

What's up dock: Tax & estate planning for your vacation property

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During the summer months, many families spend time together away from the hustle and bustle of daily living and retreat to one of the “four Cs” of summer: the cabin, condo, chalet or cottage. Unbeknownst to you, however, is that lurking under the surface of your idyllic retreat may be a host of tax and estate planning issues that, if not tackled early on, could not only cost you (or your heirs) a lot of cash, but in extreme cases, could force the sale of the recreational property that may have been in your family for generations.

With some professional advice and some advance planning, however, you may be able to mitigate some of these potential problems.

Income Tax Planning

Perhaps the biggest tax problem associated with the vacation property is the potential for capital gains tax upon either the sale or gift of the property or upon the death of the owner. As a general rule, if you sell or gift the property while you are alive, you will be taxed on the difference between the amount you receive (the “proceeds of disposition”) and the adjusted cost base (ACB) or tax cost of the property. Note that it's important to keep receipts for all improvements and renovations made to the property, as these expenditures can be added to the ACB of the property, thus potentially reducing the amount of capital gain upon sale, gift or death. The main exception to this general rule is if the property is gifted to a spouse or common-law partner, either during your lifetime or upon death. If that's the case, then the property is deemed to automatically “roll over” (i.e. be transferred) to the other spouse or partner at its ACB and no gain will be immediately reportable. While many parents may wish to give the vacation property to their kids, either while they are alive, or upon death, doing so will result in an immediate capital gain if the property has gone up in value since the date of acquisition. As a result, we need to explore some tax planning strategies to either permanently avoid the capital gains tax or, at the very least, to defer paying it as long as possible.

Principal Residence Exemption

The principal residence exemption (“PRE”), if available, can shelter the gain on a principal residence from capital gains tax. A principal residence can include a vacation property, even if it's not where you primarily live during the year as long as you, or your spouse/common-law partner or child “ordinarily inhabit” it at some point during the year.

A cottage is considered to be ordinarily inhabited by someone, even if that person lives in that

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property for only a short period of time during the year (e.g., during the summer months), as long as the main reason for owning the property is not for the purpose of earning income. Even if you rent it out occasionally, the CRA has stated that incidental rental income won't prevent a cottage from still qualifying as a principal residence.

Note that the home does not have to be located in Canada to qualify as a principal residence. The only requirement is that the individual who claims the PRE must be a resident of Canada for each year of claim. As a result, a U.S. vacation property, for example, owned by a Canadian resident may be eligible for designation as a principal residence for the purposes of claiming the PRE. Of course, whether or not it's advisable to do so will depend on both the income and estate tax considerations of the other country. (See "U.S. Vacation Properties" below).

Prior to 1982, it was possible for each spouse to own a property and designate it as his or her principal residence, with the resulting capital gains being tax-free upon disposition. The change of rules means that for years of ownership after 1981, a couple can only designate one property between them as their principal residence for any particular calendar year. This becomes a challenge when a couple owns more than one home and is forced to choose, upon ultimate sale of the first one, which property will be designated the principal residence for each year during the period of multi-home ownership.

As a result, a conscious decision should be made when you sell one of your personal residential properties as to whether the gain should be reported since failure to report will result in the assumption that the "sold property" has been designated as your principal residence for the years you owned it, precluding you from using the PRE in the future on the sale of your other property, at least during the overlapping years.

Generally, the decision to claim the PRE when you sell your vacation property as opposed to "saving it" for the disposition of your other property will depend on a number of factors, including: the average annual gain on each property (i.e., the gain on each property divided by the number of years each was held), the potential for future increases (or decreases) in the value of the unsold property and the anticipated holding period of the unsold property.

Non-economic factors may also come into play as you may be more concerned about a current, immediate tax liability today versus a tax liability payable later on (say upon death, by your estate) on the sale of your other property.

The calculation of the PRE is done on Form T2091-(IND), "Designation of a Property as a Principal Residence by an Individual." The CRA, however, did not administratively require the sale of property by an individual to be reported on a tax return if the entire gain from the sale was sheltered from tax by claiming the PRE.

