TD Wealth

Cottage Succession Planning

The cottage occupies a special place in the hearts of many Canadians. It is often associated with happy childhood memories and possesses strong emotional and sentimental attributes for a lot of people. 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 issues involved in cottage succession planning, the most prominent of which are taxation and mode of future ownership. This article will explore each of these issues and outline some possible strategies.

Meet Shane and Jane Money, a couple in their early 60s. Shane and Jane have a nice city home in Toronto but also own (in their joint names) a cottage in Muskoka, which they bought 25 years ago for $150,000 when their children were small. Their son, Eric, and their daughter, Erica, are both happily married with children of their own. The entire family still gathers at the cottage regularly in summer. As Shane and Jane approach retirement this year, they are starting to think about handing down the cottage to the next generation. Here are the issues they are considering.

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 soared dramatically throughout Canada, this would result in a deemed disposition and hence capital gains tax when the children inherit the cottage. 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. The key is to determine which of the two properties has the higher annualized capital gains and to designate that property as the principal residence. As this calculation could be quite complex, especially for properties held prior to 1982, it would be a good idea to consult a tax professional.

(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 will not completely eliminate the capital gains tax burden on death – while the capital gains on the cottage may be tax-exempt, 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, they can consider buying life insurance.

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

The main consideration with this approach is the payment of premiums. For one thing, the premiums may be quite high given the ages of the Moneys, especially if they have any 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

An alternative is to “freeze” the value of the cottage now and deal with the tax liability. The merit of this approach is that the tax liability becomes predictable. After all, if the cottage continues to grow in value, the capital gains tax bill could grow much bigger. There is of course a downside: the capital gains tax becomes immediately payable, so the Moneys will need to come up with the cash to pay the tax bill right away.

If the Moneys decide to take this route, they could (i) gift the cottage to their children now, (ii) sell it to them, or (iii) enter into a joint tenancy with right of survivorship (JTWROS) with Eric and Erica. Incidentally, opting for either of these alternatives may result in probate savings (since the cottage will no longer be an estate asset).

With respect to the JTWROS solution:

- The capital gains tax is not entirely eliminated. Since Shane and Jane continue to own the cottage (albeit in joint ownership with the children), they may still have a future capital gains tax liability if the value of the cottage continues to increase.
- In addition, the potential problems of holding a property in JTWROS cannot be overlooked. Aside from the fact that there may be an immediate capital tax liability, once Eric and Erica are on title, the cottage may be exposed to potential creditor/family law claims of the children. For a fuller discussion of the impact of property held in JTWROS, please refer to the article “Joint Accounts and Estate Planning”.

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

- The tax consequence is no different from a real sale, since the cottage will be deemed to pass at fair market value for tax purposes, even though they have received no money from the children.

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 situation, if the sale price to Eric and Erica is less than fair market value, Shane and Jane will still be deemed to have sold at fair market value for tax purposes.
- One way to mitigate their tax liability is to structure the sale in such a way that they 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 one year. In addition, by having the value of the cottage tied up in the form of a mortgage, the asset may be protected from the creditors of the children (including any ex-spouse). Any unpaid balances under the mortgage can be forgiven under their Wills.

Modes of Shared Ownership

Tax liability is often regarded as the predominant issue in cottage succession planning. However, it is certainly not the only one. Indeed, on an ongoing basis, the question of how best to structure the future ownership is perhaps even more crucial, where more than one child will be inheriting the cottage.

Shane and Jane should definitely give some thought to maintaining a harmonious relationship between Eric and Erica, once they become the new owners. 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?” need to be answered.

Cottage Co-ownership Agreement

Aside from having the children own the cottage as joint tenants, another option may be draw up a joint use and ownership agreement, in which all the above questions, as well as decision-making and dispute resolution procedures could be ironed out in advance. Indeed, if they wish to retain a life interest in the cottage, a co-ownership agreement is a must, so that the roles, rules and responsibilities of each co-owner can be clearly defined.

Cottage Trust

While a well drawn-up cottage co-ownership agreement will go a long way towards minimizing potential friction, the Moneys may wish to explore using a trust if they intend to “keep the cottage in the family” for generations to come.

Shane and Jane could create a testamentary trust in their Wills to pass the cottage to the children. Funds will be set aside in trust to be used exclusively for cottage purposes. This way all maintenance, taxes and repairs can be paid for out of the cottage trust, lessening the financial burden on the part of Eric and Erica.

While the cottage trust may be a useful mechanism, to make the trust structure really work, Shane and Jane should obtain the children’s input – 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 is to have the trust properly drawn up by a legal professional. The trust arrangement should be detailed enough so that issues such as cost allocation, use allocation and termination of the trust are clearly set out.

The key is to create a trust arrangement that is flexible and agreeable to those involved, thereby avoiding any future bickering among the heirs that could turn into bitter litigation.

Cottage Corporation

Finally, another ownership structure that may be considered is a cottage corporation. There are two types of corporations – share and non-share corporations. The creation of a new share corporation to hold a cottage may be less attractive now that shareholders may be imputed with a taxable benefit for the free use of the cottage. A non-share corporation (with members rather than shareholders) may be considered depending on the owner’s goals and objectives.

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Revised 15/11/2011