The Hidden Tax Time Bomb

Transitioning the Family Cabin

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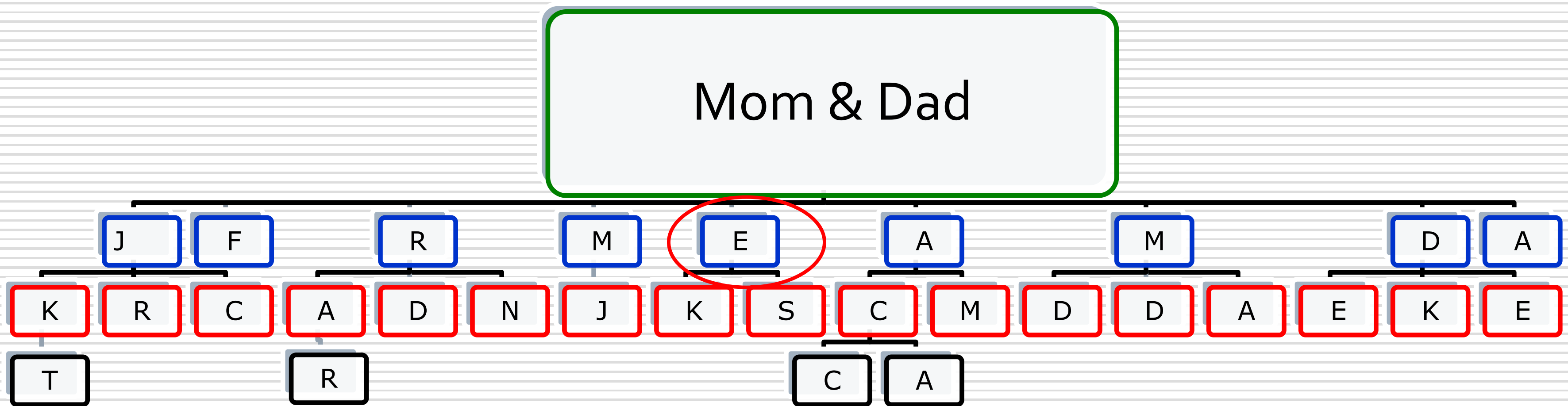
- This information is deemed to be correct but Wiegers Financial & Benefits bears no responsibility for any errors or omissions that may be presented or implied.

How Do You Plan a Transition?



Introduction

Total Asking Price?

$1,149,800

$469,900

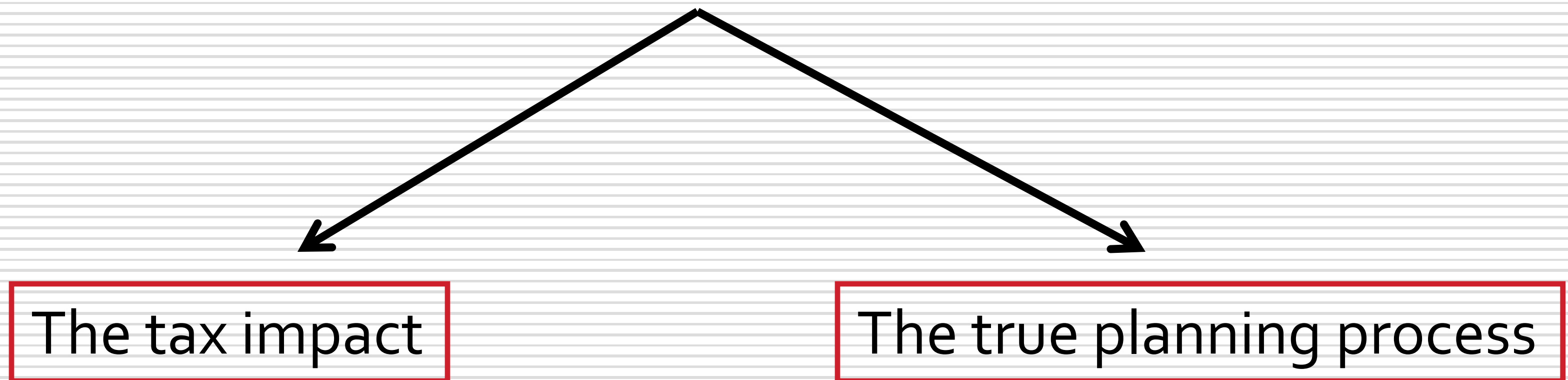
$429,900

$250,000

Agenda

- Introduction
- Tax planning options/calculations
- Key dates
- Probate issues
- Obstacles to overcome
- Plan-solution
- Conclusion

There are two major areas of planning to examine:



Primary Tax Issues

When transitioning a family cottage there are 2 primary tax issues to resolve:

1) Calculation of capital gains

2) As property changes hands, the potential for probate costs

When property is transferred to someone other than a spouse, it generally has a **deemed disposition** at its fair market value.

