Cottage Succession Planning

The cottage occupies a special place in the hearts of many Canadians. It is often associated with joyful family memories. When the topic of succession planning arises many cottage owners are often anxious to preserve the cottage for future generations to ensure its continued enjoyment by children and grandchildren. There are a number of considerations associated with cottage succession planning, the most prominent of which involve taxation and mode of future ownership. This article will explore each of these considerations and outline some possible planning opportunities with the use of a fictitious family scenario.

Meet Shane and Jane Money, a couple in their early 60s. Shane and Jane own a home in a large Canadian city as well as a cottage located 2 hours outside the city. They purchased the cottage 25 years ago for $150,000 when their children were small. Their son, Eric, and their daughter, Erica, enjoyed spending summers at the cottage as children. Although both children are happily married with children of their own, the entire family still gathers at the cottage regularly during summer months. As Shane and Jane approach retirement this year, they are starting to think about handing down the cottage to the next generation. The following are considerations they may need to explore and address through planning.

Capital gains tax

Shane and Jane are contemplating leaving the cottage in their wills to Eric and Erica. However, since the value of vacation properties have appreciated steadily throughout Canada, this would typically lead to potential capital gains tax as a result of deemed disposition rules upon their death. The current value of their cottage is about $750,000.

To calculate capital gains, subtract the adjusted cost base (ACB) of the property from its fair market value. In this regard, note that:

- ACB is the price paid plus the cost of all capital improvements made: for example, if the cottage owner spent $50,000 to add a deck and made other upgrades to the cottage, the $50,000 should be added to the ACB. Receipts should be saved to prove what was spent on improvements. Note, however, that only capital expenditure qualifies - regular maintenance costs do not. Also, only amounts actually paid to others qualify - the owners' personal labour costs ("sweat equity") cannot be included.
- If the cottage was acquired prior to 1972, the ACB is the value as of December 31, 1971, since capital gains tax was not imposed in Canada until 1972.
- If the cottage owner elected to realize accrued gains on the cottage in their 1994 income tax return, by using the $100,000 lifetime capital gains exemption prior to its elimination in 1994, then the ACB could have been "stepped up". The ACB for the purpose of capital gains calculation will then be the ACB indicated on the 1994 tax return.

Possible strategies to deal with the tax liability

Use the principal residence exemption to eliminate the tax liability on the cottage

While Shane and Jane have a primary residence in the city, they may wish to consider claiming the principal residence exemption to shelter the accrued capital gains of the cottage instead (assuming both properties meet the rules associated with the principal residence exemption). A key element to this strategy is to determine which of the two properties has the largest average capital gain per year and to designate that property as the principal residence.

> **Note:** prior to December 31, 1981, it was possible for each family member to designate a separate principal residence for capital gains purposes. Since 1982, however, the rules were changed to restrict the principal residence designation to one residence per family unit per year.

Use life insurance to pay the tax liability

Designating the cottage as principal residence may not completely eliminate the capital gains tax burden on death (all else being equal) – while the capital gains on the cottage may be eliminated as a result of the principal residence exemption, the primary city residence may now be exposed to capital gains tax liability. If Shane and Jane would like to ensure that, on their deaths, there will be sufficient funds in the estate to pay the capital gains tax along with other taxes arising on death, they may consider buying life insurance.

On death, there will still typically be a capital gains tax liability; however, the tax-free insurance proceeds received can be used to offset the tax bill.

The main consideration with this approach is the payment of insurance premiums. Given their ages, the Moneys may encounter insurance premiums which are quite high, especially if they have any pre-existing health issues. Then

there is also the question of who should be paying the premiums. Since the life insurance would be put in place for the benefit of the children (assuming they are the estate beneficiaries), Shane and Jane may feel that the children should contribute to the payment of the premiums.

Deal with the capital gains tax liability now

Another option for managing future tax exposure is to "freeze" the value of the cottage now and deal with the potential tax liability associated with the current accrued capital gains. The merit of this approach is that the tax liability becomes predictable. After all, if the cottage continues to grow in value, the potential capital gains tax associated with the property could be compounded. There is of course a downside with this strategy: the capital gains tax becomes immediately payable, so the Moneys will need to come up with the resources to pay the tax bill right away.

If the Moneys decide to take this route, there are a number of additional considerations that may need to be evaluated. For example, they could (i) gift the cottage to their children now, (ii) sell the cottage to them, or (iii) enter into a joint tenancy with right of survivorship (JTWROS) with Eric and Erica.

If Shane and Jane are to gift the cottage to their children now, they should be aware that:

- Although no consideration is received when the cottage is gifted, the cottage will be deemed to pass to the children at fair market value for tax purposes.
- In addition, they may be concerned about their right to the use and enjoyment of the cottage during their lifetime. One possible way to deal with this is for Shane and Jane to retain a life interest in the deed of gift.

What if Shane and Jane are to sell the cottage to the children instead?

