

Advisory

PLANNING FOR SUCCESSION OF YOUR COTTAGE OR VACATION HOME

If you own a cottage or vacation home, your personal, emotional and financial commitment to it is often very significant. Who will inherit the property and how and when it will be inherited become serious concerns and are often worrisome. Without proper planning, cottages and other vacation homes can become the basis for family disputes, turning what should bring the family together into what tears the family apart. In addition, planning for financial aspects of succession, including taxes, is important, particularly if your property has significantly increased in value since its original acquisition.

In this Advisory, we provide a brief overview of personal, succession and tax considerations of importance to cottage and vacation home owners, and summarize a variety of general planning points and considerations with a view to ensuring a successful ownership transition and the avoidance of family disputes.

Personal and Family Considerations in Cottage and Vacation Home Ownership

Emotional Attachment and Desire for Ownership

A vacation home may have been owned for many years and, in some cases, through more than one generation of the family and may have an almost inexplicable personal and emotional significance to a family. If a vacation home

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has only been recently purchased, or has not been used as a family vacation destination, it may not have as many emotional ties for family members.

While some family members may have a very strong emotional attachment to the family vacation property, others may not. However, an owner of a family cottage or other vacation home may have assumed, or may in some cases expect, that each family member and his or her own family places a significant personal value on the family vacation home. It is extremely important that this assumption or expectation not clash with reality for a successful succession plan to be implemented in relation to the vacation home.

In addition, emotional attachment may or may not dictate an individual family member's own desire to have an ownership interest in the family vacation home. While he or she may not want to own it for his or her own use when the current owners pass it along to the next generation, he or she may still wish to have an ownership interest to pass along to their children or other beneficiaries as part of his or her family legacy.

Financial Ability and Other Personal Considerations

A desire to own or share in the ownership of the family cottage does not always coincide with the financial ability to pay for all or a share of the upkeep and maintenance costs of the property. A vacation home is often expensive to maintain, especially as the structure, septic and docks age and property values in certain areas rise, making for potentially high maintenance and replacement costs, and increasing property taxes. Without proper planning, leaving an ownership interest in a family cottage to a beneficiary who cannot pay their share of the costs, even if he or she wishes to have an interest, invites a host of future problems, and is often the source of family disputes.

Family members may also be unable to agree on how to share responsibility for upkeep and maintenance, both the financial and physical labour aspects. Family members with less ability to pay expenses may expect other, more financially able, members to pay more of the expenses. Family members using the property less often, or who are not as "handy", may expect to perform a smaller share of the upkeep than those using it more frequently or who are more "handy", despite equal ownership interests. Also, scheduling visits and issues of guest access, especially in regards to in-laws and ex-in-laws, may be a source of friction for multiple owners of cottages and other vacation homes.

Tax Considerations

Canadian and Ontario Tax Considerations

Of great significance for vacation homes which have gained in value is dealing with the potential capital gains tax burden. Barring a tax-free rollover to a spouse, significant capital gains taxes may be payable on transfer of the property or immediately on an owner's death.

Most owners of vacation homes located in Ontario are aware of the potential probate fee burden on an estate in passing on the property to beneficiaries, assuming the property is not passing to a joint owner with right of survivorship, which might be the case for a spouse or other joint owner. Probate fees in Ontario ("Ontario Estate Administration Tax") amount to approximately 1.5% of the value of the property (e.g. \$15,000 for a \$1M property).

Both capital gains tax and probate fees, unless otherwise provided for, are payable from the owner's estate. Proper consideration of the size of this tax burden and how it will be funded is important, especially where only some family members will take ownership of the vacation home, but the residue of the owner's estate will be left to different family members, or where there are not enough liquid assets to pay the taxes owing on the owner's death without sale of the vacation home, or where funds from the estate are also required for other purposes, including providing for the needs of surviving family members.

Cross-Border Canada-US Tax Considerations

Vacation properties located outside of Canada can pose additional tax and succession problems for Canadian-resident owners' estates. By far the greatest number of vacation homes outside Canada owned by Canadian residents are located in the US. If the Canadian-resident owner is not a US citizen (where a different set of considerations apply), owning US real property brings the Canadian owner's estate within the US gift and estate tax regime. As a result, US vacation homes may require additional planning in order to adequately provide for the potential US estate tax burden arising on death.

