

COTTAGE SUCCESSION PLANNING

A. Introduction

Cottage succession planning is a complex and difficult area. Complex because it involves capital gains planning. Difficult because it involves very emotional issues for the families who engage in it.

B. The Building Blocks

The conceptual building blocks for cottage succession planning are as follows:

- Capital Gains – Cottages are capital property and have historically appreciated at a pace that exceeds the appreciation in the owners other assets. It is not uncommon to see a retired person who owns a cottage that is worth \$500,000 and has other combined assets worth less than \$500,000. The cottage is appreciating at a fierce rate. Their other assets are decreasing as they collapse and spend RRIF's and spend the children's inheritance.
- The Principal Residence Exemption – A cottage can be claimed as a person's principal residence, thereby sheltering it from capital gains. A person can only have one principal residence at a time, and if they own both a house here in town and a cottage they normally have an option to

elect one or the other to be their principal residence. Before 1982 spouses could own two properties and each could claim one under their own personal residence exemption. That was discontinued, and each couple is limited to one personal residence at a time between both of them. That choice between principal residences has to be made in the year they dispose of one property or the other. It does not have to be made along the way on a year-by-year basis. Since cottages tend to appreciate more quickly than houses in the city or rural areas outside of cottage country, people will often select their cottage to be their personal residence.

There are some technical requirements before a property will qualify for the principal residence exemption, such as the total acreage of the property cannot exceed a certain maximum. This paper does not delve into those technical requirements in any detail. The chief requirement, however, is that the cottage be "ordinarily inhabited" by the taxpayer or certain members of the taxpayers immediate family. The phrase ordinarily inhabited has been held by CCRA to include weekend use for recreational purposes over the summer season. It need not be every weekend, and it need not be year round. Thus, the common pattern of family cottage usage will generally be sufficient to ground a claim of the cottage as a principal residence. The cottage can be rented out on an

occasional basis without interfering with the principal residence exemption.

Manipulation of the principal residence is one of the mainstays of cottage succession planning.

- Probate Fees – Probate fees in Manitoba amount to \$6 that has to be paid to the government for every \$1000 of value flowing through the estate. This has been said by commentators to be insignificant, and the traditional suggestion from the legal community has been that probate fees are low enough that they ought not to drive estate planning. The public does not buy in to this view. Cottage owners are typically very interested in probate avoidance strategies and frequently seek assistance from their lawyers in implementing them. Many cottage owners in Winnipeg own property in Ontario, as well. The probate fees in Ontario are charged at the rate of \$15 per \$1000, more than double those here in Manitoba.

The standard go-to probate avoidance technique is placing property into joint tenancy. That creates potential trouble for the parent that has to be carefully explained. This is discussed later in this paper. As more complicated probate avoidance measures, the cottage can be transferred into an alter ego or joint partner trust, or into the ownership of a corporation. Again, these are discussed at greater length later.

- Adjusted Cost Base And Fair Market Value – Cottage succession planning is difficult without knowing the cost base (normally abbreviated as “ACB”) and fair market value (“FMV”) of the cottage and any other property owned by the client that might be available for designation as a principal residence.

The enquiry does not end with the cottage, but extends to the house. Clients frequently have maintained receipts and other records of capital improvements relating to the cottage but are surprised to discover they should have been keeping them for the house as well. The adjusted cost base for a piece of capital property normally the purchase price paid plus the cost of improvements made after that date. If a new dock is built, or a new room is added, the cost of those improvements is added into the ACB for capital gains purposes.

One or two additional wrinkles have to be borne in mind in determining the adjusted cost base of a recreation property. If the cottage was owned prior to December 31st, 1971 (the valuation date at the beginning of capital gains taxation, also known as “V-day”) then the opening value is not the price paid for the property but the fair market value as of that date.

If the cottage were owned prior to February 22, 1994 then the owner would have had an opportunity to “bump” the cottage and crystallize gains at that time. This was to allow persons a last chance to use the \$100,000 personal capital gains exemption as it was phased out. The bump value will become the cost base as of that date. Future improvements will then add to it.

Clients frequently present with a rough idea or belief as to the ACB and FMV of their cottage property. Before a cottage succession plan is implemented these values should be nailed down to the extent possible. There are two reasons for this. First, an organized client will keep careful and up to date records to establish and keep a running balance for the ACB on the cottage and the house. An unorganized client will not, and when the time comes they will be forced to conduct archaeology in determining the ACB on the property. They will not have the material to justify the true ACT and will either have to take a tax risk (“I don’t have the receipts but I remember spending \$45,000 on capital improvement and want to claim it”) or they will have to give up the higher ACB (“I don’t want to claim those amounts and then face reassessment”). The sooner they get on the paper trail the better for them. Second, as guesstimates give way to hard figures, a client may change directions. A client planning to designate their home as a principal residence may change field when the math is done and hard numbers become available.