The Department of Finance recently announced proposed changes to the Principal Residence Exemption (PRE) rules. At the same time, Canada Revenue Agency (CRA) announced changes to their administrative policy with respect to reporting gains from the sale of a principal residence. Effective for sales that occur in 2016 or later, details of the sale of a principal residence by an individual will be required to be reported on Schedule 3, Capital Gains of his/her income tax return, and to designate the property as the principal residence.

Life Insurance

Although numerous planning ideas are available to reduce or defer the tax liability on the transfer of the cottage, one of the most common is the use of life insurance. You can purchase a life insurance policy to offset the tax liability upon death. Owners, however, often overestimate the amount

and the cost of such insurance. As demonstrated in the following example, to insure the potential tax on a half a million dollar gain, the cost can be less than \$1,400 per year, depending on the age and health of the insured.

Take Drew, for example. He's 50, and owns a mountain chalet in Canmore, Alberta that he purchased for \$400,000, which is now worth \$900,000. He's sitting on an accrued gain of \$500,000, of which only 50% is taxable. How much life insurance does he need to cover off the tax liability so he can pass the cottage on to his kids tax-free?

Using Alberta's top marginal tax rate of about 48%, Drew's current tax liability to be insured is \$120,000 (48% of \$250,000). The cost of a term-to-100 insurance policy varies by provider but averages about \$1,400 per year if Drew is in good health. It is important to note that should the property further appreciate in value while under Drew's ownership, additional insurance coverage would be required in order to offset the tax liability on those future gains. Practically speaking, life insurance may not always be feasible. If the cottage owner is in his or her 70s or older, he or she may be uninsurable or the premiums prohibitively expensive.

Use of a Corporation

It's generally not advisable to hold a personal residence inside a corporation. The main reason is that under the Income Tax Act, the value of the rent-free use of the corporation's residence by the shareholder is considered to be a taxable shareholder benefit and must be included in the owner's personal income. The value of the benefit will generally be equal to a market rate of return multiplied by the fair market value of the vacation property, less amounts paid for the use of the property. While it used to be commonplace for Canadian purchasers of U.S. vacation homes to purchase U.S. real estate through a Canadian corporation, referred to as a single-purpose

corporation, a change in the CRA's administrative concession relating to this shareholder benefit issue effective in 2005 has put an end to this planning for the most part. (See below "U.S. vacation properties".)

The other problem with a corporation holding the property is the inability to claim the PRE on the sale, gift or transfer of the property or the shares of the corporation.

Use of a Trust

One of the most common alternate ways to own a vacation property is through a trust. This is often done to avoid the deemed disposition of the property upon the death of the owners. A trust is not a legal entity but rather a relationship that separates the legal ownership of property from the beneficial use and enjoyment of that property.

In Quebec, a trust is a "patrimony by appropriation," autonomous and distinct from that of the settlor, trustee or beneficiary and in which none of them has any real right.

In a typical scenario, the property's current owner (the trust's "settlor") would transfer the property in trust to a "trustee," perhaps the owner's spouse or partner, for the benefit of their kids (the "beneficiaries.") The problem with using a trust for a property you currently own is that a transfer of the property to a trust may trigger immediate capital gains tax. There are specific exceptions (such as a transfer to an "alter-ego trust," discussed below under the heading "Probate Fee Planning"). On the other hand, if you are purchasing a new property or own one that has little or no accrued capital gains or even a loss, you may wish to purchase the property through the trust or transfer the existing property into a trust today so that any future capital gains tax that arises can be deferred until the trust's beneficiaries (generally the children) ultimately sell the property. (Note that a loss on a transfer of a residence to a trust is considered a loss from the

sale of "personal use property" and cannot be claimed as a capital loss.)

