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Fun, sun and the tax department

Saving the family cottage

Mark Halpern

Many *Investor's Digest* readers are fortunate enough to own a family cottage or vacation property. It's the place where priceless memories are made: the first giant sunfish you landed with your Dad, the first time you ducked your head under water, or the one and only time you beat a sibling in a swimming race from the boat to the dock.

The cottage is an away-from-home refuge where families gather to relax, kick back, and hopefully enjoy each other's company. In most cases, it's also an important asset whose value has risen considerably (along with most real estate across the country).

There aren't many assets left that don't attract the attention of a Canada Revenue Agency (CRA) tax collector. The big one is your principal residence, the place you live. You can sell it for more than the original cost with no tax liability. For most Canadians who have benefited from huge real estate gains these past years, that's a huge plus.

While you enjoy idyllic times at the cottage, an often-overlooked tax liability continues to grow, threatening to separate your family from this cherished asset.

In contrast to your home, the cottage is deemed an investment property with looming tax implications that require your attention and planning now.

What do you want to do with it when you no longer want to go there every year?

Most people want to pass 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 would be 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.

Let's look at a recent case. The Gates family cottage, purchased for $500,000 years ago, is now worth $1.5 million, representing a capital gain of $1 million. Capital gains are taxed at approximately 25 per cent in Ontario, so the capital gains tax liability was estimated at $250,000.

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

Here are seven options for dealing with the issue, along with their benefits and drawbacks:

Start creating a 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. So $500,000 pre-tax provides $250,000 after tax to pay the tax bill.

Borrow against the equity in the cottage: The problem with borrowing is that you must pay it back, with interest – and the interest paid is not deductible. While cottage values continue to rise (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.

This leads naturally to questions such as who will lend you the money? Will banks be tight with lending then? What will interest rates be like? These questions can only be answered with a crystal ball.

Sell the cottage: Many people have to sell their cottages or other investment real estate to pay taxes. It happens all the time, and it's often devastating when a family is forced to sell.

Buy life insurance: This is the most cost-effective way to deal with any tax liability. A joint and last-to-die life insurance policy costs much less than individual life insurance. When a couple buys it, the benefit will be 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.

Some parents may not have the money to fund the premiums, so in many cases adult children get together and pay the parents' premiums.

For example, the annual cost for 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.

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

Another problem with this approach is how the children will establish a cost based on the selling price, which 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 one day, their eventual capital gains tax could be much higher.

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.

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.

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 – as long as you don't own the property to produce income, like rental income.

To avoid any confusion, CRA announced 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, and 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.

Whatever you decide to do with the cottage, you should keep your children and grandchildren in the loop.

They may not all want the cottage, especially if they have moved far away from home for business or personal reasons. Some may prefer cash rather than the real estate, though 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 would surely ensue.

But what happens if there are no children or other familial beneficiaries for the cottage? Consider donating the cottage to charity. No capital gains tax is charged on the sale of real estate (and private company shares) if the proceeds go to a registered charity within 30 days. On top of that, donors will also receive a sizable charitable tax credit.

A cottage is a great place for the family to schmooze and have fun. You may not be able to control the weather on those weekends, but you can assure (figurative) blue skies ahead 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.

Don't hesitate to contact us. Our advisors across Canada are available to help you.

Mark Halpern is a Certified Financial Planner (CFP), Trust and Estate Practitioner (TEP) and one of Canada's top life insurance advisors. He is CEO of WEALTHinsurance.com® and illnessPROTECTION.com®, with special expertise for business owners, entrepreneurs, medical professionals, high-net worth individuals and their families. He can be reached at 416-364-2929, toll-free at 1-866-566-2001 or by email at mark@WEALTHinsurance.com. Visit WEALTHinsurance.com. Get your FREE Estate Planning Toolkit at www.WEALTHinsurance.com/toolkits.html. The expanded toolkit now includes an Estate Directory, Estate Planning Checklist, Executor Duties Checklist, and Business Owners Planning Guide. Visit www.MarkHalpernBlog.com and sign up for free updates.

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