



## Passing it on – Ensuring a tax-effective transfer of the family cottage

The family cottage is an important part of the legacy for those who wish to leave it for future generations to enjoy. What many don't realize, however, is that cottages have increased significantly in value, and 50 per cent of this increase could be taxable at death. There are several strategies you can use to help ensure a tax-effective transfer of the family cottage to your heirs.

Many cottage owners want to keep their retreat in the family so their children and grandchildren can continue to enjoy it. The problem is, when they die, assets can be transferred to the spouse tax-free, but a transfer to the children may trigger a capital gains tax that must be paid before they (or other heirs) can enjoy the property. While a principal residence can be sold tax-free, this

usually applies to the home and not to the cottage, which means that the transfer of the family cottage to children or grandchildren may not be exempt from tax.

This is a serious concern for many cottage owners today. With the recent real estate boom in Canada, cottages and other vacation properties have increased significantly in value and are now worth substantially more than their purchase price. At death, 50 per cent of this increase in value is subject to taxation. This could trigger a significant capital gains tax liability for your estate.

If you haven't planned for this tax liability, your estate may be forced to sell the cottage to pay the tax, which means the cottage wouldn't stay in the family. It's a tax time bomb that many people are simply unaware of and don't plan for.



## THE OPTIONS

There are a number of strategies you can use to limit your tax liability or provide cash to pay the tax after you pass on. It's important to match the best possible option with your situation – something your financial advisor can help you with.

Some of the options include the following:

- Start saving today
- Borrow the required funds from a bank
- Sell the asset after death
- Purchase life insurance to cover the anticipated tax liability
- Sell the cottage to your children today and transfer the future tax liability to the next generation

Let's explore the last two options in more detail.

## PURCHASING LIFE INSURANCE

Life insurance is often the most cost-effective planning tool used to cover the tax liability on a cottage at death. Life insurance provides cash to pay the tax exactly when it's needed – when you pass away. It helps to ensure that your heirs receive what you want and puts your mind at ease because you know you have taken care of this important issue. A little planning can make your dream of handing over the family cottage to your heirs come true.

In addition to giving your estate the liquidity to pay for the tax, life insurance is a flexible option that allows you to design a solution that meets your specific needs. You can choose a death benefit that increases over time to match the growing tax liability. You can even customize the amount and number of deposits made to suit your situation. In addition, certain insurance products offer a broad range of investment contracts if you choose to invest money in your policy over and above the cost of the insurance it provides.

## SELLING THE COTTAGE TO THE KIDS TODAY

Another option is to sell the cottage to your children while you are still alive. This option is particularly attractive if you can't afford to set aside money or purchase life insurance to fund the expected tax liability at death or if you are uninsurable.

If you sell the cottage to your children today instead of transferring it at death, your tax liability is capped. In addition, any future growth in the value of the cottage will now be taxable to the children when they dispose of it, for example, when the adult children transfer the cottage to their own children. This also ensures that the cottage will belong to the people you choose to pass it on to (i.e. your children).

Because the transfer of the cottage occurs outside of the estate, the property should be protected from any potential claims against your estate by creditors or other interested parties. It also eliminates probate fees that may be charged on the value of the cottage upon your death, enhancing the size of your legacy.





Selling the cottage today may trigger a taxable capital gain for you in the current tax year, and mean that you will relinquish control of the cottage. However, if you sell the cottage and take a mortgage back from your children, you can spread the capital gain over as long as five years. And if you're feeling generous, you can make the mortgage interest-free and forgive any remaining balance in your will so that the children will own the cottage with no debt payable.

While you may be tempted to sell the cottage for a nominal price to reduce your capital gain, be warned that the Canada Revenue Agency (CRA) will calculate the capital gain based on the property's fair market value, regardless of the price you and your children agree on. In addition, when the children eventually sell or pass on the cottage to their heirs, the CRA will calculate their capital gain based on the nominal price they paid to you, resulting in double taxation.

There is one more advantage of this strategy worth noting: selling the cottage today can provide you with a much-needed source of income. Maintaining a cottage can be an expensive drain on retirement assets. When you sell the cottage, not only do the related expenses disappear but you can also use the mortgage payments to fund your retirement, pay for that dream vacation or retire earlier. Or, if you choose to invest the mortgage payments you receive from your children, you can accumulate significant assets that may be used to enhance your retirement and/or pass on to heirs.

## RETIRING TO THE COTTAGE

For some, retirement will mean selling the home and moving to the cottage. What are the implications for the eventual transfer of the cottage at death if the principal residence exemption is used on the sale of the home to eliminate any capital gains?

If the cottage qualifies as a principal residence, then you can use the principal residence exemption to reduce any capital gain on the deemed disposition at death.

**To qualify for the principal residence exemption, the cottage must meet all of the following criteria:**

- 1** You must own the property. Joint ownership with another person also qualifies.
- 2** You (or your spouse or common-law partner, former spouse or common-law partner, or child) must inhabit the cottage in the year, even if just for a day.
- 3** You, your spouse or common-law partner and any unmarried children under the age of 18 (the "family unit") can only designate one property as your principal residence for a particular tax year. For tax years prior to 1982, you may be able to designate more than one property as a principal residence per family unit.
- 4** If the total area of the land on which the cottage is situated is not more than one-half hectare, it usually qualifies as part of the principal residence. Land in excess of one-half hectare may also qualify, but only to the extent that it is necessary for the use and enjoyment of the cottage as a residence.

If the above criteria are satisfied, the capital gain on the sale can be reduced by the following formula:



## A x (B ÷ C)

**A** = the amount of the capital gain.

**B** = 1 + the number of taxation years the cottage was the taxpayer's principal residence and during which they were a Canadian resident.

**C** = the number of taxation years ending after the acquisition date (the later of December 31, 1971, or the date the property was acquired) during which you owned the property, whether individually or jointly with another person.

### FOR EXAMPLE

Fred purchased a home and a cottage in 1996. In 2006, he sells the home, realizing a capital gain of \$200,000, and uses the principal residence exemption to eliminate the capital gain.

#### The principal residence exemption

$$\$200,000 \times \frac{1+10 \text{ (1996 to 2005)}}{11 \text{ (1996 to 2006)}} = \$200,000$$

Fred doesn't have to designate the home as the principal residence for 2006 to get the full capital gains exemption on the sale of the home because of the "bonus" year allowed in the formula under **B**.

Fred wants to know how this is going to impact the tax liability on the transfer of the cottage at his death.

Assuming that Fred passes away 20 years later (2026), that the capital gain at that time is expected to be \$500,000 and that the cottage qualifies as Fred's principal residence from 2006 to 2026, how much of the capital gain is exempt?

#### The principal residence exemption

$$\$500,000 \times \frac{1+21 \text{ (2006 to 2026)}}{31 \text{ (1996 to 2026)}}$$

Therefore, the principal residence exemption eliminates approximately \$355,000 of the \$500,000 capital gain, leaving only \$145,000 to be declared on Fred's terminal tax return and significantly reducing the amount of tax his estate has to pay from \$112,500 to \$32,661 (assuming that 50 per cent of the capital gain is taxable at a marginal tax rate of 45 per cent).

For the majority of people, it's important that the cottage stays in the family so that future generations can enjoy it. If you are planning to pass on the cottage through your estate be aware of the potential tax bomb that may be triggered upon your death. Your financial advisor can help you plan for this tax liability now and ensure that your wishes are carried out in the years to come.

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