



# Passing on the Family Cottage

Deciding how to transfer the family cottage to your loved ones is often one of the most difficult estate planning challenges. In addition to all the usual tax-planning and gift-equalizing considerations, you and your children may have powerful emotional attachments to your cottage. After all, this was a place of recreation, family get-togethers, and family history, often for several generations. That emotional component can make it tough to decide on an estate plan that keeps everyone happy.

One way to think about your family cottage is to view it as a photo album. This is where many memories have been made, and because of that, the value of a cottage to your family is probably far greater than the appraised value of the property. Therefore, it is important to think about how significant the cottage is to each family member before deciding on a plan to pass it on. Evaluating the emotional attachment to the cottage of you and your family members should be the first step before looking at financial factors such as assessing tax liability.

However, the tax liability on the cottage could be a huge burden if your property has increased significantly in value over the years. Unless the cottage is your primary

residence, it will be subject to capital gains tax at the time of actual or deemed disposition. Since a cottage is often owned over a period of several decades, that tax bill may be in the hundreds of thousands of dollars.

What this all means is that careful planning is necessary to minimize both the tax burden and any friction that may exist between the beneficiaries as a result. Discuss the details of passing on your cottage with your chosen beneficiaries well in advance. Even seemingly mundane issues need to be addressed so there is no confusion about who will be responsible for the property tax, maintenance costs, landscaping, or other large expenses.

## Three Choices

Essentially, when it comes to transferring ownership of a cottage, you may find yourself in one of these situations:

- confirming with your family if they want to retain the cottage, and whether they can afford the ongoing financial commitment
- planning for the transfer to occur during your lifetime by selling the cottage or moving it into an inter-vivos trust
- planning for the transfer to occur in a will, and perhaps using life insurance to cover any capital gains taxes due

Des Jardine of TD Waterhouse Insurance Services Inc. describes a case he encountered in which four beneficiaries inherited a cottage from their parents with a \$300,000 capital gains tax bill attached to it. They could not come up with the money to pay the taxes and had to quickly sell the cottage for about \$100,000 less than what it was actually worth.

After real estate fees, taxes and other expenses, each heir ended up receiving just \$150,000. The \$1 million property was no longer in the family and the grandchildren were unable to enjoy the lasting legacy their grandparents hoped to pass on.

A sale to the next generation during your lifetime comes with its own considerations. No matter what “discount” price you charge your children or grandchildren, the Canada Revenue Agency (CRA) will consider the property to have been sold at fair market value. The capital gains tax will be due at the time of sale or transfer, unless you take back a demand mortgage with deferred payments. In that case, they may be able to spread the tax payable over a period of five years. Crystallizing the capital gain in a cottage by effectively selling the property to your heirs may be a desirable option if you have capital losses to offset the gain or if you are anxious to set a cap on



the capital gains. No matter how the sale is structured, it is important to realize that you will lose control over the cottage to your children. As owners, they will then make their own decisions about the property.

One alternative, an inter-vivos trust (or living trust), is where the trust becomes the legal owner, and you can retain a right to occupy/use the cottage in your/your spouses' lifetimes. Again, moving the cottage asset into the trust is a deemed disposition, so the taxes are due right away. This approach can be useful if the real estate market experiences a sudden drop and you want to crystallize a relatively small capital gain now and allow the property to appreciate in value within the trust.

The third option – planning for the transfer to occur following your death, according to instructions left in a will – ensures that you maintain control over the cottage. Instead of paying a big tax bill now, you can take full advantage of the time value of money and defer the amount owing until after your death, or the death of

your spouse. Furthermore, you can arrange for life insurance to cost effectively cover the tax liability when it comes due.

### **Joint Last-to-Die Insurance Solution**

Assume that a husband and wife bought a cottage 25 years ago for \$100,000 that today is worth \$1,100,000. Since 50 percent of that \$1,000,000 capital gain is taxable, the estate could be subject to a tax burden of \$250,000 (at a marginal tax rate of 50 percent). Unless there are sufficient liquid assets either in the estate or in the hands of beneficiaries to pay this bill, the cottage will have to be sold to settle the tax debt.

That is where “joint last-to-die” insurance comes in. It pays out a death benefit when the second spouse passes away. They recently arranged a \$250,000 “joint last-to-die” insurance policy for themselves – both 68 years old and both nonsmokers. The premium costs each year will be about \$4,000 a year. If the second spouse dies in 17 years, at age 85, the couple

will have paid a total of \$68,000 in premiums for a \$250,000 tax-free death benefit that their beneficiaries can use to pay any capital gains taxes due on the cottage.

There are ways of structuring the life insurance policy to take into account potential future increases in the value of the cottage. This may be accomplished by linking the death benefit to a cost-of-living index or by purchasing a higher benefit amount. There are also cases where a family pays for a higher death benefit to fund an equalization gift for a child who does not want to own part of the cottage.

### **Speak to Your Advisor**

When it comes to the family cottage, a well-thought-out strategy is essential to ensure that your wishes are carried out to the maximum benefit of your heirs. Speak to your Financial Advisor to find out more.

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