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ESTATEPLANNING

It's Different Now

The Family Cottage

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Many Canadians who own a family cottage or vacation property are especially fortunate this year. No one expected his or her vacation retreat to become an away-from-home refuge in a literal sense during the COVID epidemic. Surrounded by family, people are enjoying life in their 'bubble' while creating new family memories.

On the topic of "refuge," regular vTaxLetter® readers know that only a few types of assets remain free from taxation. These are the Final Four: your personal residence, lottery winnings, Tax Free Savings Accounts (TFSAs) and Life Insurance.

If you own a home, you have probably benefited from significant real estate value gains over the past several years. Until now, the profits on the sale of your home aren't taxable; you can sell it for more than the original cost with no tax liability. That may change very soon, as new taxes (perhaps a wealth tax) and higher tax rates will be imposed to help governments at every level recover some of the billions now flowing out of Ottawa and provincial capitals.

TFSAs are great savings vehicles; the one downside is the maximum annual deposit of only $6,000. My March 2020 TaxLetter® article - "No Limit TFSA" describes strategies to create unlimited tax-friendly savings.

Lottery winnings are great, but difficult to arrange.

And finally, there's Life Insurance, which still enjoys unique treatment under Canada's Tax Act, unlike other investment assets like stocks, bonds, gold, real estate, cryptocurrencies etc.

The cottage. What to do?

But unlike your home, the family cottage is deemed an investment property, and with higher taxes looming, now is the time to turn your attention to tax minimization and estate planning.

What are your plans for the cottage when you are no longer able, or no longer interested, in using it?

Most families prefer to keep it in the family, passing on the cottage to the next generation without going deeply into debt.

Do you want to sell the cottage? If you bought it before February 1994 you were eligible for a $100,000 lifetime limit for tax-free capital gains. (After that date, the exemption was done away with for all Canadians). Some Canadians who owned a cottage at that time filed an election with CRA to claim a deemed capital gain on the 1994 fair-market value of the cottage. This then became the new cost base for the purpose of calculating capital gains taxes.

A recent case

The Carter family cottage, purchased for $500,000 several years ago, is now worth at least $1.5 million, representing a capital gain of $1 million. Capital

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gains are taxed at approximately 27 per cent in Ontario, so the capital gains tax liability was estimated at $270,000.

Without proper planning, the family would have to pay those taxes when Mr. and Mrs. Carter die.

7 Ways to deal with the taxes

1 - Start creating a sinking fund today. Put away money now to pay the tax bill. The problem is making sure you are around long enough to accumulate the necessary funds. The second big problem is taxation. You would have to earn twice the amount needed in pre-tax dollars to pay the tax bill. That means saving approximately $540,000 pre-tax to have $270,000 after tax to pay the tax bill.

2 - Borrow against the equity in the cottage. The problem with borrowing is that you must pay it back, with interest – and the interest paid isn't deductible. While cottage values continue to rise in many places (along with most other real estate prices) there is no certainty as to what the market will be like when it comes time to sell. Who will lend your family the money? Will banks be tight with lending then? What will interest rates be like? Will you need to pay back the loan when the interest is not be deductible? These questions can only be answered by looking into a crystal ball.

3 - Sell the cottage. Many people are forced to sell their cottages or other investment real estate to pay taxes. This can be a devastating and disappointing outcome for the family. (FYI, this scenario will also play out if you own a business that has appreciated over the years or any other investment real estate.)

4 - Transfer ownership of the cottage to your children now. But you can't just sign the deed over to the kids or sell it to them at a below-market price. CRA will re-calculate the transaction based on fair-market value and tax you accordingly.

Another problem with this approach is the way in which the children establish a cost base on the selling price, which the CRA will deem to be the lower value – the one you tried to use with them in the first place. That means that if the children decide to sell the cottage, their eventual capital gains could be much higher. Also, now the property becomes an asset of your children. What if they have creditor issues, litigation or divorce to deal with? The cottage will be part of their assets.

5 - Set up a trust for the cottage. This is called an inter-vivos, or living trust, which means you have control over your assets now and don't have to make an immediate decision on what should happen to the cottage. Trusts are popular because they provide you with control over your assets, which get distributed to the beneficiaries in the future. While they do provide you with some flexibility, in most cases you will still be taxed on the capital gain at the time of transfer.

6 - Sell your current home and designate the cottage as your principal residence. Your cottage may have appreciated more than your home. And you may also be at that stage in life when you want to leave the city behind you and move permanently to that winterized retreat. If you transfer ownership to a family member you can shelter the full amount of future gains. There is a specific formula that one has to work with to determine which property was a principal residence and for how long.

7- Buy life insurance. This is the least costly way to deal with any tax liability. A joint and last-to-die life insurance policy costs much less than insurance on an individual life. When a couple buys it, the death benefit is paid on the second death, exactly the time those taxes will be due. Each spouse leaves the cottage to the other either by will or by right of survivorship, if owned jointly. When the surviving spouse dies, the insurance benefit is paid to the beneficiary or the estate, providing all the cash required to pay the tax bill. The cottage itself is left to the children in the will.

In many cases, when parents do not have the money to fund the premiums, their adult children get together and pay the parents' premiums.

For example, the annual cost of a single $250,000 individual life insurance policy for a healthy 65-year-old is about $7,600. The same amount of joint-and-last-to-die insurance covering two healthy 65-year-old spouses is roughly $4,500 a year.

Under the Income Tax Act, your cottage can be considered to be "ordinarily inhabited during the year," even if you only spend a few weeks of the year there – buy only if you don't own the property to produce income, like rental income.

To avoid any confusion, the CRA announced a few years ago that it will allow the principal-residence exemption only if you report the sale and designation of principal residence in the capital gains section of your return. You will also have to report when you purchased the principal residence, a description of it, along with the proceeds of the sale.

If you don't claim the exemption in the year you sell the residence, you will have to amend your return to claim the exemption but applying for it late can translate into hefty fees and penalties.

Donate To A Charity

Whatever you decide to do with the cottage, be sure to keep your children and grandchildren in the loop. They may not all want the cottage, especially if they have moved far away from home. Some may prefer cash rather than the real estate, and others may indeed want the cottage. Equalizing this part of your estate can be tricky and you should consult with a professional to avoid future problems. Whatever you decide to do, discuss your plans with your family and ensure family harmony by avoiding sudden blindsides and the unnecessary arguments that surely ensue.

But what happens if there are no children, no familial beneficiaries for the cottage? Consider donating the cottage to charity and getting a charitable receipt to offset estate taxes.

Your cottage is a special place for the family, especially now. You may not be able to control global epidemics, but you can assure financial certainty by seeking help from an experienced trust and estate-planning professional who can explain the financial implications of dealing with the cottage for future generations.

Our advisors across Canada are available to help you. Contact us for a free and no-obligation consultation. It will be a great investment of your time. ❑

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He guides successful business owners, who are already challenged for time, through the com plex process of ensuring the people and organizations they care about are taken care of.
If you are like his other successful business owner clients, you are looking to reduce your tax obligations, preserve your wealth and leave a legacy. Incompletions rob us of energy. Mark collaborates with your professional advisory team to achieve your desired outcomes. His approach is simple. He makes sure what is important to you gets done. He gets you organized, provides a big picture view of your financial affairs, determines your strategy and helps you take action. He will simplify the complicated, so you and your family can rest easy. He can be reached at 416-364-2929, toll-free at 1-866-566-2001 or Mark@WEALTHinsurance.com.
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