BY MIKE GEORGE

It's all relative

Issues with passing on the family cottage


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Memories of summers at the cottage — paddling a canoe, late-night bonfires and family dinners — are important reasons to keep it in the family. Yet succession planning for the cottage is complex, especially when it's to be shared by multiple family members who all have an emotional attachment. For many cottage owners, values have increased so significantly that their children may be forced to sell it just to pay capital gains and probate taxes.

Since tax rules change frequently and each family's circumstances are unique, discuss your client's particular situation with your legal and tax team to ensure your cottage succession plan is appropriate. You should also determine how much your client's anticipated capital gains and probate taxes will be.

QUESTIONS TO ASK

- Which children are interested in owning the cottage?
- What's the impact of passing the cottage to only one child?
- Are the children/spouses/grandchildren capable of jointly owning the cottage?
- Do any children have the financial resources to purchase it from siblings?
- Does it make sense to pass on ownership prior to death?
- Are there sufficient estate assets to equalize the estate with other children?
- Is your client counting on the sale of the cottage to fund his current lifestyle?

Step 1

Calculate capital gains tax

This will occur when clients sell, gift or pass the cottage on to their children upon death. Capital gains tax equals approximately 25% times the amount the fair market value exceeds the adjusted cost base for tax purposes. We'll assume a marginal income tax rate of 50%, which will vary by province.

Step 2

Calculate probate tax

If your client holds the cottage until death and leaves it to someone other than a spouse, some provinces impose a probate tax based on the fair market value of the cottage. Probate taxes can be as high as 1.5%.

Step 3

Reduce taxes or fund potential liabilities

As seen in Step 1, your client does not necessarily have to pay tax on the adjusted cost base. The adjusted cost base includes the cost paid to acquire or build the cottage as well as the cost of any renovations or improvements.

Because the client's executor will need to justify the cost base, make sure clients adequately document these costs and store them where the executor can find them.

If your client purchased the cottage prior to 1972, special rules apply, but typically the fair market value at December 31, 1971 will be deemed the cost for tax purposes. Also, your client may have increased his cost base in 1994 if he utilized the capital gains exemption election that year.

Life insurance can be a very cost-effective method of funding the looming tax bill. This way of funding can be efficient for risk-averse investors with modest estates who want to guarantee funds are available so as to avoid the sale of the cottage to pay the taxes on death.

Principal residence exemption

If your client has a large capital gain on the cottage or inadequate records, consider using the principal residence exemption to shelter the tax. In order for a cottage to qualify as a principal residence, your client must own the property and it must be "ordinarily inhabited" by him (or certain family members) during the year.

For taxation years after 1981, only one property per family unit can be designated. However, if your client owns property purchased prior to 1982, he may be able to claim more than one property as principal residence.

For many cottage owners, the amount of land owned can also impact the ability to shelter tax. Where the cottage land exceeds one-half hectare, owners need to prove the excess was necessary for use and enjoyment. This may be as simple as identifying where the dock resides, where the septic tank sits and the part of the property with road access. Where properly structured, the entire land may be considered necessary for use and enjoyment.

Once you determine which residence (home or cottage) should be the principal residence, your client or his executor should report the disposition in your client's personal income tax return in the year the property is disposed of, or in the year of death, as applicable.

If your client has a large capital gain on the cottage or inadequate records, consider using the principal residence exemption to shelter the tax.

Unfortunately, many people inadvertently use up the exemption by selling one of their properties and not reporting it for tax purposes. Therefore, we recommend you find out if your clients own more than one property, and review clients' circumstances when they sell one of those properties.

"But I don't want to sell!"

Most clients can't imagine selling their cottages after all the years of hard work and great memories. However, selling the cottage and dividing the proceeds could maintain harmony. Clients may sell the cottage to a third party or directly to children, or provide children with a right of first refusal.

Selling the cottage prior to death will also have the added benefit of avoiding probate taxes and settling up the capital gains taxes that would otherwise be payable upon death.

In addition, the proceeds can be an important part of retirement income. While you may trigger income tax on the current value, you will at least defer the ongoing growth (and related tax liability) to future generations. If the growth is expected to be significant, this can be a very good alternative. The next best thing to avoiding or reducing taxes is to defer them.

You may also want to consider transferring your client's cottage to a trust. This vehicle may be used for tax efficiency, creditor protection, maintaining control of the cottage during your client's lifetime, or all three.

One option is to transfer the cottage to a trust while your client is alive. In this case, other people would manage the property within the terms of a trust agreement.

A testamentary trust would work in a similar manner except in this case the trust would be created upon the death of the cottage owner, in accordance with their will. Generally, a trust agreement would deal with any issues that may potentially cause conflict. It may also be used for a period of time to allow the children to decide on their own how best to divide this precious asset.

EFFECTIVE USE OF A TRUST

Using a trust to hold the family cottage may be appropriate when:

1. Parents would like continued access to the cottage throughout their lives but would like to pass on the increase in value, as well as the related tax liability, to future generations.
2. The trust agreement should address the ongoing management of the property and responsibility for costs. As part of the trust, the parents may also choose to include a sum of money for the upkeep of the cottage.
3. Parents feel the children are not able to handle the financial responsibilities, or have concerns about existing or potential creditors, or situations of marital breakdown.
4. Decision-making can be simplified by having the trustee make the decisions as to use, upkeep and eventual disposal. This would simplify the process of having consensus on sensitive issues.
5. Probate fees will be avoided on death because the cottage will be owned by the trust and not the deceased.

If one child doesn't want (or can't afford) to own the cottage, life insurance can play a significant role in estate planning. By using a joint last-to-die insurance policy, you can provide your client's children with funds to operate the cottage. In some instances, these funds may be used to equalize the estate.

For children who don't currently have the resources to maintain the cottage, a life insurance policy may provide added security against having to sell the cottage. A similar strategy could be used so that one child may receive the value of the cottage, while the insurance policy could be directed to the other. An added benefit is that, if properly structured, a life insurance policy can avoid probate fees.

Agreements to reduce conflict

While setting up an agreement will not eliminate conflict, a well-thought-out agreement can go a long way in reducing disagreements and ensuring summers at the cottage continue to leave fond memories.

When setting up an agreement, your client should consider:

Scheduling. In cases where the cottage is shared by a number of families, set up a fair schedule that outlines how prime cottage time will be shared. Also consider allocating the responsibility for performing the annual opening and closing of the cottage.

Financial contributions. Outlining the annual costs associated with running the cottage may help children assess whether they have the funds necessary to own or share it. Annual contributions may help with cash flow. Where one family is expected to use the cottage more than others, consider alternative cost-sharing arrangements.

PRINCIPAL RESIDENCE MYTHS

- Your principal residence must be the residence where your mail is sent;
- You need to file your personal tax return in the province of your principal residence;
- Your principal residence must be in the same location as your office or place of employment;
- You must register your vehicle in the same location as your principal residence.

Decision-making. Outlining how decisions are to be made (majority rules, tie-breaking mechanisms, etc.) may eliminate the concern that certain parties to the agreement (such as overly aggressive siblings or spouses) may overstep their bounds without such an agreement.

Future sale of property. Circumstances change: children move, get divorced, die prematurely and run out of money. Right of first refusal agreements, for example, could prevent conflicts from arising in such circumstances. Consider having spouses sign an agreement that the cottage will not form part of a marital property claim, if allowed under matrimonial law. AER

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