US estate tax on US real estate owned by a Canadian resident who is not a US citizen is calculated based upon the value of the US property owned at the owner's date of death. There is an available tax credit, and two options for its calculation. One method is calculated based on the value of all US property in relation to the owner's worldwide estate, and the other option is a basic credit of approximately USD\$13,000.

For 2011, US estate tax rates start at 18% and go up to 35%. If an owner's worldwide estate is valued at \$5M or less, in 2011 and 2012, no US estate tax should be payable by their estate. If an owner's worldwide estate exceeds \$5M, (and for such purpose a number of assets are included, including certain life insurance proceeds) there is an exposure to US estate tax. However, the current US estate tax rates and credit levels apply until the end of 2012 only, and it is currently unclear what form US estate tax will take after 2012. Individual advice is required to calculate US estate tax exposure given its complexity.

Family Law Considerations

Gifts to Beneficiaries and Exclusions from Net Family Property

Under the *Family Law Act* (Ontario), the post-marriage increase in the value of gifts and inheritances and income arising from gifts or inheritances, including an interest in a vacation home, *which have been received prior to the date of the marriage* and is owned on the date of a marriage breakdown or death is included in the calculation of the value of each spouse's assets for equalization purposes, unless a domestic contract excludes it. The capital value of gifts and inheritances received *during marriage*, but with the exception of a matrimonial home, is excluded in the equalization calculation, unless this exclusion is lost, as discussed below. As well, the increase in value of gifts or inheritances received during marriage and the income arising from such gifts or inheritances if the person who has made the gift has stipulated that the gains and income is to be excluded in a deed of gift or in his or her will, is excluded. For this reason, it is common practice in Ontario for wills and deeds of gift to include a special clause for this purpose.

Treatment of a Matrimonial Home in the Equalization of Family Property

The *Family Law Act* (Ontario) accords special treatment to matrimonial homes, which include not only a primary residence, but also cottages and other vacation homes, if such properties are occupied by spouses or by a spouse and their children as a family residence. Accordingly, anyone with an ownership interest in multiple residences can have more than one matrimonial home. An indirect ownership interest in a vacation home, including through a corporation or trust, may also be included in some circumstances.

The *value* of a matrimonial home (not the property itself), net of liabilities, is subject to equalization upon marriage breakdown. A matrimonial home owned by one spouse at the date of marriage, and which is also owned on the date of termination of the marriage, is included in the calculation of the value of that

spouse's assets, and is *not* deducted from the value of his or her property along with other property owned by the spouse at the date of the marriage. As well, a matrimonial home which was gifted or inherited during the marriage and is owned on termination of the marriage or its sale proceeds is *not* excluded from the calculation of the value of a spouse's property on termination of the marriage, even though it is a gift or inheritance.

Matrimonial homes are also subject to claims for possession where there are minor children or dependent children and the matrimonial home is regularly used as a family residence.

For more information on family law and property considerations, please refer to our Client Advisory *Estate Planning and Marital Property Considerations*.

Considerations and Planning Options for Cottage Succession

Several planning options are available to vacation property owners in planning for succession to such properties. However, the viability and desirability of the different options depends on each individual owner's circumstances and requires professional advice.

Direct Ownership and Gifts

(i) Joint Ownership

Especially popular for succession planning between spouses, joint ownership with right of survivorship can be a simple and effective method of property succession. However, such ownership will not allow for sophisticated tax planning, including the use of a trust to hold the property on the first spouse's death, and in addition, is not usually advisable for US vacation properties owned by Canadians who are not US citizens due to the operation of the US estate and gift tax regime and Canadian taxation on death.

While transfer into joint ownership or by outright gift during the owner's lifetime can be used to allow for succession planning with, for example, the owner's children, such gifts can give rise to immediate capital gains tax consequences if the vacation property is not designated as the giftor's principal residence (discussed below), and can expose the property to claims by the joint or new owner's personal or business creditors as well as matrimonial claims against him or her.

(ii) **Sale to Beneficiary**

Another option is to sell the vacation home to the intended beneficiary and take back a private mortgage at the prescribed interest rate, which is currently low, making it an attractive option for some owners. The mortgage can be forgiven in the mortgage holder's will and other assets left to other beneficiaries to equalize the distribution of the estate. However, the new owner would have to make minimum interest payments if this strategy is used. A capital gain based on the fair market value of the property (no matter what price the home is sold for given the sale is not considered "at arms' length" because it is to a family member) would also be triggered on a sale of the vacation home, assuming the property is more valuable on the date of the sale than it was on the date of the acquisition, but with the use of a take-back mortgage, the taxes payable on this gain could be spread over five years, instead of being payable all in one year.