- Rights of Use – The ownership of a cottage carries with it the right to use and enjoy the cottage. The sunsets, fishing, and quiet time on the porch are the essence of a cottage and the reason why families purchase them. In a bid to minimize probate or freeze capital gains exemptions, parents frequently give up their legal rights to use and enjoy the cottage. This is often inadvertent. While the legal rights on paper may not actually govern the family use of the cottage, the failure to advise clients on these points can create some truly disastrous results in cases where a family might have a falling out. Mom and Dad do not want to risk eviction if that risk can be minimized or done away with. Some of the tools that can be used here are co-ownership agreements, trust declarations, or life leases.
- A Clear and Articulated Vision of the Future Discussed With The Whole Family – This is an item that rarely is considered when it comes time to discuss cottage succession planning, but is indispensable in helping clients come up with a solution that fits the family needs and will be palatable to all involved. After the legal and accounting advice has been secured, after options have been identified and discussed, and after a direction has been identified for implementation, a family is well advised to sit down and review the plan together. Parents may think that their children want the cottage, or want to own it jointly, but until they ask they really do not have an accurate picture. Further, a co-ownership structure

like a cottage trust is a structure that the children have to live with, not the parents. The children often have some strong ideas of what will work and what will not work. Tailoring the suit to the person who has to wear can be invaluable.

C. Transfers To The Kids Now

Transferring the cottage into the names of the children is a commonly pursued strategy. It can take different forms and achieve different ends:

- Transfer Into Joint Tenancy – This is the most common option selected among do it yourself estate planners. The cottage is placed into the joint names of the parents and the child or children ultimately destined to receive the cottage for their own use. This will succeed in probate avoidance. The joint ownership leaves the parents on title where they enjoy some rights of continued use, although the rights of the parents will be no stronger than the rights of the kids in that event and contests could develop. A lease back to the parents or a joint ownership agreement can preserve their rights of use and leave them in control. These measures are uncommon unless a lawyer is involved.

In terms of capital gains, the transfer into joint names is generally a disposition for capital gains purposes and any pent up capital gains will be

triggered. At this stage it may be possible for the parents to invoke the principal residence exemption to shelter the gain incurred to date. If they have a house as well, they should understand that their house will now attract capital gains for the years that were claimed for the cottage. They need to know and compare the capital gains exposure on both properties before selecting between them. A transfer into joint tenancy without proper documentation leave a muddy situation relating to future capital gains treatment beyond the scope of this brief paper and careful advice is required.

There are some additional risks inherent in joint ownership. The cottage becomes subject to the claims of any creditors the children may have. The children, as co-owners, can apply to court to have the cottage sold from beneath the feet of the parents. These risks can be controlled with a trust declaration or co-ownership agreement making it clear that the children's' rights to force sale or to access the capital locked up in the cottage are limited or nonexistent. Again, a lawyer will be helpful in preparing this documentation and there can be unforeseen implications for capital gains treatment awaiting the unwary.

If a trust declaration carefully reserves all rights of beneficial ownership, then the disposition and capital gains can be deferred until the death of the parent. There appears to be some flexibility in either triggering the

gain or deferring it. There is case law and commentary to suggest that an effort to defer the gain may defeat the effort to avoid probate fees however.

- Outright Into the Name of the Child or Children – If the property is placed outright into the sole ownership of the children, the capital gains situation is clear. The gain up to the moment of the transfer is the problem of the parent, and the gains thereafter the problem of the children. The principal residence exemption is available to the parents first, and the children second.

Risks relating to loss of use are more pronounced, and a lease back or trust declaration are advisable.

- Dangers In the Transfer Documents – Whether the transfer is into joint names or into the names of the children alone, the wording of the transfer of land documentation deserves careful attention to avoid possible disputes with CCRA. A gift to the children should be shown to be for the consideration of “natural love and affection” in the transfer documentation. This ensures that the children’s’ cost base will be the FMV of the property at the time. If, in error, it reads “\$1.00 and other good and valuable consideration” it opens the possibility that CCRA will take the position that the ACB is the one-dollar figure. This would trigger a capital gain and

taxes in an exaggerated and unnecessary amount when the children later sell the cottage or die.

D. Transfer To A Corporation or Trust Now

Strategies are available to allow for a formal freeze of the cottage value. They are more expensive and more complicated. These strategies are much like the transfer into the outright names of the children, but then allow for a multiple generation carry over of the strategies thereafter as well as decision-making structures.

Insurance can be put in place to ensure that the capital gains taxes can be covered off and paid using insurance proceeds.

An alter ego trust becomes a tax neutral probate avoidant possibility for parents over the age of 65 years.

E. Transfer to the Kids At Death Under Will

Transferring the cottage to the kids under the parents wills attracts full probate and additional legal fees on the larger estate value.

Any pent up capital gains will be triggered at the date of death of the parents. If the principal residence exemption is not available this can result in huge tax liability for the parents estate. If the tax liability exceeds the balance of the estate assets it can cause the forced sale of the cottage to meet tax liability. If one child is to get the cottage and the other child or children are to get non-cottage assets it creates difficulty in ensuring that the children are treated equally. Life insurance is sometimes a solution here. Where that is impossible one of the freeze strategies may be necessary while the parents are still alive.

G. Information in this Paper not Substitute for Legal Advice

This paper is intended as an introduction to this topic. It is not a substitute for specific legal advice tailored to a client's particular needs. Any person wishing advice on how to order their affairs, or those of a client, should contact a member of our Wealth and Succession Practice Group. This paper is also based on the laws of Manitoba, and while laws are similar from Province to Province, the content of this paper may not be accurate in other provinces.

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