EXPERT SERIES

IG PRIVATE WEALTH MANAGEMENT

Vacation Property Succession Planning

For many families, it is much more important to preserve the family cottage than any other asset. Those who want to leave the cottage to their children must plan for the tax consequences and disputes which may arise upon their death. The concepts here apply to any vacation property, including a ski chalet or condo.

Christine Van Cauwenberghe,
B. Comm (Hons),
LL.B., TEP, CFP, RRC
Head of Financial Planning

Tax liability at the time of death

The first hurdle to overcome when leaving an asset to your children is to make sure that there are sufficient funds in your estate to pay any tax liability that may arise at the time of your death. Many individuals do not realize that the increase in value of their vacation property since the time it was purchased may result in a tax liability for their estate. This is because upon death, there is a "deemed disposition" of all of a person's assets, unless the assets are transferred to their spouse or common-law partner. A deemed disposition means that all of your assets are deemed to be disposed of for fair market value. Therefore, upon the death of the last spouse, there may be tax owing before the assets can be transferred to the next generation. The danger in failing to do estate planning is that you may need to sell some of the estate's assets (including the vacation property) in order to pay the tax.

Principal residence exemption

One possible way to reduce the tax liability is to designate the property as your principal residence for tax purposes, and thus exempt some or all of the capital gains on the disposition of the property from taxation. However, families can only designate one residence as their principal residence for any given year. If you have owned more than one personal-use property during the same period of time, then the calculation of the principal residence exemption can become quite complicated. For example, if you have owned the family cottage for the last 20 years, but during that same 20 years you have bought and sold several "city homes" and exempted the gains on the sales of those city homes, you will not be able to shelter the entire gain on your cottage.

You do not have to designate a property as your principal residence until you actually sell the property or you are deemed to have sold it (as you would be in the year of death). At that point in time, you (or your executor/ liquidator) should speak with your financial and tax advisors to determine how to use the principal residence exemption to your best advantage.

Preserving the adjusted cost base

Another option for minimizing the taxable capital gain is to ensure that all additions to the adjusted cost base or "ACB" of the property are fully accounted for. This is important because capital gains are calculated by subtracting the ACB of the property from its fair market value, so the higher the ACB of the property, the lower the gain which must be recognized. The ACB of the vacation property is not just the amount you initially paid for it. Many people pour thousands of dollars of capital improvements into their vacation properties over the years, thereby increasing the ACB. However, the ACB is not increased by sweat equity, only out- of-pocket expenditures. You should keep the receipts for the improvements that have been made in order to justify these costs in the event you are (or your estate is) audited by the Canada Revenue Agency or Revenu Québec.

Many property owners also had their properties appraised in order to use the $100,000 lifetime capital gains exemption which was eliminated for real property in 1992. In order to claim the exemption, an election would have been made on your tax return by the 1994 deadline or such extended date as allowed at the time (all allowable extensions have now passed). If you made such an election, be sure to keep copies of the relevant documentation and the tax return on which you made the election so that the capital gain reported by your estate is accurate.

Planning with insurance

If you know that your estate will have to pay a substantial capital gains tax upon your death, and you do not have any other way to minimize it, you will need to find a way to fund this liability, or risk the sale of the vacation property in order to pay the tax bill. If your estate has sufficient liquid assets, this may not be a problem, but it is sometimes difficult to guarantee that there will be a sufficient amount left in the estate, particularly if you incur significant long-term care costs. Life insurance is usually the solution used to ensure that there will be sufficient funds to pay the tax liability. Even if you can't afford it, your children may be willing to pay the premiums if it means preventing a "fire sale" of the family vacation property at the time of your death. In any event, it will be important to have this conversation sooner rather than later, since delaying the conversation too long could result in the life insurance option no longer being available (due to advanced age or poor health).

Gifting during your lifetime

One mistake that some property owners make is to try and escape paying tax by transferring the property to their children during their lifetime. These individuals assume that if they transfer the property to their children now, then no tax will be payable. Unfortunately, this is not the case, as the Canada Revenue Agency and Revenu Québec will deem the property to have been sold for fair market value at the time it is transferred to the children, potentially triggering an immediate capital gain. If you do not transfer complete ownership of the vacation property, but instead add a joint owner or owners, then there is a disposition of a proportionate amount of the gain when an additional owner is added (e.g. if a sole parent is currently the owner, and that parent adds two children as joint owners,

then two-thirds of the gain is triggered now, with the remaining one-third triggered at the time of the parent's death, although in some cases it may be possible to argue that the new owner is simply a "trustee", and does not actually have an ownership interest in the property).

