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Tax & Estate

Planning for a family cottage

Few things in life bring families closer than the time they spend at the cottage. Whether it's for weekends throughout the year, a couple of weeks in the summer or an annual Thanksgiving or holiday dinner, the memories created for many families are rich and enduring. Unfortunately, these memories can be tarnished without proper tax and estate planning, as a second property can trigger tough financial issues for children upon the death of its owners. To help ensure a tax-efficient transfer of the family cottage to heirs, the following has been developed, which provides useful background information on the topic and up-to-date tax and estate planning strategies for vacation properties.

Background

Prior to 1972, there was no capital gains tax in Canada and a principal residence or a second vacation property could be sold without any capital gains tax. With the introduction of the capital gains tax regime in 1972, it became more important to plan around the ultimate disposition of property. Planning for a second property didn't really become an issue, however, until the beginning of 1982, when the government changed the rules governing the principal residence exemption (PRE).[†] Prior to 1982, it was possible for each spouse to own a property and designate it as his or her own principal residence. Beginning in 1982, this was no longer possible. A couple may only designate one property between them as their principal residence for years of ownership after 1981.

The PRE is limited to the residence and the half hectare of land surrounding the residence. Where the total area of the cottage exceeds half an hectare, unless the "excess" land can be evidenced to have contributed to the use and enjoyment of the property, the PRE will be unavailable to the value attributed to this excess land.

Before March 1992, the $100,000 lifetime capital gains exemption was available on all property and would have been available to shelter a gain on the sale of a second property (or on the deemed disposition of the property upon death of the last surviving spouse before a transfer of the property to the next generation); however, in February 1992, the capital gains exemption was modified to exclude gains on most real property and, in February 1994, the $100,000 exemption was repealed completely for all property. This led estate practitioners to come up with strategies to pass the vacation property to the next generation in the most tax-efficient manner.

[†] Per subsection 40(2)(b) of the Canadian Income Tax Act (ITA), the calculation of the capital gain when disposing of a principal residence is, [A - [(A x B) ÷ C] - D], where: A = the gain realized from the sale of the housing unit; B = 1 + the number of years that end after the acquisition date during which the property was designated as the individual's principal residence and during which the individual was a Canadian resident; C = number of tax years that end following the acquisition date for which the individual has owned the property; D = zero, if the acquisition date is after February 22, 1994

Personal-use property
A cottage is considered to be personal-use property (PUP) under the *Income Tax Act* (Canada) (ITA). This means that while any capital gains are taxable on dispositions, capital losses are not recognized for income tax purposes and are deemed to be nil. A capital gain is generally calculated by adding the price paid for the cottage plus outlays and expenses on the purchase plus capital expenditures. Be sure to keep detailed records and receipts of any capital improvements to the cottage (e.g., additions and permanent fixtures, such as a new roof). This will lessen the tax burden on the eventual sale of the property by increasing your ACB. Also note that the Canada Revenue Agency (CRA) has previously stated that the costs for current expenses (e.g., general maintenance and repair costs) cannot be added to the ACB of the property.

Example: PRE - Choosing between the cottage and the home
Individuals are often faced with choosing between multiple housing units that qualify as their principal residence to benefit from the PRE. There is a method of allocating the PRE between multiple properties, which involves determining the average annual capital gain for each property. By using this method, an individual can most efficiently designate the properties for maximizing the PRE. To illustrate this method, suppose Jim purchased a house in 1995 for $100,000. In 2005, Jim acquired a cottage for $140,000. In 2016 both properties are sold. The house is sold for $214,000 and the cottage is sold for $230,000. We assume that there are no additional costs to sell or acquire these properties and no capital expenses were incurred. Given that the house has an adjusted cost base (ACB) of $100,000 and proceeds of disposition of $214,000, the individual has realized a capital gain of $114,000 on the house. The cottage has an ACB of $140,000 and proceeds of disposition of $230,000; thus, the capital gain on the cottage is equal to $90,000. The next section illustrates the efficient allocation of the PRE across multiple properties.

