Planning for the Family Vacation Property

Many Canadians appreciate the benefits and joys of owning a cottage, cabin or chalet ("vacation property"), and wish to pass the ownership and enjoyment to the next generation. Designing a succession plan for the future ownership of your family vacation property can be challenging, especially because these properties often hold tremendous sentimental and monetary value. In addition, it is likely that more than one child may want ownership; however, the asset cannot be divided. As a result, it's important that your estate plan take this asset into consideration to ensure that it is properly accounted for and, if applicable, transitioned properly based on the needs and desires of the family.

Communicate, communicate, communicate

Parents often agonize over a complex succession plan for the family vacation property, only to learn later that some, or all, of their children have no interest in its eventual ownership. That's why it's important to keep the lines of communication open between all parties when developing your plan, and that it's regularly reviewed to ensure it remains relevant for everyone concerned. This is especially important in situations where children are unsure whether they would like to own the property, their lives are unsettled or sibling rivalry exists. Your succession plan for the family vacation property may need to be flexible and/or revised to make certain that it takes into consideration the unique dynamics of your ever-changing family situation.

Don't forget the taxes

The value of the vacation property relative to the value of your entire estate is an important consideration. Over the years, its value may have increased significantly, resulting in insufficient funds in your estate to pay the capital gains and probate tax (if applicable), as well as to compensate any children who will not be inheriting the property.

Provided that the vacation property is owned by you alone or jointly with another family member and is "ordinarily inhabited," the Principal Residence Exemption can be applied to a vacation property upon declaration (or election) of the property as the principal residence in the year of disposition. An individual taxpayer or a married/ common-law couple can only claim the Principal Residence Exemption ("PRE") for one property in any particular year of ownership (after 1981). Of course, both your home and vacation property may have increased significantly in value since they were purchased. If so, when there is a sale or a deemed disposition of one of these properties, you must decide whether or not to apply the Principal Residence Exemption to the sale or deemed disposition in order to reduce or eliminate the capital gains tax payable on that property, while exposing the other property to tax on its eventual disposition. For more information about owning multiple properties and the Principal Residence Exemption, please speak to your advisor.

If you do not apply the Principal Residence Exemption to a vacation property upon disposal, you may still have the opportunity to reduce the capital gains tax payable by amending the adjusted cost base ("ACB") of the property, for example by adding eligible renovation expenses to the original cost of the property. Therefore, it's important to monitor and update the ACB of your vacation property (or home) and keep records confirming the original cost of acquisition or construction and supporting documents reflecting additional costs for betterment (versus maintenance), improvement and renovation of the property. These capital expenses are added to the ACB of the property, thus reducing any capital gains at the time of disposition.

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Depending on your province of residence or the province in which the vacation property is located, significant probate tax may apply to the fair market value ("FMV") of the property upon death of the owner, in addition to the capital gains tax. Probate tax may be avoided by holding the vacation property in a qualifying trust, a corporation (though this ownership structure is generally not recommended), by way of joint tenancy with right of survivorship, or by gifting it during your lifetime.

Plan for liquidity

Most people apply the Principal Residence Exemption to the family home and have their estate pay any capital gains tax with respect to a vacation property after their death. However, if your estate has a shortfall of liquid funds to pay the capital gains tax, you'll need to consider ways to provide additional funds in your estate for this purpose. Instead of gifting the property, you can give your children the option to purchase it from your estate upon your death. Your children can use all or a portion of their cash inheritances to fund the purchase. The proceeds of the sale will then be available to the estate to pay taxes and distribute the balance to your beneficiaries.

Insurance can also be used to provide a funding solution. In this situation, your children purchase an insurance policy on both your and your spouse's lives. Your children are both the owners (pay the premiums) and beneficiaries (receive the proceeds at death) of the policy. Upon the last parent's death, the proceeds of the life insurance policy provide the funds necessary to pay the taxes owing by the estate, and perhaps fund equalization payments to the other beneficiaries.

Another option is for the life insurance policy to be owned by you, and for you to then name either your children or your estate as beneficiaries to provide the necessary liquidity. Note that naming your estate as beneficiary may result in additional probate fees.

The following example shows how there can be a $146,250 tax bill on a cottage originally purchased for $350,000.

Value upon last parent's death	$1,000,000
Cost base of cottage	$350,000
Total capital gain	$650,000
Capital gains taxable (50% of total)	$325,000
Tax payable (assumes a 45% tax rate)	**$146,250**

Using the proceeds from a life insurance policy to offset this tax bill can be a simple and effective solution.

