How to hand down your cottage while keeping the peace and saving money

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Published: July 30, 2018

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Nothing is sure but death and taxes. Ben Franklin said it centuries ago, but it's never been more relevant than now for the aging cohort of **cottagers**preparing to transfer ownership to the next generation. "If you've got time and some creativity, and you are dealing with advisors who have done it before, then it's straightforward," says Jamie Golombek, the managing director, tax and estate planning with CIBC Financial Planning and Advice. "The problem is if you haven't done any planning, and someone dies, then there's a tax bill to pay right away. Where's the money going to come from?"

Where indeed? But finding the money for **taxes** is only one part of a sound succession strategy. With planning, you can also ensure that the cottage stays in the family and that it goes to the children who really want it. You can lessen the capital gains tax hit or even postpone it for generations. You can reduce or avoid costs such as the estate administration tax (also known as probate fees). And you can protect the cottage from financial or marital claims, a concern that's top of mind for many parents. Finally, and perhaps most important, you can put a cottage sharing agreement in place that provides a framework for solving multi-owner conflicts.

Where to start? The good news is that there's at least one neat, novel trust technique for keeping the cottage in the family. But hold that thought. To understand the benefit of planning, you first need to understand all the ugly issues around cottage succession, because the best option may be a combination of strategies. Ready? Here we go.

Issue #1: The federal capital gains tax (CGT) liability

This is the biggie, and a primary reason cottages are sold out of families. The reality is that many families own valuable properties not because they're wealthy, but because they're lucky. Some adventurous soul bought a plot of land and built a cottage. It's been handed down, possibly for generations, without a significant capital gain—until recently, when the value of waterfront property skyrocketed. When the kids inherit the beloved cottage, their only option may be to sell it in order to pay the tax. There is no way to avoid paying capital gains tax entirely. Even if you gift the cottage to your kids, the government views it as having been sold at fair market value—a deemed disposition. You or your estate will pay tax on the difference between that value and the adjusted cost base (ACB), which is the value of the cottage when you purchased it, plus any expenses you incurred for capital improvements, such as a renovation or a septic system. We heard of one cottager who had kept receipts for $360,000 worth of improvements over the years, significantly increasing the ACB—and reducing the tax liability for his estate when he died.

Capital gains tax came into effect on December 31, 1971, so if you've owned the cottage since before that date, you only need to calculate the increase in value since then. And if at any time you designated your cottage as your principal residence (more on this later), then you can benefit from the principal residence exemption for those years. Figure out your ACB and subtract it from the cottage's selling price, or its market value (you'll need an appraisal) if you are gifting it to the kids. Fifty per cent of the difference will be added to your personal income for that year, and you (or your estate, if this is an inheritance) will pay tax on that additional "income" at your marginal tax rate. Still with us? One tactic you can use to spread out the capital gains tax burden is to transfer a portion of the cottage to the kids over several years. Your tax liability each year will be based only on the percentage sold that year. In addition, this technique could help keep you in a lower tax bracket and avoid pushing you over the maximum annual income allowed to receive the Old Age Security pension.

Whatever you do, if money is trading hands, be careful if you're selling the cottage to your kids at a discount, warns Peter Lillico, of Lillico Bazuk Galloway Halka in Peterborough, Ont., who is an expert in the legal aspects of cottage succession planning (and who worked with the families in the case studies written about **right here**). Here's what can happen: say your cottage is worth $600,000, but you are prepared to sell it to the kids for $300,000. You'll pay capital gains tax calculated on a fair market value of $600,000, but the cottage's new cost base will be only $300,000. This means that when the cottage is next sold, the tax will be paid twice on the difference. The workaround, suggests Lillico, is to sell the cottage at full market value on paper, take $300,000 in cash and a $300,000 promissory note from the kids, and then forgive the note. (Your lawyer can help you set this up.) "Although you pay a little bit more land transfer tax," Lillico says, "it's better than doubling the capital gains tax." A word about land transfer tax: in some situations, you may be eligible for an exemption, such as in B.C. when property is transferred to certain family members, or in Ontario when it's transferred to family members as a gift. Ask your accountant.

Issue #2: What about estate administration tax?