Option 1: Jim can designate the housing unit with the largest overall capital gain as the principal residence for the entire period of ownership.

Since the house's capital gain of $114,000 is greater than the cottage's capital gain of $90,000, we designate the house as the individual's principal residence for its entire period of ownership of 21 years (1996–2016).

PRE (house) = 114,000 x [(1 + 21) ÷ 22] = $114,000

	House	Cottage
Capital gain before PRE	$114,000	$90,000
PRE	($114,000)	($0)
Remaining capital gain	$0	$90,000

Therefore, the individual would report a total capital gain from the disposition of both properties of $90,000. However, there is generally an advantage to designating principal residences based on the highest average annual capital gain as illustrated below.

Option 2: Jim can designate the housing unit with the highest average annual capital gain for its entire period of ownership.

	House	Cottage
Capital gain before PRE	$114,000	$90,000
Number of years owned	22	12
Average annual gain	$5,182	$7,500

The cottage has a greater average annual gain than the house does. To maximize the PRE, the individual will designate the cottage as the principal residence for its entire period of ownership (except for year 2005). Using the PRE formula, the cottage will be designated as the principal residence for 11 years (2006–2016). The house is designated as the principal residence during all of the years that the house had been owned minus the years that the cottage was designated as the principal residence (1995–2005 = 11 years). During the years in which the cottage is designated, the house cannot be designated. We assume that both housing units were ordinarily inhabited for the entire time period.

PRE (cottage) = 90,000 x [(1 + 11) ÷ 12] = $90,000

PRE (house) = 114,000 x [(1 + 11) ÷ 22] = $62,182

PRE (total) = $152,182

	House	Cottage
Capital gain before PRE	$114,000	$90,000
PRE	($62,182)	($90,000)
Remaining capital gain	$51,818	$0

In option 2, Jim has a capital gain of $51,818 and in option 1, a capital gain of $90,000. Designating a principal residence based on the highest average annual capital gain can generally yield more tax-efficient results compared with designating the housing unit with the highest overall capital gain. The "1 +" is included in the formula to account for situations where an individual acquires a new residence in the same year in which he or she disposed of a previous residence. That being said, as this is an academic exercise, other factors (e.g., disposition of one of the properties only) may impact the decision in the application of the PRE across multiple properties. Individuals are always reminded to consult with a professional in respect to these decisions.

Strategies

Although numerous planning ideas have been suggested over the past number of years to reduce or defer the tax liability on the transfer of a cottage, probably the most common are the use of life insurance, transfers into joint ownership and the transfer of the property to a trust.

Life insurance

A life insurance policy can be purchased on the life of the owner of the cottage or, more commonly, on the last-to-die of the owner and his or her spouse or partner. In some cases, children (or grandchildren) who stand to inherit the property may be willing to pay the premiums on the policy. Practically, however, this may not be feasible. If the cottage owner is in his or her 60s or older, he or she may be uninsurable or, if he or she is insurable, the premiums could be prohibitively expensive. That's why it may be worth exploring other solutions.

Joint ownership

Holding property in joint ownership is a way to manage the transfer of legal title on death without having an estate involved. When spouses are joint owners, capital property can flow from one to the other at the ACB, thus deferring tax due. Still, while joint ownership is most often used where spouses are involved, this need not be the case. When employing joint ownership in non-spousal arrangements, the ACB rollover will not be available. Generally, it will be a taxable event if a non-spouse is added as a joint owner or where a death of any joint owner occurs. However, it may be possible to record the joint ownership in a manner that still allows a deferral of the taxable event in some circumstances.

A potential concern will arise if, for instance, a widowed spouse who has acquired 100% of the cottage by right of survivorship remarries and adds his or her new spouse as a joint holder of the cottage. This could create contention among the children of the first marriage and set the stage for litigious circumstances on the death of the widowed spouse of the first marriage.

