it challenging to contribute to the maintenance and periodic capital improvements of the vacation property. Also, some of your family members may live relatively far from the property, thus making it more difficult to visit it frequently in comparison to other family members.

If you're concerned about how these issues might impact the relationship among your family members, proper planning is required to ensure the successful transition of ownership of your vacation property.

Creditor and matrimonial claims

When you transfer your vacation property to your intended beneficiaries, either during your lifetime or on death, you may be exposing the property to their creditors, including matrimonial creditors. Matrimonial property laws vary among the provinces and territories in Canada. However, it is possible if your beneficiary's relationship breaks down, their interest in the vacation property may be subject to division, even if they received their interest as a gift or inheritance.

Even an indirect interest in a vacation property, for example, through a trust, may be included as part of the assets subject to division on relationship breakdown in certain provinces and territories. You may wish to confirm with a qualified legal advisor the matrimonial property law that applies in both your and your beneficiary's jurisdiction of residence and consider how it may impact any planning with respect to your vacation property.

Planning options

Transferring the vacation property during your lifetime

If your vacation property value is expected to appreciate significantly in the future, gifting or selling the property now to your intended beneficiaries may be advantageous so that you can shift any future appreciation of the property to them, capping your ultimate tax liability. This can also help reduce probate fees to which your estate may be subject to on death, as the vacation property will no longer form part of your estate.

Gifting the vacation property to a beneficiary, other than your spouse, 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. You may want to consider whether you can and should use your PRE to shelter any of this gain from tax. Alternatively, you'll need to consider how you're going to fund that tax liability.

If you sell your vacation property to a beneficiary, you'll also generally trigger a capital gain based on the difference between the ACB and the greater of the FMV of the property or the proceeds received (if you sell the property to a non-arm's length person for less than its FMV, you are deemed to have disposed of it at its FMV). If you don't receive all of the sale proceeds in the year of sale, or you choose to take back a note, you may be able to spread out any taxable capital gain over a period of up to five years by using a capital gains reserve. For more details on the capital gains reserve, ask your RBC advisor for a copy of the article on that topic.

If you choose to transfer your vacation property while you are living, either by gift or sale, it's important to consider that you're giving up control over the property, as well as the security of owning that property. In addition, you are possibly exposing the property to your beneficiaries' creditors, including matrimonial creditors.

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 may specify the individuals to whom the property can be transferred to, both during lifetime and on death.

Joint tenancy with right of survivorship

Transferring title to a vacation property into joint tenancy with right of survivorship (JTWROS) may help reduce probate fees payable on death. If it can be demonstrated that you intended to gift the property to the surviving joint tenant(s) on your death, the property should pass by right of survivorship directly to the joint tenant(s) outside of your estate and shouldn't be subject to probate. As the legal and tax issues are complicated when transferring assets into joint ownership, it's important to seek professional legal and tax advice if you're considering this option. Note that the transfer of the vacation property into joint tenancy may trigger a disposition for tax purposes, and a portion of the unrealized gains may be deemed to be realized and taxable to you. This tax consequence may be significant if the property being transferred has appreciated significantly.

> When you transfer your vacation property to your intended beneficiaries, either during your lifetime or on death, you may be exposing the property to their creditors, including matrimonial creditors.

In addition to the potential tax liability that may be triggered when the property is put into joint names, there are other potential pitfalls or drawbacks of a JTWROS arrangement that should be considered. As in the case of an outright gift or sale, transferring your property into joint tenancy could mean a loss of control over the property and decisions relating to it. There's also the risk that the property could be exposed to the creditors, including matrimonial creditors, of the joint tenant.

There are other considerations if you transfer ownership of a vacation property into joint tenancy with more than one person, for example, your two children, where you documented your intention for the property to go to them on your death. If one of those joint tenants predeceases you and you don't engage in further planning, on your death, the property will pass to the surviving joint tenant and the estate of the predeceased joint tenant would not receive any interest in the property.

Transferring the vacation property to a trust

You may wish to consider transferring your vacation property to a trust settled during your lifetime. There are a number of potential benefits to using this strategy, including:

- **Proper governance**: In cases where there's more than one beneficiary sharing a vacation property, having one or more trustees manage the property may help with conflict and dispute resolution.
- **Tax minimization**: If your vacation property is transferred to a trust during your lifetime, any future growth in the value of the property will not be taxed in your hands. This may reduce or defer capital gains tax.
- **Reduced probate fees on death**: The use of a living trust to hold a vacation property can help minimize probate fees payable on death since property inside the trust is not included in the value of your estate.
- **Protection from creditor claims**: If structured properly, the trust may offer protection from your beneficiaries' creditors, including marital creditors.

When you transfer a vacation property to a trust during your lifetime, there will generally be a deemed sale of the property at FMV. Any accrued gains on the property will be taxable to you in the year of transfer.

As well, most trusts are subject to the 21-year deemed disposition rule. On the 21st anniversary of the trust (and every 21 years thereafter), there will be a deemed disposition of the trust property, which could trigger capital gains if the vacation property has appreciated in value. These capital gains would be taxable in the trust at the highest marginal tax rate in the trust's province or territory of residence. If the trust is expected to last longer than 21 years, it's important that a qualified tax advisor be consulted to plan for this event.

