BMO NESBITT BURNS

Your Plan for the Family Vacation Property

Many Canadians know the joys of owning a cottage, cabin or chalet, and wish to pass the ownership and enjoyment of the family vacation property to the next generation.

Designing a succession plan for the future ownership of your family vacation property can be challenging, especially because the property holds tremendous sentimental and monetary value. In addition, it is likely that more than one child may want to own it; however the asset cannot be divided. As a result, the desire to keep the vacation property in the family may be impractical or inconsistent with your other estate planning goals.

Get Input From Your Family

Parents often agonize over a complex succession plan only to learn later that some or all of their children have no interest in owning the property. If your children are unsure, or their lives are unsettled, your succession plan for your vacation property needs to be flexible.

Look at the Numbers

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 compensate any children who will not be inheriting the property.

Remember the Taxes

Provided that it is “ordinarily inhabited”, the Principal Residence Exemption can be applied to a recreational property upon declaration (or election) of that property as the principal residence in the year of disposition. However, a married or common law couple can only claim the exemption for one of their properties 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 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, while exposing the other property to tax on its eventual disposition.

If you do not apply the Principal Residence Exemption to the vacation property upon disposal, you may have the opportunity to reduce the capital gains tax payable by increasing the Adjusted Cost Base (ACB) of that 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 construction

Irit Gertzbein, LL.B
Senior Manager, Trusts & Estates
Wealth Planning Group

or acquisition, and supporting documents reflecting additional costs for betterment (versus maintenance), improvement and renovation of the property. These capitalized expenses can be added to the ACB of the property, thus reducing any capital gains at the time of disposition.

Please note that if the vacation property is located in Ontario, British Columbia or Nova Scotia, significant probate tax may apply to the fair market value of the property upon death of the owner. Probate tax may be avoided by holding the vacation property in a Trust, a corporation (though this ownership structure is generally not recommended), by way of joint tenancy with right of survivorship, or gifting it during your lifetime.

Provide for Liquidity if Necessary

Most people apply the Principal Residence Exemption to the family home and have their estate pay any capital gains tax with respect to a recreational 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, after 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 your lives. 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.

Set Up a Testamentary Trust to Manage Multiple Users

If several family members will be sharing the recreational property, or if multiple buildings or parcels of land need to be kept together, a Trust can provide easier management and less 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 Trusts's assets (i.e. to the vacation property) prior to the deemed disposition 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 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 cannot cooperate, or if you know that they cannot get along. A short-term Trust, one for 5 years or less, can be used as an alternative to give your 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 conflict that may arise in the year after death when emotions may be running high and children are not sure of what they want or whether they can afford to be vacation property owners themselves.

When to Transfer the Property

It is possible to transfer the vacation property to your children during your lifetime – 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, as discussed earlier, the transferors elect to utilize the Principal Residence Exemption at the date of the transfer. This also applies to the transfer to a Trust – except for an alter ego or joint partner Trust (available only for those who are 65 or older and resident in Canada). One disadvantage of an inter-vivos Trust is your loss of control over 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.

Seek Professional Advice

While every family situation is unique, tax and estate planning professionals are experienced in helping you explore all the options available before selecting a solution that produces the right result for your circumstances. Obtaining good advice is well worth it, particularly where succession of recreational real estate is involved. Contact your BMO Nesbitt Burns Investment Advisor who can introduce you to an estate planning professional to assist you in your succession planning.

Visit www.bmo.com/nesbittburns for more information about the products and services available through BMO Nesbitt Burns.

Note: Some terms are capitalized for purposes of greater clarity in the context of this discussion only.

June 2013

All insurance products and advice are offered through BMO Nesbitt Burns Financial Services Inc. by licensed life insurance agents, and, in Quebec, by financial security advisors.

® "BMO (M-bar Roundel symbol)" and "Making Money Make Sense" are registered trade-marks of Bank of Montreal, used under licence. "Nesbitt Burns" is a registered trade-mark of BMO Nesbitt Burns Inc. BMO Nesbitt Burns Inc. is a wholly-owned subsidiary of Bank of Montreal.
The comments included in this publication are not intended to be a definitive analysis of tax applicability or trust and estate law. The comments contained herein are general in nature and professional advice regarding an individual's particular tax position should be obtained in respect of any person's specific circumstances.
If you are already a client of BMO Nesbitt Burns, please contact your Investment Advisor for more information.

Member-Canadian Investor Protection Fund

EWPG-13-007