The trust deed may permit you to enjoy the use of the property during your lifetime. Later on, when you find you are no longer using the property as much, it can be distributed from the trust to the appropriate beneficiaries. When the property is distributed from the trust, it can generally be "rolled out" to the beneficiaries at the original ACB of the property, and thus tax would be deferred until the property is sold by the beneficiary. With respect to any gain accrued until the end of 2016, the beneficiary of the family trust who receives the property is deemed to have owned it since the trust acquired it for the purposes of claiming the PRE upon its ultimate sale. This allows a child who is the beneficiary of a trust that held the vacation property and who did not own another home while the property was in the trust, to use the PRE to potentially shelter the entire gain from the date of original purchase by the trust to the end of 2016.

Perhaps the biggest problem, however, stemming from using a trust to hold the vacation property is the "21-year rule." This tax rule states that there is a deemed disposition of the trust's property on each 21st anniversary of the trust, which could result in a capital gain on property held in the trust, accelerating the tax liability which otherwise may have been deferred until the last-to-die of the parents who originally owned the vacation property. Note that the tax obligation occurring as a result of the 21-year rule can be avoided by distributing the property to the trust's beneficiaries within the 21 year period, as discussed above. The 21-year rule will create difficulties where the beneficiaries are too young to receive a share of the property within that timeframe. While the trust may be able to claim the PRE to shelter any gain accruing until the end of 2016 on this disposition, that may cause problems if the children who are beneficiaries of the trust also own their own homes as it would preclude them from using the PRE to shelter a gain

from the sale of those homes. Similarly, if a beneficiary has used the PRE on another property, the trust cannot designate the property as a principal residence for those years. In addition to tax planning, properly structured trusts may also be used for other non-tax reasons, such as avoiding a variation claim under British Columbia's *Wills, Estates and Succession Act*, asset protection or minimizing provincial probate fees, as will be discussed below.

Effective for years after 2016, under proposed amendments to the Income Tax Act, only very limited personal trusts will be able to utilize the PRE. These "eligible trusts" must have a resident beneficiary and fall under one of the following categories:

- certain life interest trusts where the settlor and/or the settlor's spouse or common-law partner have use of the property during their lifetime, and another beneficiary(ies) are entitled to the property after their death;
- Qualified Disability Trusts, which are certain trusts established on death where at least one beneficiary is entitled to claim the disability tax credit; or
- certain trusts for minors whose parents are deceased.

Personal trusts who do not fall into any of the above categories will not be able to claim the PRE for years after 2016.

Grandfathering Rules

Certain "grandfathering rules" apply for trusts which are not one of the eligible trusts listed above, but were otherwise eligible to claim the PRE for 2016 or previous years. So long as the trust owned the property at the end of 2016, and continued to own it until it was disposed of in 2017 or a later year, the gain accruing until December 31, 2016 will be eligible for the PRE.

Probate Fee Planning

Upon death, each province (except Quebec) levies a probate fee on the value of assets passed through the estate. That probate fee ranges from 0.4% in Prince Edward Island to 1.645% in Nova Scotia. Only Alberta and the territories have maximum caps of (\$400 in Alberta, Northwest Territories and Nunavut and \$140 in the Yukon). For example, the estate of an Ontarian with a \$500,000 Muskoka cottage would face a probate or estate tax bill of about \$7,000. In fact, a vacation property could be subject to probate fees twice: once on the death of the original owner and, if left to a spouse or partner, again on the death of the survivor. There are some common planning techniques that may be helpful to reduce or eliminate probate fees payable upon death.

Joint Ownership

One common probate-avoidance technique is to register title of the property in joint tenancy with right of survivorship (JTWROS), whereby each joint owner has an undivided interest in the entire property. This type of joint ownership means that upon the death of one owner, the property is owned solely by the surviving joint owner, bypassing the estate and therefore, not subject to probate. JTWROS is not available in Quebec.

