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WHO GETS THE COTTAGE?

Continuing your family's summer traditions

Continuing your family's summer traditions

So many sentiments attach to the place you and your family call home during the summer. Everyone looks forward to vacation and the chance to get away from the city … but have you thought about what happens to that special place after you're gone?

Most people leave the cottage to their children in their will – to all their children equally. However, when children have children of their own and begin their own family traditions, will they agree on who gets to use the cottage for a particular week during the summer?

Talk with your children before deciding who gets the cottage in your will. Some of them may not want the hassle of scheduling cottage use or paying for upkeep and bills. They may suggest the best thing is to sell the cottage.

WHAT YOU NEED TO KNOW

Assets can incur capital gains tax upon the death of their owner. In the case of a cottage that's been in the family for decades, rising property values could result in significant capital gains. Vacation property values in some parts of Canada have multiplied 10-fold or more. Half the growth in value since 1971 is taxable income in the year in which the property is disposed of, either by death or sale of the property. An estate plan can minimize these capital gains taxes.

Your principal residence exemption can cover off a large portion of capital gains tax. A number of conditions must be met for a property to qualify as your principal residence. Since 1981 you can have only one principal residence per tax year. In some situations or tax years, you might want to designate the cottage as your principal residence, but in others it might make more sense to designate your home. Whether it's your home or the cottage, the property not elected (or not consistently elected) as your principal residence is subject to capital gains tax, just like any other growth asset.

For periods prior to 1982, each spouse can elect a separate principal residence exemption. If the cottage has been in the family since before 1982, one spouse can still claim a partial separate exemption if that spouse had an ownership interest prior to 1982. This can help minimize taxes if both properties have been held a long time.

EXAMPLE

If a cottage purchased 30 years ago for $60,000 has grown in value to $259,317, then the capital gains tax owing upon death of the owner or sale of the cottage today would be $45,843.

This example assumes a 50 per cent capital gains inclusion rate and 46 per cent personal marginal tax rate.

YOUR OPTIONS

You can structure your affairs concerning the cottage in several ways.

TRUSTS

A trust is a separate taxable entity, providing the trustee is someone other than the transferor. If you transfer ownership of the cottage to a trust, then capital gains tax arises from this disposition. However you can use the trust to settle such issues as joint ownership and rules on the use and maintenance of the cottage. Trusts created under amendments to the Income Tax Act in June 2001 can provide further planning opportunities. If it's uncertain who should inherit the cottage, a trust allows the cottage to be held in such a way that the decision does not need to be made until some time in the future.

Trusts are subject to the "deemed disposition" rule every 21 years for capital assets within a trust. This means that every 21 years, either the trust or a beneficiary of the trust must pay capital gains tax on any increase in the value of the cottage. Every year the trust has to file an income tax return and pay taxes on any income not distributed to the beneficiaries. Trusts can be complex and the rules are detailed. Seek advice from professionals, including your financial security advisor, before implementing a trust solution.

BUY-SELL AGREEMENT

Most families simply leave the cottage to all the children equally. In this case, it's a good practice for the children to complete a buy-sell agreement when they take ownership of the cottage. This agreement establishes the terms and conditions necessary for an efficient, equitable sale of the cottage. It should generally contain a "shotgun" clause, whereby if one child offers to buy the others' shares at a price, the others can either sell to that child at that price or buy the initiating child out at the same price. This provision ensures the child exercising the "shotgun" clause offers at a fair price.

LEAVE THE COTTAGE TO ONE CHILD

One way to avoid problems associated with sharing the cottage is to leave it to one child, while leaving assets of equal value to the remaining children. In this case, your will should address the payment of taxes and adjust the division of the estate based on the value of the cottage, which may require an appraisal.

MANAGING EXPENSES

Whichever method you use, you should consider making arrangements to cover the capital gains tax, pay for the obligations under the buy-sell agreement and provide estate equalization for children who won't receive ownership.

Your options here include:

- Your estate or your children could pay the related expenses from current funds.
- They could borrow money to pay the expenses.
- You could purchase suitably designed life insurance to pay for all or part of the anticipated tax liability, buy-sell needs and estate equalization.

Regardless of how you decide to pass on the cottage, or any other asset, you should seek professional advice to structure your affairs as tax-efficiently as possible. Thinking now about the transfer of your cottage will enable you to put in place a plan that eliminates as many obstacles as possible. This plan can include the use of life insurance to pay the capital gains tax liability in the future.

The best way to start?

Plan a family weekend at the cottage this summer. While enjoying the sunset, talk to your children about how they want to preserve these summer memories … and then talk to your financial security advisor.