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THE FAMILY COTTAGE—10 TIPS FOR TAX AND ESTATE PLANNING

A cottage is generally associated with feelings and memories of fun, swimming, boating, fishing, games, BBQs and family gatherings. However, for a number of reasons, in tax and estate planning, the family cottage often represents a thorny issue for financial, sentimental and family relations reasons, among others. As such, careful consideration should be given to the family cottage when undertaking tax and estate planning. What follows is a non-exhaustive list of matters which are relevant to tax and estate planning with respect to the family cottage.

1. **Ownership—**Who currently owns the cottage and in what fashion? This is not always as clear as one might expect. For example, a cottage might have been built decades before. Records may not have been properly maintained regarding ownership, transfers of ownership through the generations and/or one adult child's family may be more aggressive in asserting use and ownership of the cottage. Alternatively, do Mom and Dad own the cottage jointly, or as tenants in common? Do several siblings share ownership of the cottage? Is there an agreement with respect to ownership and usage of the cottage? Was the cottage transferred into a trust? Knowing and understanding the implications of the current ownership structure is a critical consideration when it comes time to consider tax and estate planning.

2. **Does the family want to keep the cottage?—**Does the family, or one faction of the family, wish to keep the cottage, while another faction has little interest in maintaining the cottage? Cottages are often valued more by some members of the family than others. If grandmother owns the cottage and has three children, each child may place a different level of importance on retaining the family cottage for sentimental, financial, or practical reasons. Only one of her children may wish to retain the cottage, live close enough to the cottage to make regular use of it and/or have the financial resources to maintain the cottage. What about the other two children who would rather sell the cottage on grandmother's death? Forcing ownership and the related costs of the cottage on these children is a recipe for family disagreements.

3. **Transfer now/Transfer at Death and Taxes—**A cottage may be disposed of/transferred during the lifetime of the owner. In this case, assuming that the fair market value of the cottage is worth more than its cost, income tax will be payable on 50% of the gain realized on the sale. There may also be Land Transfer Tax incurred. Upon death, a cottage will be deemed to have been disposed of for proceeds equal to the fair market value of the cottage and property at the time of death of the owner. In this case, in addition to income tax, Estate Administration Tax (frequently referred to as "Probate Tax") will be exigible. Tax and estate planning can often often help in

minimizing the income tax, Land Transfer Tax and Estate Administration Tax burden.

4. **The Principal Residence Exemption—**Depending upon the value of the cottage versus the value of the cottage owner's home, the "principal residence exemption" may be used to reduce or eliminate the tax liability arising on the disposition of the cottage. However, an individual can only have one "principal residence" for any given year. As such, using the "principal residence exemption" to avoid tax liability on the disposition of the cottage will generally result in income tax being payable on 50% of the gain realized on the sale/disposition of the cottage owner's home.

5. **Estate Administration Tax—**Estate Administration Tax arising on the owner's death may be avoided if "legal title" of the cottage is held by a trustee (often a company with no assets) in trust for the cottage owner and the cottage owner executes a secondary will that will deal with the shares of the trustee company and the cottage. "Legal title" of a cottage property may be transferred to a trustee without incurring income tax and generally without incurring Land Transfer Tax. However, this planning does not avoid the application of income tax on the deemed disposition of the cottage on the owner's death.

   Another approach which might be used to avoid Estate Administration Tax with respect to a cottage includes holding title to the cottage jointly (e.g., husband and wife), although this is something that is generally done upon the acquisition of a new cottage and Estate Administration Tax would still apply on the second to die of the joint owners. Alternatively, a cottage owner may transfer beneficial ownership of the cottage to another person while still alive, although this will likely result in income tax being payable by the owner (seller) and will result in a liability for Land Transfer Tax. If the cottage owner is older than 65 years of age, the cottage may be transferred into an "Alter-Ego Trust," on a tax-deferred basis. On death, Estate Administration Tax and Land Transfer Tax will be avoided, but not income tax.

6. **Other Planning Options—**Tax and estate planning with respect to a cottage may involve one of the following, each having different tax implications:

   (a) the sale of the cottage property before, or after the death of the cottage owner to a third party. This represents a simple option. After-tax funds from the sale of the cottage may be retained by the owner (if sold before death), or distributed in accordance with the Will of the owner (if sold after death);

   (b) the purchase of the cottage property by those family members who wish to keep it. Assuming that the value of the cottage is greater than its cost at the time of sale, income tax will be payable on 50% of the gain realized. The purchaser will be liable for Land Transfer Tax;

   (c) transferring the cottage into a "Cottage Trust". Note that if the value of the cottage is greater than its cost, income tax will be payable on the transfer.

Land Transfer Tax will also be payable. Careful consideration must also be given to the identities of the settlor, trustees and beneficiaries of a "Cottage Trust" and the actual drafting of the trust itself in order to avoid potentially negative income tax implications. Absent the sale of the cottage in the intervening 21 years and tax planning, the "Cottage Trust" will be deemed to have disposed of the cottage for proceeds equal to its fair market value, 21 years after the settlement of the trust. Income tax will be payable in such circumstances representing a potentially significant financial burden for the "Cottage Trust";

(d) dealing with the passage of ownership of the cottage as part of the cottage owner's Will. Assuming that the value of the cottage is greater than its cost at the time of the owner's death, income tax will be payable on 50% of the gain realized (assuming the "principal residence exemption" is not claimed or not available). Absent planning, Estate Administration Tax will also be payable.

7. **Agreements Amongst the Family—**In any circumstance in which a cottage is owned by multiple family members (e.g., siblings), it may be helpful for the family members to enter into an agreement addressing matters, such as, usage of the cottage, responsibility for upkeep and costs of the cottage, opportunities for one family member to buy another family member out in the event the latter family member wishes to sell his/her interest and succession planning with respect to ownership of the cottage passing on the death of an owner.

8. **Beware Non-Residents—**Particular caution must be exercised if a non-resident of Canada has, or it is intended that he/she will have, an ownership interest in the cottage.

9. **Family Law and the Cottage—**Don't forget family law considerations! Former in-laws may be entitled to monetary compensation with respect to the cottage in a divorce, potentially representing a significant financial burden. Certain planning can be undertaken to minimize this family law risk.

10. **Communication is Key—**In the context of any tax and estate planning involving family cottages, it is best that all in the family participate in, or at least understand, the plan. Communication about cottage planning can potentially help avoid family discord and, in a worst case scenario, litigation between family members.

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