Using a trust to manage multiple users

If several family members will be sharing the vacation property, or if multiple buildings or parcels of land need to be kept together, a trust can provide easier management and fewer risks than co-ownership.

Trustees are appointed – usually one to represent each family group – and the trustees decide on time allocations and repairs, as well as paying insurance, taxes and utilities. In this situation, a maintenance fund should be established to provide for major expenditures. The trustees' decisions must be made in accordance with the terms and conditions set out in the trust. Often, the terms of the trust include a requirement for all beneficiaries to enter into a Co-Management Agreement.

One tax consideration of using a trust is the "21-year rule," which deems property in the trust to be sold at fair market value every 21 years, potentially triggering capital gains tax. A common strategy to defer the 21-year capital gains tax from being payable is to distribute the trust's assets (i.e., the vacation property) prior to the deemed disposition date to the (Canadian) beneficiaries outright, at the ACB. The capital gains tax would then be payable by the beneficiaries in the future, when they eventually dispose of the property, or at their death. Children and grandchildren then have the option to enter into their own arrangements for co-ownership, or to be bought out. An option to sell the property and distribute the proceeds to the beneficiaries should also be included in the terms of the trust.

Consider a "cooling off" trust

A long-term trust may not be practical if children will not cooperate, cannot afford the long-term expenses, or if you know in advance that they will not get along. A short-term trust, one for five years or less, can be used as an alternative in order to give children time to recover from their grief, and examine their own financial situation in light of their inheritance. During this period the children can sort out whether they are interested in continuing to use, or perhaps own, the property. Postponing the decision can be a good way to avoid conflicts that may arise in the year after death when emotions may be running high, and children are not yet sure of what they want or whether they can afford to be vacation property owners themselves.

Transfer during lifetime

It is possible to transfer the vacation property to your children during your lifetime – known as an "inter-vivos" transfer. However, the transfer will trigger capital gains tax on any increase in the value of the property since its purchase. The tax is payable unless you elect to utilize the Principal Residence Exemption at the date of the transfer, and if the vacation property qualifies as a principal residence during the time you

owned it. This also applies to an inter-vivos transfer of your vacation property to a trust (though there can be exceptions if the trust is an Alter Ego, Spousal, or Joint Spousal/Partner trust). One disadvantage of a transfer of your vacation property to an inter-vivos trust is that you lose control over – and perhaps access to – the property which can lead to problems if your intention is to continue using the property during your lifetime. Another disadvantage is that transferring the property to your children exposes the property to the children's creditors, family law claims, and unexpected events which may make the property vulnerable.

You may also consider selling the cottage to the child(ren) at FMV using a take back loan (with or without interest) that could be forgiven upon the parents' death. To the extent that not all the proceeds were receivable upfront, a capital gains reserve could be claimed to defer the tax hit. For more information about minimizing capital gains taxes, please ask your advisor.

Principal Residence Exemption

In considering the transfer of a vacation property to a trust, the possible impact to the Principal Residence Exemption ("PRE") should be considered. Prior to amendments to the Income Tax Act introduced for 2016, it was generally possible for a personal trust to claim the PRE to reduce or eliminate a gain that the trust would otherwise realize on the disposition of a property, with some modifications to the basic rules (including a potential impact to the trust beneficiaries in respect of their ability to claim the Principal Residence Exemption on their own homes). Under the amended rules, the PRE will not be available to certain trusts, including family trusts, on dispositions after 2016. However, transitional rules allow the PRE to be claimed by a trust which disposes of property after 2016, for gains accrued prior to 2017. For more information on trusts and the Principal Residence Exemption, including certain types of trusts which may still benefit from the PRE, ask your advisor.

Residential property flipping rule

The 2022 Federal Budget proposed new rules to ensure profits from "flipping" properties are taxed and that the Principal Residence Exemption is restricted to Canadians who use their properties as residences. Specifically, on or after January 1, 2023, any person who sells a property they have held for less than 12 months is considered to be flipping the property and would be subject to full taxation on their profits as business income, with specific exceptions for certain life circumstances, such as a death, disability, the birth of a child, a new job, or a divorce. For more information, please ask your advisor.

Seek professional advice

While every family situation is unique, tax and estate planning professionals are experienced in helping you explore all the options available for your family vacation property before selecting a solution that produces the right result for your circumstances. Obtaining good advice is important, particularly where succession of recreational real estate is involved.

For more information, speak with your advisor.

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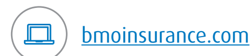

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