(iii) **Loss of Control**

All of these options have advantages and disadvantages. One of the biggest disadvantages to an immediate transfer is the loss of control of the property by the original vacation home owner. However, if a properly drafted occupancy agreement is put in place for the benefit of the original owner, or a lifetime interest is retained in the property by him or her, this could solve this problem, although some loss of control is necessarily a part of such planning.

(iv) **Use of Principal Residence Exemption**

As mentioned above, if an owner anticipates that the vacation property will significantly increase in value from the date of acquisition (or from January 1, 1972 if acquired before that date which is when the capital gains tax regime came into effect in Canada), they can consider designating the vacation property as their primary residence for tax purposes, thus exempting it from capital gains tax. This would only be advisable for those individuals whose cottage or vacation home is anticipated to gain more in value than any other residence they own. Professional advice is required with regard to this determination.

Will and Trust Planning

One of the primary methods to plan for succession of a cottage or vacation home is in your will. An outright gift to one or more beneficiaries can be made, or the property can be gifted in trust, as further discussed below. Options to purchase can also be provided for, allowing each beneficiary to decide if they wish to own the cottage with other beneficiaries, and for methods of valuation and payment,

including allowing beneficiaries to take ownership of the cottage as part of their share of the estate. Tie-breaker provisions can be included in case the beneficiaries reach in impasse with regard to ownership, and as well co-owners' agreements, discussed below, can be encouraged or mandated to keep disputes to a minimum. Trust funds for payment of ongoing maintenance and repairs and other expenses can also be set up to provide for maintenance and upkeep of the cottage if it is to be held for a lengthy period in a trust.

Trusts are a popular option, especially for dealing with successive generations of interests in the cottage. Trusts can also provide for special needs or financially-dependent beneficiaries, act as will substitutes, be used to plan for incapacity, and allow for protection in case of creditor claims or marital breakdown, and in some circumstances can provide significant tax savings. Trusts can be set up either during the owner's lifetime (*inter vivos* trusts) or in the owner's will (testamentary trusts). A trust can deal with succession to a vacation home, as well as providing additional funds to maintain it. Creative and sophisticated provisions can be put in place to allow for successive control and ownership tailored to individual circumstances.

Consideration should be given to future taxes arising in a trust, if this option is used. Of significance for *inter vivos* and testamentary trusts, although avoided in alter-ego and joint partner trusts during the sellor's and their spouse's lifetime, as discussed below, is the 21-year deemed disposition of a trust's assets under Canadian income tax legislation, which triggers capital gains tax on the gain in value of the vacation home every 21 years, and should be planned for if the trust is expected to continue for more than that time and the vacation home is expected to increase in value.

Inter vivos trusts can effectively gift ownership interests in the vacation home currently while allowing the owner to retain control over the property and where desired, its use as well. *Inter vivos* trusts are also attractive for probate fee planning purposes since the value of the property will not be subject to probate fees if the property passes outside of one's estate, and instead passes under the terms of the trust.

For owners who are 65 years of age or older, alter-ego or joint partner trusts can be attractive and tax-effective *inter vivos* trusts for a vacation home, as the 21-year deemed disposition rule discussed above does not apply with certain exceptions to such trusts, and the vacation home can be rolled into such trusts tax-free. For more information on alter-ego and joint partner trusts, please refer to our Client Advisory *Alter Ego and Joint Partner Trusts*.

In contrast to *inter vivos* trusts, testamentary trusts are treated as individuals for tax purposes and as a result are taxed at graduated tax rates. They only come into effect on a person's death.

An individual owner's circumstances and goals will drive the choice of a trust and the type of trust that is appropriate in their situation, and advice on one's individual situation is necessary.

Co-owner Agreements, Expense Funds and Life Insurance

As discussed above, co-owner agreements are an effective planning tool in circumstances where multiple owners are to be named as the beneficiaries of a vacation home. While they may get along well, a co-owner agreement is still a good idea so that multiple owners can jointly work out how to divide the use of the property, and how the payment of expenses as well as improvements to the property will be decided upon and shared at the time they become owners. These agreements can prevent disputes and make decision-making easier for all joint owners. Other matters that can be dealt with include a method of decision-making on various issues, transfer or sale of the property, including on death, incapacity or marriage breakdown of an owner with options to purchase and rights of first refusal for the other owners or others, eligible persons to whom the property can be transferred, defaults in payment of expenses and encumbrance of the property. Encouragement from the original owner of the vacation home to enter into such an agreement may be a deciding factor in such agreements being implemented, and should be considered.