Probate tax may also be avoided in a joint ownership arrangement as the surviving joint owner will inherit the deceased's beneficial interest in the property through the survivorship provision (which is not available in Quebec). An alternative to joint ownership would allow the joint owners to hold their interests as tenants-in-common (the only option in Quebec). The death of a joint owner in a tenants-in-common arrangement places his or her property interests into the estate, which may be subject to probate. Another complication of this arrangement is that the surviving joint owners may be disapproving of the deceased's beneficiaries who stand to inherit an interest in the property.

For more details on joint arrangements and probate planning, please see our *InfoPages* titled *Joint accounts* and *Probate planning to minimize estate costs*.

Trust

Another strategy may involve the transfer of the property into an *inter vivos* trust to avoid the deemed disposition of the property on the death of the original owner (or his or her spouse or partner). The biggest hesitation with transferring the property to a trust

is that unless certain conditions are met (i.e., the alter ego or joint partner trust rules), then a transfer to such a trust currently will trigger immediate capital gains tax.

If, on the other hand, you own a vacation property that has very little or no accrued capital gain currently, you may wish to transfer the property to a trust today so that any future capital gains tax that arises on the property may be passed on to your children. In addition, you may be unsure of whom to leave the property because each child may have a different level of interest in the ultimate use or enjoyment of the property (discussed further below). By setting up a discretionary trust, the property can be transferred to the trust today. You can be the trustee of that trust and, therefore, control who gets the property at a later time.

The trust deed would normally specify that you have exclusive use of the property during your lifetime and have unlimited access to, as well as full control of, the property. Later on, you may no longer be using the property as often, so you may wish to distribute it to the appropriate beneficiaries. Depending on the trust terms, property may be able to roll out of the trust to the children at the original cost base and thus tax would be deferred until the property was ultimately sold.

***Inter vivos* gift**

An alternative to using a trust could be to gift or sell the cottage to your child or children. While this would result in triggering an immediate capital gains tax obligation (assuming an appreciation in the value of the property), it would also result in future capital gains being taxed in your child's or children's hands. Additionally, it ensures that the property is passed outside of the estate for probate tax purposes. Note, if you sell a property to your child for less than the fair market value, the ITA generally considers you to pay tax on the difference between your ACB and the fair market value at the time of the sale. Also, your child is considered to have acquired the property with an ACB equal to the price paid, resulting in double taxation when they dispose of the property.

Who should inherit?

Of more concern than the future tax liability for some is to whom to leave the property. It is not necessarily in the best interest of parents (or, more important, their children) to leave the cottage equally to all kids. For example, a parent with three children may have one child who may be very interested in using the cottage in future years while the other two children may have less of an interest. Perhaps the other two children may be satisfied with a particular cash legacy to be received from the estate from the liquidation of other assets, such as open investments, life insurance, tax-free savings accounts or the after-tax values of registered retirement savings plans or registered retirement income funds. In this case, it would be simpler to leave the cottage to the child who truly wants it, as opposed to dividing the property into one-third interests.

You may engage in an open and frank discussion with your children or grandchildren as to whether or not they actually wish to accept the "burden" that a cottage represents. Children may not have the wherewithal to finance the annual upkeep and maintenance (property taxes, landscaping, etc.) that ownership requires. This will help to ensure that planning today is not wasted in situations where certain children have no real interest in inheriting the property and the inherent costs associated with its upkeep. As mentioned earlier, a cottage is generally considered to be PUP, meaning it does not qualify for capital loss treatment if the value declines. However, the CRA has stated that when an individual dies and the cottage becomes part of the individual's estate, capital loss treatment may be possible where the cottage is not used by the estate beneficiaries and there is a decline in the value of the property between the date of death and prior to it being sold by the estate. Both tax and estate planning considerations need to be discussed thoroughly before undertaking any type of plan with regard to a second property.

For more information about this topic, contact your advisor, call us at 1.800.874.6275 or visit our website at www.invesco.ca.

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