LAFRENIÈRE SANNA
ESTATE LAW
A BOUTIQUE FIRM

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Estate Planning for the Family Cottage

The family cottage is often considered a treasured heirloom to be preserved and passed down to future generations. When estate planning for the family cottage, special considerations – legal, financial, and practical – apply.

There are various options depending upon the family's desires and unique circumstances, all of which have their own advantages and disadvantages. Several of these options are reviewed below.

This brochure is written from the perspective of parents passing a cottage on to their children but could equally apply to other relationships.

Option #1: Outright Gift in your Wills

One option is to retain complete ownership of the cottage while you are alive and gift the cottage to some or all of your children upon death. This is usually done through a Will.

Unless the cottage is the only residence that you own at your death, capital gains tax is likely payable upon your death. Consider whether there will be sufficient liquid assets in your estate to pay the taxes owing. If not, your children may be forced to sell the cottage in order to raise the needed funds to pay the tax bill.

Also seriously consider whether this option is a practical one for your children. Ask yourself,

- Would your children be able to amicably share the cottage?
- Do your children live close enough to use the cottage or are they willing to travel there regularly to enjoy it?
- Are all your children interested in shared cottage ownership or would one prefer to own it alone and pay the others for their share?

We recommend that you get your children's thoughts on the matter. When the family next gathers for an event or holiday, take the opportunity to raise the issue and hear what everyone has to say.

If your children do not have similar financial means, perhaps your Will should include a trust fund which could be used to pay such costs as property taxes, insurance, major repairs, etc.

If you leave the cottage to one of your children, you can even things out in other ways so that all of your children are treated equally. As capital gains tax will be paid from the estate, consider having a life insurance policy in place to be used to pay the capital gains tax.

Option #2: Option For Child(ren) to Purchase the Cottage From your Estate

Another strategy is to give each of your children the option to "purchase" the cottage from your estate. Your Will would set out that each of your children could use some or all of their inheritances to purchase the cottage from the estate at its fair market value.

If two or more of your children chose to exercise the option, they could agree to an equal or unequal ownership depending upon each child's own circumstances. A benefit to this option is that it allows each of your children to evaluate their own personal situation at the relevant time and make a decision with respect to an interest in the cottage.

The clause could be drafted such that, if a child had predeceased you, the option which would have been given to that deceased child could be exercisable by your executor on behalf of the children of the deceased child.

Another benefit of this option is that it leaves the sale proceeds of the cottage in your estate and thus available to pay any capital gains taxes that may be owing.

Option #3: A Cottage Trust

A trust can be a useful vehicle when planning for the family cottage. It is possible to establish a trust to hold the cottage property as well as some funds to be used for its ongoing expenses and maintenance. This could be done during your lifetimes by way of an 'inter vivos' trust or established pursuant to the terms of your Wills (a 'testamentary' trust).

There are numerous issues to take into consideration, including:

- A testamentary trust of short-term duration (for example three to five years) may offer some time for your children to make decisions regarding their continued ownership and sharing of the cottage;
- A trust is deemed to have disposed of its capital property every twenty-one (21) years at which any accrued capital gains become payable. This rule can be avoided by transferring the property to the children prior to the twenty-one year anniversary. It could be transferred at the trust's tax cost thus deferring the capital gains until property is actually disposed of by the children. It is important to note that the transfer of the property into an inter vivos trust generally triggers a deemed disposition unless it is a trust of a particular nature such as a spousal or alter ego trust;
- If the cottage property is placed in an inter vivos trust, probate fees on the value of the cottage property would not be payable at your deaths; and,
- The principal residence exemption would likely not be available to the trust.

Option #4: Outright Gift or Sale to Child(ren) While Living

Gifting your cottage outright to your children while you are living may be a good option if you no longer wish to own or maintain the cottage and one or more of your children have the financial means to take it over. Of course, if you are in need the equity you have in the cottage, you could also sell it to one or more of your children at its fair market value or some other agreed-upon price.