Every province, except Quebec, imposes an estate administration tax (probate tax) on assets that pass through an estate. The fee varies, but if the property is held as Tenants in Common or only in the name of the first spouse to die, then the tax may have to be paid on the death of the first to die and again on the death of the surviving spouse. Avoid this doubling up by holding the cottage as Joint Tenants with Right of Survivorship. When one spouse dies, their interest in the property passes directly to the surviving spouse. Probate is only triggered on the death of the second spouse. Peter Lillico describes a situation when Tenants in Common may be advantageous: "if there's a second marriage and each of the spouses wants his or her share to pass to his or her children, not to the surviving spouse who may remarry or cut the children of the first spouse to die out of inheriting the cottage." Tenancy in Common allows the will of the first spouse to die to provide "everything to my spouse if he/she survives me except for my interest in the cottage, which passes to my children." This approach does give rise to probate tax and triggers CGT, Lillico says, but the imposition of taxes earlier rather than later may be preferable to the risk of the kids losing the cottage.

Another way to avoid probate is to place the property in a trust, where it is not considered part of the estate assets and therefore is not subject to probate.

Issue #3: The principal residence exemption

Your principal residence, as you likely know, is exempt from capital gains tax. A married or common law couple can have only one principal residence at a time. That said, your principal residence needn't be where you live full time. If the value of your cottage has increased more than your home over the time that you've owned it, you can elect to designate it as your principal residence for some or all of those years. And here's another piece of happy news, as CIBC's Jamie Golombek points out in his online article "What's Up Dock": "Even if you rent it out occasionally, the CRA [Canada Revenue Agency] has stated that incidental rental income won't prevent a cottage from still qualifying as a principal residence." A word to the wise: there are some conditions, so check with your accountant.

How do you decide which property to designate as your principal residence for which years? That "will depend on a number of factors," Golombek advises, "including: the average annual gain on each property (i.e., the gain on each property divided by the number of years each was held), the potential for future increases (or decreases) in the value of the unsold property, and the anticipated holding period of the unsold property." You may also be more concerned about an immediate liability if you sold your cottage now "versus a tax liability payable later on (say upon death, by your estate) on the sale of your other property," Golombek points out. Did we mention the part about getting expert advice?

Keep in mind that the principal residence exemption only covers the cottage and a half-hectare of surrounding land, unless you can prove to the CRA that any additional land has contributed to your use and enjoyment of the property (access to a public road, for example). You wouldn't think that would be hard to prove with a cottage, but this is the government we're talking about.

Strategy #1: Put the cottage into a trust

Peter Lillico recommends a sweet, innovative strategy for keeping the cottage in the family: a joint partner trust (JPT) combined with a sprinkling inheritance trust (SIT). Here's how it works: if you and your spouse are both 65 years or older, you can transfer the cottage into a JPT without triggering the capital gains tax, even if the cottage is not your principal residence. You both share responsibility and control of the cottage, and, when one of you dies, ownership transfers to the other, who becomes the sole trustee, again without triggering capital gains or probate taxes.

The surviving spouse can name one or more co-trustees, usually one or more of the children, to help make decisions, a mechanism that can also protect the cottage from a potential predatory remarriage.

Death of the surviving spouse triggers the termination of the JPT and the start of the SIT. At this point, capital gains tax is owed, just as it would have been had the cottage stayed in the individual names rather than going into the trust. The adjusted cost base is the same as if it were in the spouses' names. While the cottage is in the JPT, the parents (you and your spouse) typically will designate the trustees of the SIT (likely your children) and a pool of potential beneficiaries (children and grandchildren). Then the SIT trustees decide whether all of the potential beneficiaries will inherit the cottage, or, more likely, will select the most appropriate candidates from among the pool.

This is one of the main advantages of the sprinkling trust: you are not obliged to transfer ownership to your beneficiaries equally. "Most trusts (and wills) provide for equal distribution of assets among all children upon death," Lillico explains. "The sprinkling trust, by design, provides more flexibility, so as to exclude a child who doesn't want cottage ownership, or can't afford to share the expenses, or refuses to play by the same rules as the other beneficiary children."

Once the sprinkling trust kicks in, its trustees have up to 21 years to decide who will inherit ownership. While it is in the trust, the cottage is sheltered from creditor claims against all the beneficiaries, and it can't be included in a division of family assets in the event of marital breakdown. The drawbacks? Trusts have to file annual income tax returns, though the income will likely be nil (you will have to claim any rental income). There's the legal cost for a lawyer to develop the trusts, but that will be much less than the probate tax savings. The good news is that the pros outweigh the cons.

