Wealth Management

the Navigator

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC WEALTH MANAGEMENT SERVICES

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Succession planning for your Canadian vacation property

Vacation properties go by many names: cottage, chalet, camp, cabin or secondary home, for example. For many Canadians, regardless of what you specifically call it, these types of vacation properties are a source of great personal enjoyment. Some owners may feel strongly about keeping their vacation property within the family, and if that's the case, it's important to consider how best to transfer ownership to younger 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 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 read our article, 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 you may face 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 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 deemed disposition rules occurs 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 other spouse or qualified spousal trust at its ACB and no gain will be immediately reportable. Please note that if you realize a capital loss on personal-use property, the loss is generally denied.

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 that you may face on death.

Determine the ACB of your vacation property

In order to get a better sense of what your potential capital gains tax exposure may be with respect to your vacation property on the sale or transfer or on your death, 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 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.

The ACB of a property also includes capital expenditures, such as the cost of additions and improvements to the property. It is important that you keep documentation to substantiate the costs for 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 since before 1972, the starting point for calculating your ACB is generally the FMV of the property on December 31, 1971.

In addition, in 1994, the federal government eliminated the $100,000 lifetime capital gains exemption. 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 allowed you to bump the ACB of your capital property, such as real estate, to its FMV or the $100,000 limit, whichever amount was greater. The election was a one-time opportunity and 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.

> A principal residence for a particular year may include a vacation property, as long as you "ordinarily inhabit" the property at some time during the year.

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, as long as 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 since 1981, you will need to decide upon the 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 that 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 detailed discussion of the rules relating to the principal residence exemption, ask an RBC advisor for our article "Principal Residence".

Probate fees

Generally, if you own your vacation property in sole name, it will form part of your estate on death and may be

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

subject to probate fees. Probate fees vary from province to province, and in many cases the fees are based on a percentage of the value of the estate. There are different strategies that can be employed to reduce probate fees with respect to your vacation property. These strategies will be discussed later in this article. The key element of all 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 employing 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 avoid probate taxes are worthwhile, it's important to pursue 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 that they too 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 her 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.

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.

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.

If you are concerned about how these issues might impact the relationship among your family members, proper planning required to ensure 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 marriage 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, e.g. through a trust, may be included as part of the assets subject to division on marriage breakdown in certain provinces and territories. You may wish to confirm with a qualified legal advisor the matrimonial property laws that apply in both your and your beneficiary's jurisdiction of residence and consider how they 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 beneficiary or beneficiaries may be advantageous so that you can shift any future appreciation of the property to your beneficiary or beneficiaries, capping your ultimate tax liability. This can also help reduce probate fees to which your estate may be subject 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 will 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 will need to consider how you are going to fund that tax liability.

If you sell your vacation property to a beneficiary, you will also generally trigger a capital gain based on the difference between the ACB and the FMV of the property (regardless of the actual sale price). If you do not receive all of the sale proceeds in the year of sale, or choose to take back a note, you may be able to spread out any taxable capital gain over up to five years.

If you choose to transfer your vacation property while you are living, either by gift or sale, it's important to consider that you are giving up control over the property as well as the security of owning that property. As well, 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 such as disputes over the use of the property, expenses and 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, expenses and property improvements. It may provide a decision making process for the transfer or sale of the property on an owner's death, incapacity or marriage breakdown or may specify the individuals to whom the property can be transferred 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. Upon the death of one joint tenant, the property is transferred directly to the surviving joint tenant, bypassing the estate. The property is therefore not subject to probate. It's important to 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.

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 which 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.

Upon the death of one joint tenant, the property is transferred directly to the surviving joint tenant, bypassing the estate. The property is therefore not subject to probate.

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. If one of those joint tenants predeceases you and you do not 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.

Transfer the vacation property to a trust

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

- Proper governance – in cases where there are many beneficiaries sharing a vacation property, having one or more trustees manage the property may reduce the risk of conflicts and disputes.
- Tax Minimization – if your vacation property is transferred to a trust during your lifetime, any future growth of the property will not be taxed in your hands. This may reduce or defer capital gains tax.
- Reducing probate fees payable 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 gains that have accrued on the property will be taxable to you in the year of transfer.

As well, most trusts are subject to the 21-year 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 exception to the deemed disposition rules at the time assets are transferred to a living trust is when you're at least 65 years of age or older 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's no deemed disposition at the time the property is transferred to an alter ego or joint partner trust or at the 21st anniversary of the trust. However, there is a deemed disposition of the vacation property on the death of the settlor of an alter ego trust or on the death of the last spouse to pass away in the case of a joint partner trust, which is subject to tax at the top marginal tax rate. An alter ego or joint partner trust may be able to claim the PRE to shelter capital gains that arise from a deemed disposition or sale from tax. For more details on an alter ego or joint partner trust's ability to access the PRE, ask an RBC advisor for a copy of the article "Principal Residence".

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; and
- 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 of time. 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.

Non-profit organizations

Another potential strategy is to hold a vacation property in a non-profit organization (NPO). One way to structure a NPO is by using a not-for-profit corporation (NFPC). Your family members or intended beneficiaries could be the directors and/or members 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. 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.

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 defer any tax until you die and continue to maintain control of 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. The cumulative costs of this strategy may therefore outweigh any benefits. With this in mind, 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 defer any tax until you die and continue to maintain control of the property. In your Will, you can leave the vacation property to one beneficiary who uses it, and make 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 in excess of the 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 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 in the event that 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 take into account that your beneficiaries may have varying priorities and wishes. With this in mind, it may be beneficial to sit down with your beneficiaries at the beginning of the planning process to discuss these issues and considerations. A family meeting will give you and your beneficiaries an opportunity to share your thoughts with each other, and this will help reduce the likelihood of making false assumptions about the wishes of your beneficiaries and they will better understand your intentions as well.

This article may contain several 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.

Wealth Management

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