Be sure to get tax advice before taking any steps. Regardless of how much your child pays you for the cottage or if you gift it, you must report any capital gain and pay the appropriate tax as if you had sold it at its fair market value (FMV).

It is important to note that if you sell the cottage to your child at less than FMV, there is a potential for double tax. If your child pays you less than FMV for the cottage, you pay capital gains tax based on your gain (the difference between what you paid for the cottage and the FMV at the time you sell it). When your child sells the cottage or dies, your child will pay capital gains tax on his or her gain including a portion of gain on which you have already paid capital gains tax. The child's purchase price is the starting point not the FMV at the time when they bought the cottage from you.

Probate fees on the value of the cottage are avoided at your death, however, since the cottage is no longer owned by you and not part of your estate.

If you want to continue to have the use of the cottage property, consider transferring ownership but retaining a life interest. That way you can have your cake and eat it too! One or more of your children may own the cottage but you get to use it. A life interest also ensures that the cottage can't be sold without your knowledge. But if your children would consider doing that, maybe giving up cottage ownership isn't for you.

Option #5: Shared Ownership with Child(ren)

Another option is shared ownership. Instead of being the sole owner, you and one or more of your children would own the cottage together, either as joint tenants or tenants-in-common. These two ways of sharing ownership are very different and the pros and cons of each need to be carefully considered before deciding which works best for you and your family.

There is the question of taxation to consider. Capital gains would be payable on the percentage of the ownership that you transfer to the children.

This option allows you to maintain an ownership interest while sharing the financial burden of cottage ownership. The downside, however, is that it does expose the cottage to potential claims by the creditors and/or spouses of your children. If you have concerns at all about a potential marriage break-up of a child, shared ownership may not be the best option for you.

Cottage Agreement

For any of the above options involving shared ownership, whether the owners are you and one or more of your children or the children themselves, a Cottage Agreement is a must.

Before transferring ownership, the parties involved should have a frank and open discussion about cottage expenses, who will use it and when, how disputes will be settled and so on. The Cottage Agreement would then spell out what was agreed to. It is far better to head problems off before they arise and potentially damage relationships.

At a minimum, the Cottage Agreement should address:

- shared use schedule,
- operating or maintenance costs,
- capital improvements,
- what occurs if one party wishes to sell their share, and
- dispute resolution.

It cannot be stressed enough that addressing these issues before they occur can go a long way to ensuring continued harmony within the family.

Capital Gains & the Principal Residence Exemption

You may have noticed a common theme among the various options set out above: capital gains tax. Whatever you choose to do with your family cottage, for tax purposes the outcome remains the same — capital gains tax will usually be owing unless the cottage has gone down in value or it is the only residence you own. Advance planning can help anticipate and plan for the tax burden.

Generally speaking, an individual taxpayer is responsible for the accrued capital gains on both your home and your cottage when these properties are ultimately disposed of. Provided each of the properties are considered to be 'ordinarily inhabited' by you in a given year, the principal residence exemption can be applied to either property. A family unit can only claim the exemption for one property in any particular year (this has been the law since 1981). Note that the 'ordinarily inhabited' threshold is considered to be a relatively low one which would include living at the property over the summer. Any renovations or capital improvements to a property can have the effect of reducing the amount of capital gains owning.

Consult with Professionals

Regardless of what option you are considering, consult professionals early in the process:

- a tax accountant as the taxation issues can be complicated and you need proper advice regarding capital gains tax;
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- a financial planner who may be able to offer suggestions for ensuring there are funds to cover the capital gains liability; and,
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- a lawyer specialized in estate planning who can draft the necessary documents to ensure your desired goals are achieved.

Carefully consider the various options before deciding what is best for you and your family. Openly discuss your ideas with your children and ensure everyone is on the same page. Do what you can so that all your cottage memories and the cottage memories of your family's future generations can be happy ones.

Version: 20230109