When this creates a capital gain, a tax liability is usually created as well.

Adjusted Cost Base

Calculate the capital gain by taking the deemed proceeds (or fair market value) of the property and subtracting the **Adjusted Cost Base**.

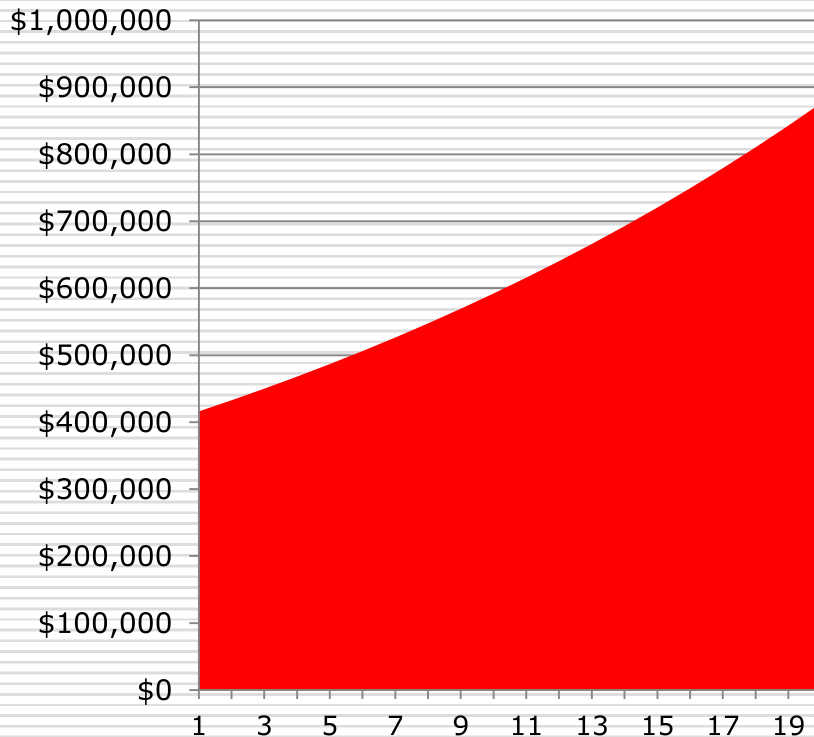
The resulting number is the capital gain, 50% of which is currently taxable

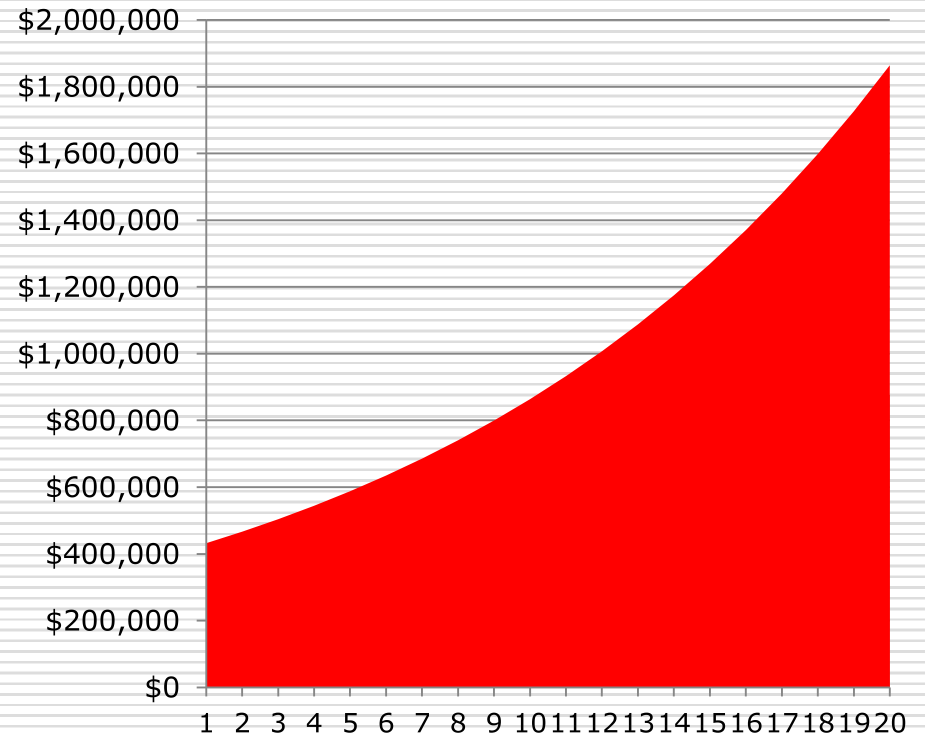
Example of Tax Calculation

Cabin – fair market value:	$400,000
ACB	$50,000
Capital Gains:	$350,000
Taxable Capital Gain:	$175,000
Tax payable at 44%:	**$77,000**

But this is today – what about the future?

