

YOUR HOME, YOUR COTTAGE, YOUR ESTATE PLAN



Introduction

If you own a home and a cottage, at some point you will have to decide how to handle these properties in your estate plan. Do you sell your cottage during your lifetime or through your will? Do you give it to your children this year or later or not at all? How do you minimize income taxes and probate fees? And, how do you fund these costs.

There is no one-solution-fits-all approach to answering these questions; however, this discussion will explain the issues you need to consider in order to make the right decision for you.

To understand the financial consequences and options available, let's start with a common situation.

You and your spouse own a home where you live most of the year, but you also spend time at a cottage which you own. You have adult children and, perhaps, grandchildren. Like most real estate the value of these properties has increased over time, and if sold, would result in a gain.

Here are the four things to consider: First, what tax liabilities are created when the properties are sold or transferred? Second, what are the tax consequences of selling or giving your cottage to your child, either during your lifetime or through your will? Third, what probate fees are charged? Finally, where do the funds come from to pay for the income taxes and probate fees?

Capital Gain or Principal Residence Exemption?

First, what would happen if you sold both properties today for cash to a third-party? During the years you own both properties after 1981, one property would be designated as your principal residence for tax purposes and would be exempt from income taxes. The other property would give rise to a capital gain equal to your proceeds of disposition less your adjusted cost base less your selling expenses. Fifty percent of this gain is included in your taxable income and subject to tax at your marginal rates.

The amount of tax you will pay on the gain will depend on what province you reside in, the amount of the gain, and your base level of taxable income. At the high-end, you may owe tax close to 24% of the gain. For example: A selling price of \$400,000 with costs of \$300,000 results in a \$100,000 gain and taxes, at a marginal rate of 44%, of \$22,000.

But what if you waited and both properties were sold from your estate for cash to a third-party? On death, the *Income Tax Act* deems you to have disposed of the properties for proceeds equal to fair market value and the tax consequences are the same: a taxable gain on one of the properties and a principal residence exemption on the other. Note, there is an exception.

Property transferred on death to a surviving spouse is done on a tax-deferred basis. The gain will be taxed in that person's hand when the property is sold or on death.

You may think you can avoid the problem of paying tax on the gain by simply giving the cottage to your children or selling it to them at a price much lower than market value, but the answer is no. The *Income Tax Act* has specific rules governing these situations.

If you gift the cottage to your children, you are deemed to have sold it for proceeds equal to fair market value and your children are deemed to have acquired it for a cost equal to fair market value. The tax consequences are the same as if you had sold it to a third party.

As for selling it at a price below market value, the Act creates a double taxation surprise. You would be deemed to have sold it for proceeds equal to fair market value and thus taxed on the full gain, but the cost base to your children would reflect the amount they paid (i.e., the lower amount). When they sell the property, their gain would include a portion of the gain that was already taxed in your hands hence a portion of the gain is taxed twice.

Capital Gain & Income Taxes		Probate Fees	
Proceeds of Disposition	\$ 400,000	Value of Property	\$ 400,000
less: ACB & Selling Costs	(300,000)		
Capital Gain	100,000	Ontario Rate	
50% Inclusion Rate	50%	\$15 / \$1000	1.50%
Taxable Capital Gain	\$ 50,000		
Marginal Tax Rate	44%		
Taxes Payable	\$ 22,000	Probate Fees	\$ 6,000

Probate Fees

Apart from income taxes, there are probate fees. Probate fees vary by province and occur when an estate administrator or trustee presents a will to Probate Court. The court grants authority for the trustee to carry out the wishes of the testator and in return receives a fee that is, in most provinces, a percentage of the estate's value. Assets not forming part of the estate are not subject to probate fees.

For real estate, probate fees can be avoided by selling or gifting the property during one's lifetime (including the use of a family trust). Since the property does not form part of the estate there are no probate fees.

Another approach is to own the property jointly with the right of survivorship (JTWROS). Property thus owned, automatically transfers to the surviving owners and does not form part of the deceased's estate.

