COTTAGE SUCCESSION

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- The family cottage is a special asset, with a great deal of sentimental value
- It also has the potential to create conflict within a family, and a high capital gains tax bill
- Capital gains are 50% taxable, and taxed at the owner's marginal rates. You are deemed to dispose of all your property at death. There is a tax free roll to your spouse, but on the death of the second spouse, the tax will be paid unless you use the principal residence exemption.
- Capital gain is calculated as proceeds of sale – cost base

Cost Base

- When comparing the capital gain in your house and cottage, make sure you get your cost base right

- Cost base is what you paid plus the cost of capital improvements made subsequently

- Keep receipts for all capital improvements to both your house and cottage to add to your cost base. You can try claiming the additions even if you don't have receipts, but CRA may challenge your numbers.

- Not all improvements are capital improvements
  - Capital Improvements: a new dock, stairs, new roof, repainting
  - Not Capital Improvements: furniture, appliances

V – Day

- If you owned your cottage before 1972, your cost base is the fair market value of the property on December 31, 1971 (called V-Day)
- Many people filed an election on V-Day establishing the fair market value of their properties as of that day.
- Not everyone has done so, and if you haven't there is some room to maneuvre in your estimate of the V-Day value
- Check with your accountant to see if you filed an election

What is your principal residence?

- Many people think they have to set up a mailing address and phone number at the cottage if they want to claim the principal residence exemption on it.
- This is not the case. Unlike proving that you are resident in a particular province or country, the test for the principal residence exemption is very low.
- You can claim your principal exemption on any property, in any province or country, as long as you stayed there for a weekend or more in that year
- It is not necessary to file an election when using the principal residence exemption, but if you do not, CRA will assume that you are claiming the exemption on the first property to be sold.

Issues

- Clients main goal is to **keep the cottage in the family** – similar concepts to the family farm
- What is the best way to hold property
- How to make the best use of the **principal residence exemption**
- Need for a "**use agreement**" between the parties
- Anticipate **family law** issues

Options for Cottage Planning

- **Voluntary Sale to Family Member(s)**
  - Husband and wife only have 1 principal residence between them, but in a cottage scenario there are often 2 residences, so tax will be payable on the sale of one of them
  - Taxpayer claiming a principal residence must be a resident of Canada
  - Plan to use the residence which has had the most gain – use the exemption on one residence early on a transfer to the next generation

- The reason for this is the formula:

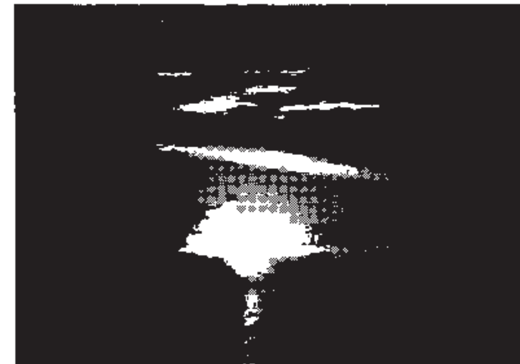
$$\frac{1 + \text{\# of years the exemption is claimed}}{\text{\# of years the property is owned}} = \text{\% of exemption}$$

- Using the Principal Residence Exemption early on to transfer the cottage to the next generation allows you to get full exemption on that property and a higher percentage of the exemption on their house

- **Example:**
- Elizabeth owns a house in Winnipeg and intends to remain in the house for 10 years

Cost	**$100,000**	**In 2003**
FMV	$400,000	In 2011
Gain	**$300,000**	**Potential tax of $69,000**

Elizabeth also owns a cottage at Falcon Lake and wants it to go to the children



Cost	**$50,000**	**In 1990**
FMV	$450,000	In 2011
Gain	**$400,000**	**Potential tax of $92,000**

- Sell the cottage now for $450,000 with no capital gains tax, claiming the principal residence exemption
- 10 years later, the clients sell the house in Winnipeg
- The formula is

$$\frac{\textbf{1 + \# of years as PR (2011-2021) 10 yrs}}{\textbf{\# of years owned (2003-2021) 18 yrs}} = \frac{\textbf{11}}{\textbf{18}}$$

- She has saved 11/18 of the tax on $69,000 or $42,166
- The legal fees to do this transfer will amount to approximately $5,000 plus extra accounting fees of about $500.
   - $42,166 - $5,500 = $36,666 net savings to the client

Note: $100,000.00 capital gains exemption eliminated as of 1994

- But CRA allowed individuals to trigger accrued gains and claim an offsetting exemption by filing a special election
- No disposition occurred by filing the special election
- This results in an increased cost base of the particular property.
- New Formula:

$$\frac{1 + \text{\# of years claiming principal residence}}{\text{\# of years you owned the property}} \times \text{FMV} - (\text{elected amount plus any capital additions})$$

- If you owned your cottage before 1994, check with your accountant to see if you made an election.

Cottages owned before December 31, 1981

- From V-Day to December 31, 1981, each of a husband and wife could have a different principal residence
- This was abolished as of January 1, 1982, and there was no deemed disposition attached to it
- If you have a cottage for a number of years prior to marrying, consider doing something before the marriage, such as a sale to the spouse or adult children

Use Agreements

- Do a "use agreement" immediately so the children agree to the rules while the parents are still alive
- What happens if someone dies, becomes incompetent or wants to sell
- Defining the value in case of sale
- Involuntary dispositions (eg family law claim, creditors)
- Renovations and repairs (set up a fund in the will?), necessary repairs versus desired repairs
- Sweat equity
- Times for joint use and individual use
- Rules of occupation including restrictions on use
- Decision making process
- You can forgive the mortgage completely or partially in the will – can't forgive during lifetime or it will grind the cost base down
- Each owner should sign a specific power of attorney for the cottage

Life Interest / Remainder Interest

- The Law allows ownership of real estate to be divided between “life interests” and “remainder interests”.
- The life interest is the ability to possess and use the property while alive. The life tenant is responsible for operating expenses and the like, and is entitled to any rent that is payable.
- The remainder interest is the capital interest: the remainder tenant has the right to full ownership on the death of the life tenant, and is responsible for capital improvements to the property.