Before the 21st anniversary of the trust, when there is a mandatory deemed disposition of assets out of the trust, the trustees must make a decision: they can pay the capital gains tax on the increase in the value of the cottage since tax was last paid at the termination of the JPT, and then reset the trust for another 21 years. Or they can designate the beneficiaries and distribute the property out of the trust, in which case the trust no longer holds property with an accrued gain, and so no capital gains tax is owed. In fact, the next time capital gains tax will be paid is when the beneficiaries sell, die, or choose to pass the cottage on to another family member. The trustees can even decide to skip a generation and designate one or more of the grandkids as beneficiaries, deferring the tax liability for yet another generation. (Keep in mind that when the cottage is no longer held in trust, it loses its trust protection from creditor and marital claims.)

Once the cottage is in the sit, you have some breathing space—21 years— to make your decision about who the beneficiaries will be. So there's no excuse for missing its anniversary. If you do, prepare to shell out the capital gains tax. The CRA will likely show no mercy.

Strategy #2: Transfer the cottage to a corporation

Transferring the cottage into a corporation will be considered a disposition at fair market value, so you will have to pay CGT at the time of transfer. Also, you cannot use the principal residence exemption for a cottage owned by a corporation. The chief benefit is that your liability would be limited only to the value of your interest in the cottage itself, but this strategy can also be an administrative headache, requiring annual meetings, annual reports and updates, and annual tax returns. Most onerous of all is that you have to report your use of the cottage as a taxable benefit (we're not kidding) and add that to your personal income. The workaround is to charge shareholders, i.e., you and your family members, a fee for using the cottage. The money can go into a kitty to help cover operating and maintenance costs, which you'd have to pay anyway. But you have to make sure that the fee is at fair market value—the cost of an equivalent hotel room or the interest income that the corporation would have been getting on an investment of similar value to the cottage. And you'll also need to report that revenue on the corporation's annual tax return. Ottawa resident Martin Low recently transferred his Lake Pemichangan, Que., cottage to his three adult children. He paid the CGT and is setting up a $50,000 fund to help the kids run the cottage. The children are considering putting the cottage into a corporation. If they do, they can withdraw from the fund to pay their user fees. "I'm privileged in that I have enough money to do that," Low says about the fund. "Not everyone can."

Strategy #3: Take out a mortgage or life insurance

Another option to discuss with your family is to gift or sell the property to the kids and have them take out a mortgage to fund the capital gains tax and/or the cost of purchasing it from you. Sharing mortgage payments on a cottage property may be an affordable alternative to the high price of a house in the city, and they may be able to designate the cottage as their principal residence.

Similarly, parents can take out a life insurance policy, payable on death, to cover the capital gains tax. "It is one of the few scenarios when I recommend life insurance," says Tara Benham, a partner in tax with Grant Thornton on Vancouver Island. "And I recommend that the beneficiaries pay for the life insurance." The cost of life insurance will depend on the age and health of the parents, but if several children will inherit the cottage, splitting the cost of the premiums is likely to be less expensive than eventually paying the tax.

The Quebec Connection

If you own property in Quebec, you have a slightly different set of rules to work with. Like advisors in other parts of the country, John Lapierre, of Gagné Isabelle Patry Laflamme & Associés in Gatineau, recommends a trust when there are children involved. There are a number of variations under Quebec civil law, so your first stop should be your lawyer.

What Every Strategy Needs

You've likely heard the sad stories: the cottage that went up for sale because of a divorce or a bankruptcy, or because the kids couldn't afford it or couldn't get along after inheriting it. Many of these situations can be resolved with a cottage sharing agreement.

Before parents make the final decision to pass the cottage on to their children, or decide to which of them it should go, Lillico advises that they ask the kids to work out an agreement among themselves. "It becomes a magnifying glass to show that the kids have a shared vision of the cottage and how it is to be used. If one is saying, 'It's my way or the highway, and I want to go whenever I wish and take whomever I wish,' then it's a time bomb. But if they can all roll up their sleeves and come back with a sharing agreement that shows they can manage it for the next generation, then, okay, sell it to the kids."

Other advisors agree. “We ask our clients, ‘Did you ever sit down with the kids and ask them what they want to do?’ ” says Golombek. The worst thing is when parents say, ‘My kids all get along.’ That’s a red flag for us.”

By now, your head may be spinning. But ask yourself a simple question: what do you want to happen to your cottage? Talk to your children if you want to leave your cottage to them. Talk to Mom and Dad, if you are the kids of parents who own a cottage, even if it’s a difficult conversation to start. As Martin Low says, “Inertia is a powerful force. So is procrastination.”