The TaxLetter®

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ESTATEPLANNING

A must do

Cottage plans

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No, we're not talking about how much time you will spend there this summer, the minor repairs lingering on your to-do list, or your renovation dreams down the road. We're talking about what's going to happen when you transfer ownership of the cottage to your heirs.

That's important to consider now because your principal residence continues to be one of the select group of four assets that are free from taxation (along with Tax-Free Savings Accounts (TFSAs), life insurance and lottery winnings). But your cottage isn't so lucky.

If you are fortunate enough to own a cottage that isn't your principal residence, you're also 'pregnant' with a potential tax liability down the road. If your cottage has appreciated in value since you bought it, that tax liability can be a substantial burden when you pass it on to your heirs.

Here's the reason why transfers of a cottage count as a taxable event: Canada Revenue Agency (CRA) treats cottages as investment properties. So, just as CRA taxes capital gains on stocks, it also taxes capital gains on cottages.

There is some relief available for people who bought a cottage before February 1994: they can take advantage of a $100,000 lifetime limit for tax-free capital gains. If you filed an election with CRA back then to claim a deemed capital gain on the 1994 fair market value of the cottage, that $100,000 was added to your cost base and will reduce the capital gain when you sell or transfer the property.

But what if you bought your cottage after February 1994, or what if you bought before February 1994 but your cottage's value has increased a lot more than $100,000? There are many ways to manage the tax liability – but (spoiler alert) the last one is the best.

Make sure you have a plan

One thing you shouldn't do about your cottage's future tax bill is ignore it, because it probably won't be pocket change. Let's say you bought a cottage some years ago for $600,000 and it's now worth $1,600,000 – not unreasonable in today's real estate market. Unless you made improvements to the property or otherwise increased the cost base, that's a $1 million capital gain when you sell the cottage or when the property experiences a deemed disposition on death.

With capital gains taxed at a rate of about 27 per cent (in Ontario), the government will come to collect an estimated $270,000. So, what are some options to cover that?

Strategy 1: Start saving now

If you plan to save up the money to cover that tax bill, start depositing money into a special cottage tax fund and be diligent about keeping up the contributions. There are two problems, though. First, what happens if you pass away before you've accumulated enough? Second, you need to earn much more than $270,000 in pre-tax dollars to pay the tax bill. You would probably prefer to be saving towards a different, more meaningful goal.

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Strategy 2: Decide to borrow or sell

You figure your estate will deal with the tax bill by either borrowing against the equity in the cottage or selling the cottage. The first option is full of uncertainty – what if interest rates keep rising and borrowing is very expensive, what if the property declines in value after it transfers to the next generation, what if banks don't approve the home equity loan? The second option of selling the cottage can be very disappointing if the goal was to keep the cottage in the family. So, not an ideal plan.

Strategy 3: Transfer the cottage today

You may be thinking about transferring the cottage ownership to your adult children to reduce the tax liability today. The trouble is that even if you agree to transfer the property at a below-market price to reduce the capital gain, CRA will recalculate based on the fair market value and still hold your children to the lower price when the time comes to calculate their capital gain. So, you'll be paying now rather than paying later and may be increasing the tax liability when your children eventually sell or transfer the cottage.

Strategy 4: Put the cottage in a trust

You may not want to give up control of the cottage by selling it to adult children – perhaps because you don't want to risk losing it to any creditor issues, litigation or divorce they may experience in the future. You can set up an inter-vivos (living) trust to hold the cottage until it is distributed to the beneficiaries. This can give you some breathing room while you consider what to do about the cottage, and the beneficiaries won't have to pay tax when they receive the cottage. However, capital gains tax is due when the property transfers to the trust, making this another expensive strategy.

Strategy 5: Make the cottage your principal residence

You might be planning to downsize and relocate outside the city and considering selling your current principal residence (with no taxes due because of the capital gains exemption) and then designating the cottage as your new principal residence. You must meet all of CRA's conditions for principal residences, and of course the cottage must be winterized. You can shelter future capital gains on the cottage from tax this way – though you will need to pay tax on the capital gains up to the point the cottage experiences a change in use to become your principal residence.

Strategy 6: Life Insurance – the most cost-effective solution

None of the above strategies is entirely satisfactory. Fortunately, there's a more efficient, significantly less costly way to prepare to pay the tax liability on a cottage. A joint and last-to-die Life Insurance policy has much lower premiums than insurance on an individual life and, when a couple buys it, the policy pays the death benefit on the second death. One spouse must be healthy to get the insurance. That's exactly when the money is needed because that's when the capital gain crystalizes. Your adult children may even pitch in to pay the premiums since, ultimately, the policy will save them much more than they'll pay.

This summer, as you enjoy relaxing days at your cottage, take a few minutes to consider its future. When you're back in town, let's talk and make sure you've got that tax liability covered in whatever way works best for you and your family. We can also discuss complexities like creating equitable gifts when one child doesn't have an interest in co-owning the cottage.

There will never be a better time for you to deal with your 'incompletions', getting your will updated, powers of attorney, estate planning, and charitable aspirations. We can help.

Stay safe and have a great summer. ❑

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He guides successful business owners, professionals, and affluent families through the complex process of ensuring the people and organizations they care about are taken care of. If you are like his other clients, you are looking to reduce your tax obligations, preserve your wealth and leave a legacy. Mark collaborates with your professional advisory team to achieve your desired outcomes. His simple approach makes sure what is important to you gets done. He will suggest appropriate strategies to get your financial affairs meticulously organized, help you take action, and simplify the complicated so you and your family can rest easy. Mark can be reached at 416-364-2929, toll-free at 1-866-566-2001 or Mark@WEALTHinsurance.com
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