Life Interest/Remainder Interest

- Sell the remainder interest in the cottage to the children at fair market value now – keep life interest and take a mortgage back
- By continuing to own the life interest in the property, you are entitled to the total use of the property, including renting it out, during your lifetime.
- You are responsible for:
  - Taxes
  - Insurance
  - Normal Maintenance

- Remainder interest owners cannot interfere with your right to use while you are alive so you keep control
- They receive the benefit of the increase in value after the date of transfer
- Have certainty that they will ultimately own the property outright. This provides an incentive to provide money and sweat equity
- The mortgage back protects you if you need more money

Tax Consequences of Life Interest/ Remainder Interest

- If you die while still holding the life interest, there is no tax to your estate, and the cost base to the remainder tenant is bumped up to the full value of the property at the time you transferred the remainder interest out

- If you have to sell the property while you still have the life interest, there may be tax payable, so if you think this is likely, rather than use life interest/remainder interest, you should sell the property and take a mortgage back.

Voluntary Sale During Lifetime

- If the sale is to a non arm's length party, s69 of the Income Tax Act treats it as being a sale at fair market value even if the sale is at less than fair market value or a gift
- Claim the Principal Residence Exemption
- Take back security:

- If on titled property, a mortgage
- If on leased property, a mortgage of the lease and a GSA on the buildings
- This protects the cottage from family law claims and your children's outside creditors, as there will be little or no equity for them to target

- Cover family laws issues:
- The children's spouse or partner should release any claim to the cottage under *The Family Property Act* (in Manitoba or applicable outside legislation) with independent legal advice
- Using Life Interest-Remainder Interest strategy can eliminate probate fees eliminate limit tax on death

- Skipping Generations:
- Rather than keep a life interest for herself, and give or sell the remainder interest to her son Charles, Elizabeth could transfer the property such that the remainder interest goes to her grandson William, and Elizabeth holds a life interest jointly with her son, Charles.
- No probate fees or capital gains tax will be payable on the remainder interest until William sells or dies, which could defer these taxes for decades longer than would be the case if the remainder interest went to Charles.
- Elizabeth should insist that William's wife Kate signs a waiver of any claim to the cottage and get independent legal advice.

- RECALL – there is no required election to be filed to claim the Principal Residence Exemption – you just don't report the transaction.

- BUT – an election can be filed IF you have more than 1 principal residence otherwise CRA will deem you to use the principal residence on the one sold first, which might not be the best tax plan.

Transfer the Cottage to a Trust

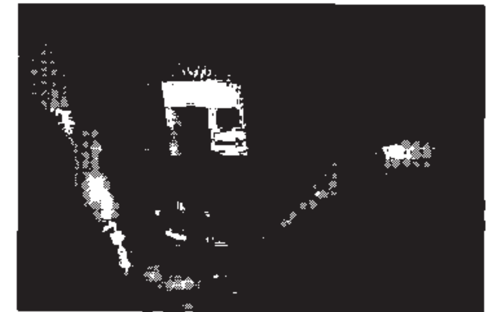
- Take title of property in name of the trust
- Every 21 years the deemed disposition will occur under s. 107(2)
- You can hopefully allocate the capital gains to children in a low tax bracket or infant grandchildren in a non-taxable position. Recall: Kiddie tax does not apply to capital gain
- Or elect the principal residence exemption on behalf of the trust. This election won't affect the other beneficiary's entitlement to their principal residence exemption provided they are over17 years of age
- A trust with a corporate beneficiary cannot claim a principal residence exemption
- This is costly to administer – most people don't want the complexity of a trust just for their cottage property

Have the Cottage Owned by a Corporation: A BIG MISTAKE

- Some people want to build or buy a cottage using money in their corporation. This is not good planning.
- The shareholder who uses the cottage is deemed to have received a benefit from the corporation, which is treated as taxable income
- Courts do **not** necessarily treat the benefit as being equivalent to fair market rent – they often assess the benefit as being greater, and in some cases have assessed the benefit as being the full value of the cottage.

Joint Names

- Take or transfer title in joint names with your children – this is not as good as life interest/remainder interest



- This can have unexpected results – in some cases the courts may presume that the property does not pass according to survivorship and will deem there to be a resulting trust in favor of the donor.

- In order to rebut the presumption of resulting trust, the court requires evidence that the transferor made a gift of the survivorship right to the adult child at the time of the transfer.
- If you intend to actually transfer ownership, you could claim the principal residence exemption on the % interest transferred
- Children may have other principal residences so their percentage of gain is not sheltered for them

- Can have unintended results:

  - Elizabeth has transferred her cottage such that she holds it jointly with her sons Charles and Andrew (her other children aren't interested). If Elizabeth and Charles are killed in a car accident, Andrew becomes the sole owner – Charles' son William has no claim.

- I don't recommend this model – there is great uncertainty in the law

Other options

- Assess who will use the property and only transfer to those who are interested

- Life Insurance

- Take out life insurance to cover the probate fees and taxes or upkeep or to compensate those that aren't interested in owning the cottage

➢ Testamentary Trust

- Properly worded clauses in a will can create a trust to hold the cottage and a maintenance fund and require the beneficiaries to come to a use agreement within a specified timeframe prior to the transfer

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