COTTAGE SUCCESSION PLANNING...

TMFD tmfd.ca Financial
Helping dentists build wealth

Cottages occupy a special place in the hearts of many Canadians. They're usually associated with happy childhood memories, family gatherings, and for many they hold a strong sentimental value. This is why cottage owners typically look for solutions to preserve their cottages, in order to ensure continued enjoyment by future generations.

The discussion around how to transfer the ownership of a cottage or vacation property in a cost-efficient manner is ongoing; and can be overwhelming to some. This is because there are several issues to consider when thinking about cottage succession planning – however, the most important are:

/// **1. Tax Implications – Capital Gains**

/// **2. Future Ownership Options for Cottage Succession**

1. TAX IMPLICATIONS – CAPITAL GAINS

Over the last 30+ years, property values in Ontario have drastically increased. Therefore, capital gains tax can be quite significant when a property changes ownership. If the property is simply sold or transferred to the next generation through the Will, capital gains tax will apply; and you will have to pay taxes on 50% of the appreciated value of your property.

For example, if you purchased the property at $100,000, and added an additional $50,000 in renovations, your cost for the property is $150,000.

If the fair market value of the property today is $900,000, here is how it would work:

Original cost of property	$100,000
Renovations added	$50,000
Adjusted cost base	**$150,000**
Fair market value of property at the time of sale	$900,000
Capital gains on property	$750,000
Capital gain subject to taxes	$375,000
Tax owing on capital gain*	**$200,625**
Capital subject to probate fees**	$850,000
Probate Fees***	**$12,750**

**Assuming highest marginal tax rate in Ontario 53.5%*

***The first $50,000 of the estate value is not subject to probate fees*

****Assuming probate fee of 1.5%*

In the preceding scenario, $213,375 in tax and probate fees will apply – and this is a significant amount of money that does not necessarily have to be "lost." Here are some possible ways to mitigate tax and probate fees:

1. Consider the principal residence exemption: when considering a principle residence exemption, the first step will be to determine which of your properties has the highest capital gain: your house in the "city," or your cottage. Inevitably, one of these properties will be taxed – but if your cottage has the highest capital gain, and is declared a principle residence, your beneficiaries will no longer have to pay capital gains tax on the cottage property when you die.

(You can declare your cottage as a principal residence as long as you, your spouse, or your children live on the property at some point during the year).

2. Plan for the tax liability now, by setting funds aside to deal with the capital gains tax in the future: the challenge with this strategy is that you may not know how many years you have left to fund this account, in order to cover the capital gains tax.

However, setting *some* funding aside for your beneficiaries is better than setting aside nothing at all.

> ***The discussion around how to transfer the ownership of a cottage or vacation property in a cost-efficient manner is ongoing; and can be overwhelming to some. Here are the most important issues to consider...***

**All Tax and Accounting services provided by TMFD Professional Corporation, Chartered Professional Accountants*

3. Buy life insurance (this is the most cost effect way to deal with the tax liability): in this case, you may want to consider something called a joint last-to-die policy, as this is more cost-efficient than individual policies for you and your spouse.

While the death benefit is only paid out to your beneficiaries at the time of the second death (of you or your spouse), the advantage is that it will be paid out tax-free, which can provide your beneficiaries with the much-needed liquidity they need, in order to pay out any tax consequence(s) – and avoid having to sell any properties or investments.

Please Note:

- Since capital gains tax were introduced in 1972, all properties acquired before 1972 would use the fair market value as of December 31, 1971.
- For cottages acquired prior to February 1994, a lifetime limit for tax free capital gains of $100,000 would apply. An election form would have had to be claimed with the CRA to declare a deemed capital gain on the 1994 FMV. This then becomes the cost base for the purpose of calculating capital gains tax. (Properties acquired after 1994 are not subject to this lifetime limit for tax free capital gains of $100,000.)

2. FUTURE OWNERSHIP OPTIONS FOR COTTAGE SUCCESSION:

1. Joint ownership with rights of survivorship can be a simple and effective way to transfer the ownership: however in some cases, it does not allow for efficient tax planning.

For example, joint ownership is only effective for Canadian-owned property (this strategy does not work for US-owned property)... and the capital gains tax will still apply, when the last survivor dies.

2. Sell the property to the intended beneficiary: this strategy can leverage the use of a demand loan. In this instance, your property can be sold at FMV to your beneficiary, who can then take out a "take back" mortgage.

A mortgage of this kind can be forgiven by the original seller/mortgage holder (aka, you) in his/her Will. The downside to this is that capital gains taxes will still apply; however, the cost can be spread out over a 5-year period.

3. Transfer of ownership by Will: ownership of property can be transfered through your Will to your intended beneficiaries; however, capital gains tax will still apply.

Note: if there are multiple beneficiaries, it's a good idea to consider drafting a co-owners' agreement in order to keep disputes to a minimum.

4. Inter Vivos Trust: also known as a "living trust," this trust can be created during your lifetime, which can help with estate planning by allowing you to transfer your assets (cash, investments, and real estate property) into the trust while you're still alive.

While there is a deemed disposition for tax purposes, capital gains tax will apply at the time the assets are transferred into the trust. However, probate fees will no longer apply to this scenario, as the property is no longer held in the individual's name.

5. Testamentary Trust: this type of trust is created at the time of your death, and can be set up through your Will. However, probate fees + capital gains taxes will apply.

When it comes to Cottage Succession Planning, everyone's situation is uniquely complex. The intention of this article is to shed some light on some issues available for you to consider – and we recommend that you use this article for information purposes only. *We advise you to seek professional guidance from your accounting and/or legal team before taking any action.*

If you have questions about your Cottage Succession Planning, please contact our integrated team of proficient Accountants and Advisors. We will be happy to provide specific advice and recommendations that are carefully tailored to your individual circumstances.