COTTAGE LIFE

Clients can prevent tax storms from eroding their summer sanctuaries.

By Sandy Cardy

THE family cottage is a source of enjoyment for many of your clients. But cottages can also generate some acute estate planning problems for clients who ultimately want their children to inherit the property.

The cottage's value may have risen astronomically, creating a large unrealized capital gain. In many situations, the gains can be so high the children are forced to liquidate the cottage to pay the tax bill. While clients cannot completely avoid capital gains taxes if they own a vacation property, there are some strategies that will lower the burden.

1 Take advantage of the principal residence exemption.

Principal residence implies that the particular property is the primary or main place of residence, but this is not always the case. The definition in the Income Tax Act is quite broad and will allow a seasonal residence or a mobile home to be considered the principal residence. Your client is not required to inhabit the property throughout the year. Instead, a seasonal residence that is used occasionally could qualify as the principal residence. Each year, a family unit (spouses and unmarried children under the age of 18) is entitled to call one property their principal residence, which will shelter all or a portion of any capital gains tax on that property.

2 Claim exemption for pre-1982 capital gains on second property.

If a client and spouse own more than one residential-type property, decide which property is to be designated the principal residence for capital gains purposes until the year that either property is sold. When the time comes to sell one or more of the properties, claim the principal residence on the property with the larger gain. Prior to 1982, it was possible for each spouse to obtain an exemption on one of the properties. So, if a client and spouse own properties that were bought before 1982, it usually makes sense for the client to be the sole owner of one property and the spouse to be the sole owner of the other property.

3 Place ownership in the name of the adult child.

Adult children over 18 and married are also entitled to their own principal residence exemption. This could double the number of exemptions a family can use. However, to transfer an existing property to an adult child, the client must realize a deemed disposition at fair market value.

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4 Maximize the adjusted cost base (ACB).

The higher the ACB of the property, the lower the eventual gain on the disposition. Remember to add the cost of any renovations to the property's ACB. This will reduce future capital gains. Ask if the client or his spouse made an election on the 1994 tax return to use up the remaining $100,000 capital gains exemption at that time. If this election was made on the value of a cottage, it resulted in an increase to the property's ACB.

TRANSFERRING OWNERSHIP NOW

Should clients pass the cottage upon death or during their lifetime? There are pluses and minuses to both options.

By leaving the cottage as part of the estate, capital gains tax would be deferred until the death of both spouses. The cottage is also protected from creditors of the children until the will takes effect.

The cottage may also be protected from claims of former spouses since inheritances in many provinces are not subject to division under family law. However, if the cottage was enjoyed by both spouses, it could be considered a matrimonial home under Provincial Family Law, and consequently could be subject to division upon marriage breakdown.

> Shifting ownership of the cottage to the children during your client's lifetime may resolve any disputes and will avoid probate fees.

Dealing with the cottage upon death could also have adverse effects. Some or all of the children may have difficulty sharing the property. And, if the cottage is not left to all the children, it may be difficult to achieve estate equalization.

Shifting ownership of the cottage to the children during your client's lifetime may resolve any disputes and will avoid probate and executor fees. There are three ways to complete a lifetime transfer.

1 Gift to one or more children.

Since children normally outlive their parents, this strategy has the advantage of deferring future growth of the cottage value to the children. Bear in mind the one-time capital gain could affect government pensions, clawbacks and marginal tax rates for the year. Land transfer taxes may also be payable. Consider the non-technical issues:

- Do all of the children want the cottage? If more than one of them does, consider having them bid on the property.
- How can the client know what the relationship will be like with any of their children in the future?
- What if one of the children has a future marriage breakup?
- Could the cottage be considered part of net family property as part of a divorce settlement?

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2 Sell the cottage to your children.

A sale may be the best option if the client needs the proceeds as support in retirement. If the client does not need the proceeds and the children lack sufficient funds, the client could take back a demand loan. Capital gains taxes on the portion of the purchase price not yet received could be spread over five years. Essentially, if no proceeds are received on the sale to the children, the entire capital gain can be spread evenly over the five-year period. With a demand loan, any interest received has to be reported, although the children would not get the benefit of an interest deduction. Ensure the cottage is sold to children at fair market value (FMV). If the price is less than FMV, your client will be deemed to have sold the cottage at FMV anyway. The child's ACB, however, will remain at the actual price paid, resulting in double taxation on a future sale.

3 Transfer the cottage to an *inter vivos* trust.

If a client wishes to maintain a high degree of control over the cottage during his lifetime, a trust can be an effective estate planning tool. Under the terms of the trust, the client could be given legal right to occupy the cottage for the duration of his life. The client would also be the income beneficiary, meaning that in the event the cottage is sold by the trust and the sale proceeds are invested, he would be entitled to receive the income on the investments. The capital beneficiaries of the trust would be the children. With this type of trust, the client and spouse could be trustees along with one other person. A third trustee prevents the possible application of the revocable trust rules, which suggests if the settler and trustees are the same people, the trust might be forced to recognize a capital gain should the cottage be transferred to any of the children during the client or spouse's lifetime. The trust agreement could stipulate that a majority agreement of the trustees is required to carry out any transactions for the trust and that the third trustee must always be one of the majority.

Understanding all the options is critical in order to minimize taxes and to maximize peace of mind. **AE**

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