An alter ego trust (AET) or joint partner trust (JPT) provides an exception to the deemed disposition rules at the time assets are transferred to the trust and to the 21-year deemed disposition rule. To be an AET or JPT, you must be at least 65 years of age at the time you create the trust. For an AET, you must be entitled to receive the income of the trust while alive and no other person other than you can receive or use income or capital from the trust during your lifetime. For a JPT, you, in combination with your spouse, must be entitled to receive all income from the trust prior to the death of the second spouse; additionally, no one else can receive or use any income or capital from the trust before the death of the second spouse. However, there is a deemed disposition of the vacation property on the death of the settlor of an AET, or on the death of the second to die in the case of a JPT, which is subject to tax at the top marginal tax rate. An AET or JPT may be able to claim the PRE to shelter capital gains from tax that arises from a deemed disposition or sale. For more details on an AET's or JPT's ability to access the PRE, ask your RBC advisor for a copy of the principal residence article.

Aside from tax, there are other considerations to keep in mind when creating a trust to hold your vacation property. They include:

- Rules regarding the use and enjoyment of the property.
- Provisions for the death of a beneficiary of the trust (e.g. does the trust agreement name an alternate beneficiary?).
- Provisions for the maintenance and upkeep of the property. The trust agreement should address who will be responsible for the upkeep of the vacation property and any related costs. You may wish to consider contributing a sum of money to the trust to cover these costs.
- Oftentimes, when individuals consider using trusts for vacation property planning, the intention is to create an organized system where trustees will be able to manage the property for the benefit of all beneficiaries for an indefinite period. However, in most jurisdictions in Canada, there are specific limitations placed on the longevity of trusts which may prevent the asset from remaining in a trust forever.

> 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.

Non-profit organizations

Another potential strategy is to hold a vacation property in a non-profit organization (NPO). One way to structure an NPO is by using a non-share capital, not-for-profit corporation (NFPC). Your family members or intended beneficiaries could be the members and directors of the NFPC. Members of the NFPC would be permitted to use the vacation property in accordance with the NFPC's constitution and by-laws in exchange for membership contributions.

One of the advantages of using an NFPC is the ability to shelter future appreciation from capital gains tax on the death of a specific individual or on the sale. The initial transfer of the property to the NFPC would trigger a disposition, crystalizing any accrued capital gains. However, future capital growth would be protected (as an NFPC is generally tax-exempt). Another advantage is that this property would no longer be subject to probate fees on your death, as you would no longer own the property.

Similar to a trust, an NFPC provides for continued governance and allows for easy transitions between management. This structure provides you with the opportunity to document and manage financial and maintenance obligations relating to the vacation property. However, unlike trusts, which may not be able to last forever, an NFPC can exist and continue to hold title to the vacation property indefinitely. As well, NFPCs are not subject to the 21-year deemed disposition rules like trusts.

Some of the disadvantages of using an NFPC to hold your vacation property include the potential capital gains tax liability on the initial transfer, as well as the costs related to filing tax returns and annual reports. The main disadvantage which may make this strategy unviable is that the use of the vacation property by a member may give rise to a taxable shareholder benefit. A shareholder benefit can be mitigated by contributions to the NFPC. It is possible that the cumulative costs of this strategy may

therefore outweigh any benefits. It's important to obtain advice from a qualified tax and legal advisor prior to implementing this strategy.

Transferring the vacation property by Will

You may wish to consider leaving your vacation property in your Will outright to one or more of your beneficiaries. This option allows you to continue to maintain control of the property and defers any tax until you die. In your Will, you can leave the vacation property to one beneficiary who uses it, while making gifts of equal value to your other beneficiaries. You can also include a right of first refusal for a beneficiary to take the vacation property as part of their share in the estate or purchase it to the extent the value is more than their share.

If you want to allow your beneficiaries to take the property together, you can set out in your Will instructions for your executor(s) to retain a lawyer to prepare a co-ownership agreement prior to transferring ownership. These agreements can provide a framework for dealing with many issues that may cause conflict.

If your beneficiaries become co-owners of the property, you may want to consider funding a trust to finance the ongoing maintenance of the property and to provide for periodic capital improvements. In this regard, you may want to consider purchasing a life insurance policy on your life. The tax-free death benefit can be used to cover ongoing costs related to the vacation property. The death benefit can also be used to cover any capital gains tax liability that may arise on your death with respect to your vacation property. This can help ensure the property can be retained and not sold. As well, you may consider buying life insurance as a means of ensuring that each of your beneficiaries receives an equivalent inheritance if only one of them inherits the property.

You can also leave your vacation property to your beneficiaries by way of a trust set up in your Will (known as a testamentary trust). Similar to a living trust, a testamentary trust allows you to set out the terms for how the property should be used, as well as determine the responsibility for payment of related expenses. It also may protect the property from your beneficiaries' creditors.

Conclusion

As part of your estate planning process, it's important to consider that your beneficiaries may have varying priorities and wishes. It's a good idea to have a conversation with them at the beginning of the planning process to discuss your plans. A family meeting will give you and your beneficiaries an opportunity to share your thoughts with each other, hopefully reducing the likelihood of making false assumptions about their wishes and providing them with a better understanding of your intentions as well.

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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