KEEPING YOUR COTTAGE **IN THE FAMILY**

SMART STRATEGIES FOR MANAGING COTTAGE CAPITAL GAINS

The vacation home your family loves has grown in value over the years. Now, as you consider transferring its ownership, you wonder about the capital gains taxes. Here are some smart strategies to help reduce taxes when leaving your family cottage to loved ones.

While you can transfer assets such as the cottage to your spouse tax free (either during your life or on death), transferring an asset to any other individual may trigger a tax liability that must be paid when the tax return for that year is due.

If the family cottage qualifies as a principal residence, you may be able to use the principal residence exemption to reduce or eliminate any capital gain realized when you transfer the property to a family member. A tax professional can help you determine if your cottage qualifies as a principal residence and calculate the potential capital gains tax.

A taxable transfer

If the transfer of your cottage is not completely sheltered by the principal residence exemption, a capital gain will be realized. The gain is calculated as the difference between the original price paid and the current value, minus any capital improvements, such as additions, boathouses and decks.[1] Half (50 per cent) of the gain on the property is included in your income and taxed at your marginal tax rate.

For example, let's assume you purchased your cottage in 1970 for $60,000. Over the years, you made capital improvements amounting to $100,000 and today it is worth $500,000. Assuming the cottage is not a principal residence, transferring it results in a capital gain of $340,000, of which $170,000 is taxable at your marginal tax rate.

Gifting your cottage to your children

Gifting or transferring your cottage at a nominal price to your children may seem attractive as you can avoid probate fees down the road and may reduce or eliminate land transfer taxes.

However, gifting your cottage is a taxable transaction. Even if you do not receive any cash, you are deemed to have sold the property at its fair market value, so this strategy won't reduce the capital gains tax.

[1] If you owned your cottage prior to 1994, certain exemptions might apply that are not addressed in this article.

Any tax you owe is due when you file your current year's tax return. In addition, when your children eventually sell or pass on the cottage, they will be required to report the reduced price (zero dollars, if the cottage was a gift) as their cost base, creating a larger capital gain for them.

Trust in trusts

Rather than transferring ownership of the property directly, you may consider setting up a trust for your children during your life or on death. Make sure you work with tax and legal professionals to ensure the transfer is done properly.

Moving the cottage into a trust is a taxable transaction subject to the capital gains tax. The transfer results in a deemed disposition of the cottage at fair market value with tax payable when you file your tax return for the year. The trust may be able to claim the principal residence exemption as long as at least one adult child beneficiary of the trust ordinarily inhabits the cottage.

Since the capital gains tax will be paid in the year of transfer, the children will not have a large tax liability on your death. However, a trust is deemed to dispose of its capital property every 21 years, which can trigger the capital gains tax. There may be additional strategies available to deal with any gain in the trust.

Selling the cottage to your children

It may seem like a good strategy to sell your cottage for a nominal fee to your children to reduce your capital gain and make the transaction affordable for them. However, the Canada Revenue Agency calculates the capital gain based on the property's fair market value and not necessarily on the price you set for your children. Plus, when your children eventually sell or pass on the cottage, they will be required to report the reduced price they paid to you as their cost base, creating a larger capital gain for them.

> Life insurance can be a cost-effective way to help pay the capital gains tax and avoid the possibility that your children will need to either pay the tax themselves or sell the property.

If you decide to sell the cottage to your children, consider taking back a demand mortgage with deferred payments. You cannot defer paying taxes forever, but you may be able to spread the payment of the capital gains tax over five years. On death, you can forgive the mortgage in your will and your children will acquire the cottage with no debt or taxes payable (assuming you have already paid them).

Leaving the cottage to your children through your will

Transferring the cottage through your will should involve planning with you, your children and your professional advisor. If there is more than one child, you may want to set out guidelines for usage, maintenance costs, decision-making and required capital improvements.

If you leave the cottage to your children in your will, your estate is liable for the capital gains tax on the disposition of the property. In some cases, if the value of your cottage has greatly increased, there may not be enough assets in your estate to pay the taxes.

Ease the way with life insurance

Consider purchasing a life insurance policy that pays out when both you and your spouse die. Life insurance can be a cost-effective way to help pay the capital gains tax and avoid the possibility that your children will need to either pay the tax themselves or sell the property. You can even ask your children to pay a share of the premiums to reduce the cost of the policy.

Your advisor can help

As you decide how to transfer ownership of your recreational property to your children, keep in mind that planning ahead may reduce some of the tax burden for you and your heirs. Speak with your advisor to find out which strategy is best for you.

The strategies provided in this article are based on Canadian tax laws and are for information purposes only. They cannot be relied upon as legal or tax advice. Before transferring a cottage property, be sure to speak with your advisor as well as legal and tax professionals to determine the best approach given your particular circumstances.

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