However, life insurance will not be an option for paying this tax, and the tax deferral in the hands of the parents is lost. Problems can also arise if you sell the property to your children for anything other than fair market value. For example, if you purchased the property for $50,000, and then sell it to your children for that same amount at a time when the fair market value is $100,000, you will be deemed to receive $100,000, and you will have to pay tax on the capital gain. However, your children will only be deemed to have a cost base of $50,000, resulting in double taxation when they sell the vacation property. If you want to transfer the vacation property to your children during your lifetime, the best options are to either gift it, or sell it for fair market value. If you give the asset to your children, you will still be deemed to have received fair market value for it, which may result in a capital gains tax liability, but your children will be deemed to have paid fair market value, so there will not be double taxation when they sell the property. The only advantage to transferring part or complete ownership during your lifetime is that the amount of the gain taxable in the hands of the parents is "capped" at the time of the gift or sale. If you choose to sell it for fair market value, ask your legal advisor if it would be beneficial to structure the sale documents so that only 20 per cent of the purchase price is payable in any one year, allowing the capital gain to be spread out over five years, as opposed to 100 per cent being taxable in the year of sale. However, if you are not receiving the entire sale price immediately, you may wish to take security against the vacation property in the event future payments are not made as promised. If you do not intend to collect payment from your children, consider forgiving the debt in your will, but include it for the purposes of dividing the estate, so that your other children receive assets of similar value.

Another concern with transferring a vacation property to a child is the fact that you will lose control over that asset. This can be problematic in the event your child suffers a marriage breakdown, or has creditor issues. Think carefully before giving up control of a major asset such as a vacation property.

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Succession issues

There are also non-tax issues to consider. Do you even know which, if any, of your children wants the vacation property? Your children may be interested in coming to the property as long as you are there, but if they live in another province, or are not interested in maintaining the property themselves, you may be surprised to learn that they do not want to keep the property after you are gone. Discussing this issue with your children can help to alleviate disagreements after the time of your death.

Equalizing the estate with insurance

If one or two of your children wants the vacation property, but some do not, the issue may become how to equalize the estate. If the vacation property will form a large part of your estate, insurance may help fill the gap for the other children. Again, if you are not interested in paying the insurance premiums, do not rule out the possibility that your children may be willing to pay the premiums if the insurance policy will be the solution to keeping the property.

Planning for multiple owners

If several children want the vacation property, then you need to consider a co-ownership agreement. There should be something in writing setting out how the vacation property will be used, who will pay for it, and who will be responsible for its upkeep. One idea may be to have the children sign a co-ownership agreement as a condition to inheriting a part of the vacation property. In that way, the agreement will be there long before there are any arguments. Once the parties start to disagree, negotiating a co-ownership agreement will become next to impossible.

The co-ownership agreement should also specify how the parties can be bought out in case of disagreement and what happens upon the death of one of the siblings – will it go to the grandchildren? Or does it go to the surviving children only? Can it pass to a son or daughter-in-law? It is best to resolve these issues sooner rather than later.

It is important to plan for how the vacation property will be passed to the next generation long before it actually happens. We can help you learn more about the issues relevant to vacation property planning, and how to prevent family disputes or unexpected tax bills.

ABOUT THE AUTHOR

Christine Van Cauwenberghe,
B. Comm (Hons),
LL.B., TEP, CFP, RRC
Head of Financial Planning

Christine is Head of Financial Planning at IG Wealth Management, leading our financial planning strategy to ensure that our clients have access to the most advanced expertise. Christine is a member of the Canadian Tax Foundation, has her Certified Financial Planner designation and is a Registered Retirement Consultant and Trust & Estate Practitioner, certified by the Society of Trust & Estate Practitioners (STEP). She is also the recipient of the prestigious STEP Founder's Award. Christine is the author of Wealth Planning Strategies for Canadians, which is published annually by Thomson Carswell and is currently in its 17th edition. Christine has given lectures to numerous professional associations and is a regular media spokesperson for IG Private Wealth Management. Christine has been appointed a King's Counsel for the Province of Manitoba, awarded to lawyers in recognition of exceptional merit in their profession.

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