If you intend to pass your property to your surviving spouse, you should consider owning your home and cottage jointly with your spouse. If one spouse has sole ownership to the real estate, it is possible to transfer ownership to joint tenants with rights of survivorship on a tax-deferred basis (i.e., your cost base is split between you and your spouse).

1. Gift To Children During Your Lifetime

Given these tax issues and probate fees, here are some options.

The gifting of the cottage to your children results in a disposition of the property at fair market value. If the property is not designated as your principal residence, there is an immediate tax hit on the capital gain. Since there is no cash received on the gift, you will have to determine how you will pay the taxes owing. Any future gain in the value of the property will be taxed in your children's hands creating a tax deferral. This

strategy eliminates probate fees; however, you no longer control the property. For example, your children could sell the cottage without your approval. Further, the property forms part of their estate with respect to death, divorce, bankruptcy etc.

This option is best suited where you will claim the principal residence exemption on your cottage and not your home, and there is little risk the property will be sold because of events in your children's life.

2. Gift To Children From Will

This option is similar to the first option, but with the following changes. Since the property is gifted from your will, it will be subject to probate. Owning the property during your lifetime means you maintain control over the use of the cottage and you avoid potential legal issues your children may encounter. There is no tax deferral benefit from an early transfer to your children.

This approach is favourable if you're con-

cerned about losing control over the cottage, where probate fees are minimal or where the future value on the property will not appreciate quickly.

Gifting the property under options 1 and 2 is appropriate where there is no need for cash to satisfy debts. Further, for single-child families, there is no sibling rivalry or "being equitable" disputes.

3. Sell Cottage to Children During Your Lifetime

The consequences of option 3 are similar to option 1 provided the selling price is the property's fair market value. To avoid double taxation, it is critical the selling price be fair market value.

The key difference between the option 1 and 3 is the consideration received in selling the property. If you receive cash, you will have funds to pay any income taxes that result from the disposition. If you receive debt (e.g., a mortgage or promissory note), it is possible to spread the gain over a five-year period (i.e., one-fifth of the gain is taxed each year). If you are not at the top marginal rate, spreading the gain over five years will result in tax savings. (Note: the debt may or may not bear interest.)

On top of the potential tax savings, the

other benefits are the avoidance of probate fees and a tax deferral of the future gain which is taxed in your children's hand and not yours. The critical negatives are the immediate taxes owing, if any, on the disposition and the loss of control over the property.

Selling the property may be necessary in order to satisfy debts, including taxes; however, the five-year tax deferral may reduce your income taxes.

If your estate holds any debt on the cottage, it is possible to forgive the debt in your will. In following this approach, you can achieve tax and probate savings, but with the end result of gifting the cottage to your children.

4. Sell Cottage to Children From Your Will

If you sell the cottage from your will, you maintain control and use of the cottage during your lifetime. This approach eliminates any legal issues your children may encounter if they owned the property. However, the full amount of the gain in the property's value is taxed in your hands. There is no deferral to your children. Further, since the property transfers from your will, it

will be subject to probate.

Selling the property may be necessary in order to eliminate sibling disputes. The child who pays the most for the cottage, gets the cottage. If you desire, the amount paid for the cottage could be forgiven and reduce that child's inheritance in order to maintain equitable treatment among your children.

5. Establish Joint Ownership With Children.

It is possible to establish joint ownership with rights of survivorship of your cottage with you, your spouse and you children. Provided there is a change in beneficial ownership (i.e., your children are not holding the property in trust for you), there is a disposition of a portion of the property at fair market value and the potential for

an income tax hit. The amount of the gain triggered on the transfer will depend on the number of joint tenants added to the title. The remaining portion will be taxed on death or sale. The primary motivation for following this approach is to avoid probate fees.

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5. Establish Joint Ownership With Children (Cont'd)

This option comes with a long list of potential deficiencies. In certain situations, courts have ruled the transfer was not effective and the child was not a beneficial owner. The property then passed through the will and was subject to probate fees.