Where successive generations are to hold the property for a lengthy period, the likelihood of disputes increase, in particular where beneficiaries have different levels of assets and/or income, or where the original owner has significant wealth and wishes to keep the cottage in the family. Separate expense funds for maintenance costs and repairs of a cottage property can alleviate the direct financial burden on beneficiaries, and can help avoid disputes regarding how such expenses are to be paid.

As mentioned, capital gains on a cottage or vacation home can be significant, especially where properties are held for the long-term. Life insurance to fund the tax payable on such gains, or alternatively (or additionally) to fund ongoing maintenance and repairs after one's death, may be an attractive and cost-effective option in planning for succession of the cottage or vacation home.

US Vacation Homes and Planning Options

Planning for succession of a US vacation home presents additional challenges and special planning should be considered which may need to be implemented prior to purchasing the vacation home, as in some cases it may not be available for current US vacation home owners.

As discussed above, estate tax credits may take care of US estate tax liability depending on the owner's individual situation, although the current state of the US estate tax regime makes reliance on this for long-term planning uncertain at present.

Joint tenancy may not be appropriate for US estate tax planning purposes, because it can give rise to significant US estate and gift tax problems.

Other possible options for US estate tax planning regarding US vacation homes include holding the property in a discretionary *inter vivos* trust. In addition, if available, a non-recourse mortgage may be an attractive option considering current low interest rates, or donation of the vacation home to a US charity may also be considered in appropriate circumstances. Professional advice is required with respect to each individual situation.

Vacation Homes Outside Canada and the US

It is important prior to purchasing a foreign property to seek professional advice with regard to types of ownership and taxation as well as succession planning options. As part of your worldwide succession plan, it will be important to consider how such property should be dealt with under your will, in particular if it is located in a civil law jurisdiction. In many situations, a separate will to deal with property in the foreign jurisdiction is desirable, written in the local language and form. Many civil law jurisdictions have mandatory rules to pass property to spouses, children and other family members, and it may not be possible to simply pass a property outright to one's spouse or to other desired beneficiaries.

Non-resident Owners of Canadian Vacation Homes

Non-residents of Canada who own Ontario-situs vacation homes or cottages face unique planning concerns regarding Canadian capital gains tax and succession issues. Non-resident owners should consider the relative advantages of a separate Ontario Will to deal with their Ontario-situs vacation home and personal property (such as boats, furniture, etc.) related to it, which should be prepared in conjunction with advice from their estate planning advisors in their home

jurisdiction including dealing with how Canadian taxation interfaces with the tax regime which they are subject to. For example, there are special opportunities available to ensure there is no double taxation on death in both Canada and the US under tax treaty provisions between Canada and the US.

General Planning Points for Succession of a Cottage or Vacation Home

- Have an open discussion with your intended beneficiaries to find out their interest in ownership of the cottage. Discuss their ability to pay expenses, look after the property, and their expected use of the property.
- Find out what the potential tax burden associated with your cottage will likely be, and consider how this liability will be funded. If there is a liquidity issue, consider available options, such as life insurance, if the tax burden will not easily be payable by your beneficiaries or estate.
- If one is contemplating making a gift of the vacation home to family member(s) during one's lifetime or on death, including to children or grandchildren, or understands he or she will be receiving such a gift, legal and professional advice should be sought on how best to plan and structure the gift.
- Consider applicable options in your situation to passing down your vacation home, including where appropriate providing a flexible mechanism in your will allowing your beneficiaries the option to purchase the vacation home or receive it as part of their share of the estate.
- Consider a co-owner agreement for joint owners/beneficiaries of a vacation home.
- Consult a professional advisor before purchasing a vacation home located in another jurisdiction, in particular outside Canada. If you already own one, seek professional advice on succession planning options.

The comments offered in this Client Advisory are meant to be general in nature, are limited to Ontario law and are not intended to provide legal advice on any individual situation. Before taking any action involving your individual situation, you should seek legal advice to ensure it is appropriate to your personal circumstances.