The advantage of joint ownership, however, is mired in a plethora of other problems, some of which may be more significant than the probate bill. The biggest problem, and the subject of two 2007 Supreme Court of Canada cases, is proving the transferor's true intention - was it a gift or merely an estate-planning strategy? For example, say Jack transfers his \$1-million Whistler condo to joint title with his adult daughter, Jill, whose family vacations there on weekends in summer and skis there for two weeks during Christmas. Jack's other child, Jane, lives in Halifax, and does not use

the property at all. Upon Jack's death, title to the property can be placed directly in Jill's name. This may mean it bypasses the estate and avoids B.C. probate fees of about \$14,000 (given the top rate of 1.4% in B.C. in 2014). But did Jack really intend for Jill to inherit the entire value of the condo, to the exclusion of Jane? What if the condo was the only major asset owned by Jack upon his death and there was little else left in his estate for Jane?

If the two Supreme Court cases (see sidebar) are any indication of what might happen in this hypothetical example, Jane would likely hire a lawyer and sue her sister for half the value of the condo, arguing that the transfer into joint ownership was merely an estate planning ploy meant to avoid probate. Surely, Dad didn't intend to disinherit Jane - or did he?

If he didn't intend to give the condo just to Jill on his death, it might in fact still form part of his estate. And if probate was otherwise required for other assets, the value of the condo might have to be included in the probated estate value in any event.

There are other issues that arise from JTWROS. The original owner gives up sole control of the property and would need the other owner's permission to mortgage or sell it. As well, the property could be subject to the creditor and family claims of the new joint owner. Given the high value at stake, it is best to obtain knowledgeable legal advice about the pros and cons of JTWROS and what can be done to make sure the structure properly reflects your intentions.

Lessons from the SCC

In May 2007, the Supreme Court of Canada released simultaneous judgments in two Ontario cases: Pecore v. Pecore (2007 SCC 17) and Madsen Estate v. Saylor (2007 SCC 18). What was at issue in both cases was the meaning of "joint ownership with rights of survivorship" (or JTWRROS) of investment accounts and the true intentions of the original owners when the joint accounts were established. In the first case, Edwin Hughes, father of Paula Pecore, put nearly \$1 million of mutual funds into joint ownership with his daughter Paula. Upon Mr. Hughes' death, the assets in the joint account were transferred into Paula's name. Two years later, Paula and her husband, Michael Pecore, separated and, in the course of the divorce, Michael tried to go after the assets in the joint account since he was a beneficiary under his ex-father-in-law's will. His argument was that the transfer of the joint account into Paula's name was not a true gift since it was done "for probate purposes only". Both lower courts disagreed and found that Paula legitimately owned the account absolutely on her father's death through JTWRROS. The second, very similar case, involved Michael Madsen who named only one of his three children, Patricia Brooks, as the joint owner of his investment accounts. After Michael's death, Patricia's brother and sister sued and claimed that their late father only named Patricia on the account "for convenience purposes" and thus no true gift was made. As a result, the monies in the joint accounts should be distributed in accordance with the will, with both siblings receiving a portion of the funds. Both lower courts agreed. The Supreme Court of Canada (SCC) saw no reason to reverse either of these lower courts' decisions. The court found that due to the presumption of resulting trust, the onus falls on the surviving joint account holder to prove that the transferor intended to make a gift of any remaining balance in the account. Factors that should be considered to determine the transferor's intent include: wording in any financial document used to open the account, control and use of the funds while the transferor was alive, whether a power of attorney was granted, who paid the tax on the account and any other evidence the court finds necessary to establish intent. As a result of these two cases, it may be a good idea to document your intention when making your vacation property JTWRROS. One way to do so is by signing a "Declaration of Intention" for joint assets. Legal advice is warranted here.