As a joint tenant, the title can be split and that owner's portion sold separately. It is possible you could end up with a co-owner you did not want. Further, the property is exposed to legal

disputes of your children due to marriage breakdown, creditors etc.

Finally, on death your estate will be liable for any taxes owing on the deemed disposition while the property is not part of the estate and cannot be liquidated to satisfy any debts.

While this option may seem simple and elegant, many times it creates more problems than solutions.

6. Establish Family Trust

In this option, you establish a discretionary family trust to hold the property for the benefit of you, your spouse and your children. A gain is triggered when the cottage is transferred to the trust; however, there is no further gain on your death. The future gain would be taxed in the trust within 21 years; however, steps can be made to transfer the trust property to your children and tax the gain in their hands.

As the trust property does not pass

through your will, there are no probate fees. Further, the trust can be created in such a way to exclude a child as a beneficiary in the event of marriage breakdown, bankruptcy etc. This measure provides a level of protection from creditors. Finally, a trust is an excellent vehicle for allowing multiple family members to enjoy the cottage.

There are however costs involved in formally setting up such a trust as well as annual administration and income tax reporting.

7. Establish Corporate-owned Cottage

If you would like to see a family cottage survive in the family for several generations, you may consider creating a corporation to hold the cottage. You or your children would own shares in the corporation which are then passed down through generations.

The transfer of the cottage from you to the corporation can be done with or without an immediate capital gain. It's your choice. Future growth in the value of the property will be re-

flected in the value of the shares of the corporation and taxed based on the shareholders' circumstances. Probate fees can be avoided by the use of a second will.

To govern the use of the cottage and the disposition or transfer of shares, the shareholders should enter a shareholders' agreement.

Given the costs and ongoing administration required to implement, this option will be appropriate for a limited number of families.

Other Matters

1. Foreign-based property. If your second property is located in a foreign jurisdiction, you will be subject to their laws as well as to Canadian income tax laws. First, since the property is not located in Canada, it is not possible to claim the principal residence exemption. Any gain on disposition or death will be subject to Canadian tax. The gain may be subject to local income tax and withholding taxes. If you do not plan on selling the property prior to your death, you should consult with a lawyer in the foreign jurisdiction to create a will for that jurisdiction. If the property is handled by a second will, it would not be subject to provincial probate fees.

2. Valuation. If you plan to sell or give the cottage to your children, a few dollars spent today for a formal, written valuation of the property may well save you many more dollars in the future.

3. Principal Residence Exemption. Currently, each family unit is allowed one principal residence exemption. The family unit is the spouses and minor children. Prior to 1982, each individual was allowed a principal exemption. This meant couples could claim the exemption for both the home and cottage.

The exemption applies to land not in ex-

cess of ½ hectares. Land in excess of this limit may or may not be exempt.

4. U.S. Estate Tax. If you are a U.S. citizen or green-card holder residing in Canada or you own property situated in the U.S., your estate plan must take into consideration the U.S. Estate Tax and Gift Tax laws.

5. Gifting. Where you plan to give the property to your children, the language of the agreement should state the transfer is in exchange for "natural love and affection." Consideration of a nominal amount (say \$1) would create the double taxation surprise.

6. Land Transfer Tax. Depending on what province you live in, land transfer taxes may be payable.

7. Adjusted Cost Base. The ACB of your property is the amount paid to acquire the property plus the cost of any improvements you made to it. Additions to the property would be considered an improvement (e.g., adding a shed, a deck), or expanding the size of the house while maintenance and replacements are not improvements (e.g., repave driveway, replace roofing or furnace). Since additions affect your ACB and potential capital gain, you should keep accurate records of your expenditures.

Biography



James Piper is a member of the Institute of Chartered Accountants of Ontario and graduated from Wilfrid Laurier University with an Honours Bachelor of Business Administration. He has completed the In-Depth Tax Course with the Canadian Institute of Chartered Accountants and uses his expertise in tax law to help individuals and businesses achieve their objectives.

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