

THE FAMILY COTTAGE

The family cottage is a place with deep emotional resonance, but also with serious tax liability, and dealing with it on death requires thoughtful planning to avoid future anxiety and disappointment for surviving family. While we like to think that children will continue to enjoy the cottage happily, often tensions do arise – spouses do not get along, one child lives farther away and seldom uses the cottage, the child who lives close does most of the maintenance, one child needs money and wants to sell, and another wants to rent it out part of the year.

Depending on the location, your cottage could be worth many times what you paid for it. Half the gain is taxable when the property changes hands (including a deemed disposition on your death) and will likely produce a large tax liability. If you have not planned for the tax, your children may have to sell the property to pay the tax bill. You cannot entirely avoid the capital gains tax, but here are some ways to reduce it.

- *Principal Residence Exemption.* Your principal residence is exempt from capital gains tax. If the cottage has a larger gain than the family home, consider designating the cottage as your principal residence, and having your house subject to capital gains tax instead. You may be able to exempt both the cottage and your house for the period before Dec. 31, 1981, depending on your circumstances.
- *Maximizing the ACB.* The cost of additions and improvements to the property - such as a new sunroom, decks, extensions, and renovations - may be added to the acquisition price when determining the adjusted cost base (ACB). Keep careful records of cottage-related expenses to evidence them to tax authorities.

Transferring During Your Life

- *Gift to Children.* An immediate gift to children avoids probate tax, but results in a deemed disposition and a taxable capital gain. Liability for any future appreciation also passes to the children. You can sell or gift a portion to the children each year over several years - that portion will still attract tax on any gain, but you may find it easier to spread it over several years.
- *Adding Children as Joint Owners.* You can add your children on title to the cottage to avoid probate taxes upon your death, but you may trigger an immediate deemed disposition and taxable capital gain on the share of the cottage deemed to pass to your children.
- *A Life Interest.* You can gift or sell the property, but retain full rights to it during your lifetime. You may still trigger the gain, however, and pass future gain to the children.
- *Selling to Children.* A sale will also trigger a capital gain, and the children will assume liability for any future increase in value. Resist the temptation to sell the property for less than fair market value - say for \$100 - which results in double taxation! The property is deemed sold at fair market value, so you pay the full capital gains tax. Your children, however, must use

Cunningham Swan offers a broad range of legal services to individual and corporate clients in the private and public sectors in Kingston and Southeastern Ontario. We welcome your inquiry: Cunningham Swan Carty Little & Bonham LLP, 1473 John Couter Blvd., City Place II, Suite 201, Kingston, ON, K7M 8Z6; Telephone: 613.544.0211; Facsimile: 613.542.9814; Email: info@cswan.com. **This factsheet does not constitute legal advice.**

the \$100 nominal price when they dispose of their share. Thus, you and the children each will pay tax on the same appreciated value.

- *A Cottage Agreement.* Before any transfers, children can be asked to sign an agreement covering potential acrimonious issues such as responsibility for maintenance and ongoing costs, guests and renters, and buying out a child who does not want to continue as an owner. Consider all the possible life changes - marriages, deaths, and divorce – and allow some flexibility.
- *Holding a Mortgage.* Taking back a demand mortgage with deferred payments may allow you to spread the tax on the capital gains over a few years and maintain some control over the property. You can gift or forgive the mortgage on your death.
- *Establishing a Trust.* While you must pay the tax if the cottage goes into a trust, you are able to hold the property in trust for 21 years without triggering any additional capital gains and maintain control. If you are over age 65, you may be able to defer the tax on the transfer into the trust until your death.

Transferring at Death

- *Leaving the Cottage Outright.* Upon the death of the cottage owner there will be a deemed disposition triggering a capital gain. The estate will be liable for the capital gain and each beneficiary's proportionate share of the estate will be reduced by the tax payable. If one of your children is not interested in owning the cottage, they may be disadvantaged.
- *Testamentary Trust.* A trust in your will takes effect only on your death. Your estate must pay capital gains tax, but you can set up a detailed regime for the use and management of the cottage, as well as protecting the cottage for minor grandchildren and from a child's creditors or ex-spouse. Your executors can hold the cottage for 21 years, after which they must either roll the cottage out to the children, or pay tax on the accrued capital gain.
- *Sale with an Option to Purchase.* Where there are many children or potential for discord, you can simply let your executors exercise their discretion to sell your assets or transfer them in kind, or you can give an option for one or more children to purchase the cottage.
- *Life Insurance.* An insurance policy on your life might cover the capital gains tax. You can have the premiums paid by those children who will inherit the cottage. Remember, however, that the cost of life insurance may become prohibitive as you get older.

Other Issues

Many cottages can still be transferred without probate, and you should talk to your lawyer about doing a special will to avoid paying probate taxes on this asset. As well, if the family cottage is located in another province, the laws of that province will need to be considered.

Succession planning for the family cottage means taking account of both tax liabilities and the dynamic of each family. Good legal and accounting advice is essential.

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