Trusts, Including "Alter-ego Trusts"

Using trusts to hold vacation property can help to avoid probate fees upon death since property inside the trust is not included in the value of your estate. As discussed above, however, transferring the vacation property with the accrued gain into the trust could give rise to immediate capital gains tax. That being said, if you are at least 65 years of age, you may wish to consider transferring the vacation property into an "alter-ego trust" or a "joint-partner trust", which can be done without having to pay immediate capital gains tax on the transfer. In order to qualify as an alter-ego trust or joint partner trust, you (or you and your spouse or joint partner, in the case of a joint partner trust) must be entitled to all of the income and no one other than you (or you and your spouse or joint partner) can be entitled to capital of the trust during your lifetime. You can continue to maintain control of the property through the trust if you are the trustee. In Quebec, you cannot be the sole trustee, so you share control with the other trustee(s).

You can name your children or others as the ultimate beneficiaries of the trust, who would then inherit the property upon your death (or upon the second death of you and your spouse or joint partner, in the case of a joint partner trust). Since at the time of death you no longer own the property - it's owned in the trust - it's not included in the value of your estate (or your spouse's or joint partner's estate, in the case of a joint partner trust) for the purposes of calculating probate fees. And it likely won't be held up in any delay that may arise from administering your estate. The downside, of course, is that there may be income tax consequences associated with the deemed disposition of the property upon your death (or upon the second death of you and your spouse or joint partner, in the case of a joint partner trust). Currently the property is deemed to

be disposed of inside the trust, which is subject to the top marginal tax rate. The trust, however, may be able to claim the PRE for this property, as discussed above with no limitation for gains accruing after 2016.

U.S. Vacation Properties

In Canada, upon death, there is a deemed disposition of all your property at fair market value. Any capital gains tax resulting from accrued appreciation (from the date of purchase to the date of death) is payable on your final return. Not so in the U.S. where citizens and green card holders are taxed on the fair market value of all property owned on the date of death under the "estate tax" regime. Even if you're not a U.S. citizen, the U.S. estate tax could apply to you if you own "U.S. situs property" (which includes U.S. real estate and shares of U.S. corporations) upon death. The top U.S. estate tax rate is 40% (for 2015). There is, however, an exemption available for the first US\$5.49 million of an estate (in 2017) that is available to U.S. citizens. Canadian residents who are not U.S. citizens are entitled to a pro-rated credit under the Canada-U.S. tax treaty which is equal to the US\$5.49 million exemption multiplied by the ratio of U.S. situs property to your worldwide estate. Thus, if your worldwide estate, including your principal residence, is under US\$5.49 million, you don't need to worry about U.S. estate tax on your vacation property.

One strategy to help fund a potential U.S. estate tax liability upon death is to purchase life insurance (see above) to cover any tax liability upon death. Keep in mind that the value of such life insurance will be included in the value of your

worldwide estate. Another solution is using "non-recourse" debt, which can reduce the value of the property for U.S. estate tax purposes. This is a mortgage in which the lender only has the ability to collect amounts owing from the sale of the property, as opposed to the general assets of the borrower. Before 2005, U.S. real estate was often purchased through a Canadian corporation to avoid U.S. estate tax upon death, but as a result of a change in Canada Revenue Agency administrative policy, effective for 2005 and later years, a taxable shareholder benefit is now imposed upon the corporation's owner, making this strategy less attractive. (Pre-existing structures were grandfathered.) Most cross-border tax professionals today are recommending purchasing the U.S. property through a properly established Canadian trust to avoid U.S. estate tax. The planning surrounding this strategy is beyond the scope of this report and professional Canadian and U.S. legal and tax advice should be sought before pursuing this strategy.

Other Issues

This report does not deal with other potential issues on the sale or transfer of your vacation property such as the potential liability for the Harmonized Sales Tax (HST), Goods and Services Tax (GST), and Land Transfer Tax (LTT) in applicable provinces and municipalities. That being said, a quick word about each is warranted. Generally, sales of personal-use homes by individuals or personal trusts are exempt from GST/HST. The Land Transfer Tax rules vary by jurisdiction.

For example, in Ontario, land transfer tax must be paid when real estate is transferred, based on the value paid to acquire the property. When the property is simply gifted, if nothing is paid, including when no mortgage is assumed, Ontario generally would not charge a land transfer tax.

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