- In this scenario, if the sale price is less than fair market value, Shane and Jane will still be deemed to have sold the cottage at fair market value for tax purposes while Eric and Erica will be considered to have acquired the property at the sale price. This may lead to double taxation in the future if Eric and Erica were to subsequently sell the property.
- One approach to managing the potential tax liability is to structure the sale in such a way that Shane and Jane take back a mortgage (typically an interest-free loan) from the children. By doing so, they may be able to spread the capital gains out over a five-year period rather than report the entire gain in the year of the sale by utilizing what is known as a "capital gains reserve". In addition, by having the value of the cottage tied up in the form of a mortgage, the asset may be protected from potential creditors of the children (including any former spouses). As part of broader estate planning, the Moneys may also direct that any unpaid balances under the mortgage be forgiven under their Wills (where applicable).
- Land transfer tax should also be factored into any decision involving the transfer of property by way of a sale.

With respect to the JTWROS solution:

- In addition to the possible immediate capital gain tax liability, Shane and Jane may still have a future capital gains tax liability upon death if the value of the cottage continues to increase. For example, upon the death of the first spouse, the deceased spouse will be subject to a disposition for 2/3 of his/her interest on the cottage, with the remaining 1/3 subject to a tax-deferred spousal rollover.
- Aside from the capital tax liability issue, once Eric and Erica are on the title, the cottage may be exposed to potential creditors/family law claims of the children.
- A transfer of property by parents to adult children for no consideration typically gives rise to a presumption of resulting trust. This is generally true whether the transfer is direct to the children or into a JTWROS arrangement. As a result, probate planning (where applicable) may need to be reviewed further.

Modes of shared ownership

Addressing the potential tax liability resulting from a transfer in ownership of a family cottage often garners much of the attention when it comes to cottage succession planning. However, the question of how best to structure the future ownership of the property is arguably as important.

In an effort to maintain a harmonious relationship between Eric and Erica, Shane and Jane may wish to consider the various approaches to shared ownership and what option(s) best suit the overall family dynamic. For example, questions such as "How will use of the cottage be allocated between Eric and Erica?", "How should the ongoing costs of the cottage be shared?', "What happens if Eric wants to sell his share of the cottage but Erica doesn't?" may need to be addressed.

Cottage co-ownership agreement

A possible alternative to having the children own the cottage outright as joint tenants, may be the use of a co-ownership agreement. With this approach, matters related to the above questions, as well as other decision-making and dispute resolution procedures are documented in advance. Where Shane and Jane wish to retain a life interest in the cottage, they may consider speaking with their legal representative regarding the merits of a co-ownership agreement which can help define the roles, rules and responsibilities of each co-owner.

Cottage trust

While a well drafted cottage co-ownership agreement may assist with minimizing potential friction between family members, another option the Moneys may wish to explore is the use of a trust which may provide additional benefits if they intend to "keep the cottage in the family" for subsequent generations to come.

Shane and Jane could create an inter vivos trust during their lifetime or a testamentary trust in their Wills to pass the cottage to the children. Typically, when establishing a trust that holds real property such as a cottage, additional property like cash and/or investments are also added to the trust. The additional proceeds can then be set aside to be used exclusively for cottage purposes. This way all maintenance, taxes and repairs can be paid for out of the cottage trust, which may reduce the financial burden on the part of Eric and Erica.

Often, a key to a successful trust arrangement is that the trust be flexible and agreeable to those involved as this may help lower the chances of any future bickering among the heirs that could turn into future disputes or litigation.

One of the potential pitfalls of trusts is that they are typically subject to deemed disposition rules every 21 years. This may lead to potential tax issues each time the trust is deemed to have disposed and reacquired the property within the trust. Furthermore, there may be costs associated with creating and/or maintaining the trust on an ongoing basis. These costs should also be considered when exploring the merits of using a trust arrangement as part of cottage succession planning.

Other considerations

Cottages located in the U.S. and potential cross-border tax issues

For Canadian citizens who reside in Canada (i.e., those who are regarded as "non-resident aliens" for U.S. tax purposes), cottage succession planning for real property located in the United States presents additional challenges and planning considerations.

Owning real property in the United States can potentially expose Canadians to the U.S. estate tax regime. Without proper planning, this could lead to additional costs upon death. In some instances appropriate planning may need to be implemented prior to the actual purchase of the property.

Non-financial elements

One non-financial consideration that is often overlooked during the succession planning process is the level of interest of a particular child or children. If one or more children are not interested in the use and enjoyment of the family cottage or if geography or other factors pose as challenges in the child's involvement in the cottage, consideration may need to be given to whether equalization measures are taken to provide some balance as part of broader estate planning by parents or grandparents.

This may involve leaving the non-cottage owning child(ren) more of the other estate assets, or exploring the use of life insurance in an effort to balance the overall distribution of wealth.

Irrespective of the potential planning strategies noted earlier, Shane and Jane may wish to obtain the children's input prior to undertaking any planning and talk to Eric and Erica to find out if they are prepared to share the cottage and agree with the arrangements that their parents have in mind. The next step may involve engaging the appropriate professional advisors to discuss and potentially execute the agreed upon strategy.

Considerations

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