Planning For The Family Vacation Property

Many Canadians know the 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, the desire to keep the vacation property in the family may be impractical or inconsistent with your other estate planning goals.

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, 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 compensate any children who will not be inheriting the property.

Provided that the vacation 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 exemption 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.

If you do not apply the Principal Residence Exemption to a vacation property upon disposal, you may have the opportunity to reduce the capital gains tax payable by increasing the adjusted cost base (ACB) of the property. This is achieved by adding 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.

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, in addition to the capital gains tax. Probate tax may be avoided by holding the vacation property in a qualifying Trust (see discussion on page 2), 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. However, since each of these strategies has potential consequences, the avoidance of probate tax should not be your only motivation. More importantly, prior to making a decision

to use any of these strategies a thorough review of your circumstances by, and a discussion with, a trusts and estates lawyer is recommended.

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 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 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 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.

Personal trusts owning the vacation property

Until 2017, a personal trust which owned real estate, such as a home, condo, cottage, cabin or chalet for the benefit of natural persons (not partnerships or corporations), who ordinarily inhabit the property or whose current or former spouse/partner, child, ordinarily inhabit the property, could claim the Principal Residence Exemption upon disposition of that property; avoiding payment of capital gains tax. The caveat, of course, was that for the years the Principal Residence Exemption is claimed by the trust, the beneficiaries of the trust are precluded from utilizing the Principal Residence Exemption against their own residential property, upon disposition, with respect to those same years. Notwithstanding this caveat, for many high net-worth families, owning the family vacation property in a family trust has been a useful strategy for the purposes of keeping the property in the family for several generations and, for the purposes of the Principal Residence Exemption, eliminating significant capital gains tax, perhaps for several generations. However, as of January 1, 2017, new legislation disallows the Principal Residence Exemption from being utilized by all family trusts (whether discretionary or non-discretionary, inter-vivos or testamentary). Only the following types of personal trusts are eligible, as taxpayers, to utilize the Principal Residence Exemption ("Qualifying Trust"):

1. Alter Ego Trust (settlor 65 or older);
2. Joint Spousal/Partner Trust (settlor/contributor 65 or older);
3. Self-Benefit Trust (settlor any age);
4. Spousal/Partner Trust (settlor/testator any age);
5. Qualified Disability Trust (for a named "electing beneficiary" who is the settlor's spouse or common-law spouse); or
6. Trust for a minor child whose parents are deceased.

Note that for trusts for a minor child whose parents are deceased, once the minor child attains age of majority, that trust will constitute a family trust and no longer be a Qualifying Trust for purposes of the Principal Residence Exemption. This means that where a trust is created in a Will to hold a vacation property for the benefit of minor children, once the youngest living child attains the age of majority, it would be prudent for the trustee to roll the property out of the trust to one of the beneficiaries who would then be able to use the Principal Residence Exemption when disposing of the property. Likewise, with respect to the other five trusts listed above, once the settlor and/or the surviving spouse is/are no longer alive, the trust will no longer qualify for the Principal Residence Exemption. The new law applies only to gains that accrue after December 31, 2016. That is, the Principal Residence Exemption will still be available to family trusts which continue to hold residential properties after 2016 with respect to the gains accrued prior to January 1, 2017. Such gains are sheltered from tax for the years prior to 2017, if the trust designates the property to be the Principal Residence upon disposition (actual or deemed).

In light of the above, there is good reason to revisit existing estate plans in which a family trusts own a vacation property. It may be prudent, depending on circumstances, to distribute the property to one of the capital beneficiaries (who is also an income beneficiary) on a rollover basis, or, to resettle the property into a Qualifying Trust, in order to retain the Principal Residence Exemption availability with respect to post-2016 gains.

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Non-tax-related planning with trusts owning vacation property

Asset protection and "keeping it in the family" are the two most important reasons vacation properties are transferred to personal trusts. These goals remain paramount for high net-worth families, notwithstanding the loss of the availability of the Principal Residence Exemption, for all family trusts (not Qualifying Trusts). 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 life time

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 the transfer of your vacation property to a trust – except for 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.

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 important, particularly where succession of recreational real estate is involved.

For more information, please speak with your BMO financial professional.

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