Example of Tax Calculation





Example of Tax Calculation

Cabin – fair market value:	$876,000
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Cabin – fair market value:	$1,864,382
ACB	$50,000
Capital Gains:	$1,814,382
Taxable Capital Gain:	$907,191
Tax payable at 44%:	**$399,164**

Key Dates To Be Aware Of:

The Cabin's Value on V-Day

Before 1972 there was no capital gains tax in Canada.

For tax purposes December 31, 1971 was fixed as the Valuation Day for previously acquired assets that may eventually be sold or transferred, creating tax consequences in the process.

Capital Gains Exemption on Principal Residences

Prior to Jan. 1, 1982 each spouse was allowed to designate an eligible property as a principal residence. After this date the designation was changed to each family unit.

Able to eliminate capital gains made prior to 1982 so long as one spouse is able to designate the property as a principal residence.

Note: Your principal residence does not have to be your home. Consider this when selling/taking action.

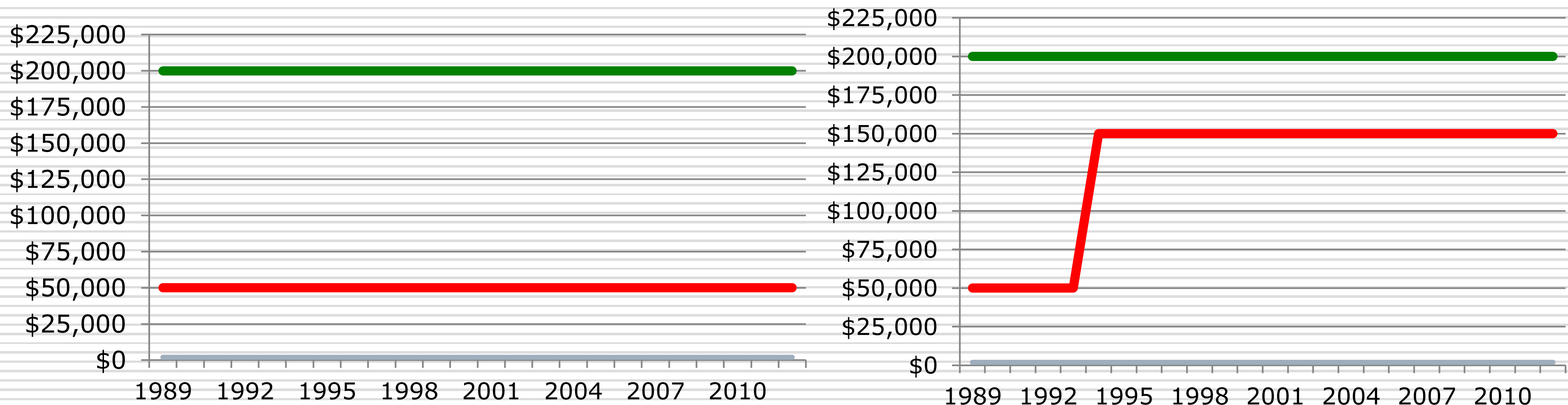
Cabin– fair market value:	$400,000
ACB	$50,000
Capital Gains:	$350,000
Taxable Capital Gain:	$175,000
Tax payable at 44%:	**$70,000**

House– fair market value:	$500,000
ACB	$300,000
Capital Gains:	$200,000
Taxable Capital Gain:	$100,000
Tax payable at 44%:	**$44,000**

*Does not have to be named until action is taken.

Special election under the old $100,000 lifetime capital gains exemption

This was eliminated in February 1994 , but the gov't allowed people to crystallize unrealized capital gains on capital property such as a cottage.



Individuals who did so would be able to increase the ACB or tax cost of a cottage by the amount elected at that time, thereby reducing the ultimate capital gain on the property.

Key Date #3

Potential for Probate Costs

What planning methods can be used?

Potential for Probate Costs

Is the process by which a court legitimizes a will, thereby allowing the executors the legal right to distribute an estate's assets.

In Saskatchewan it is currently $7 per $1,000 of estate value subject
to probate (.7%).

Families will try to find ways to avoid paying these fees. There are ways to do it but each has complications that can cause tax or other complications.

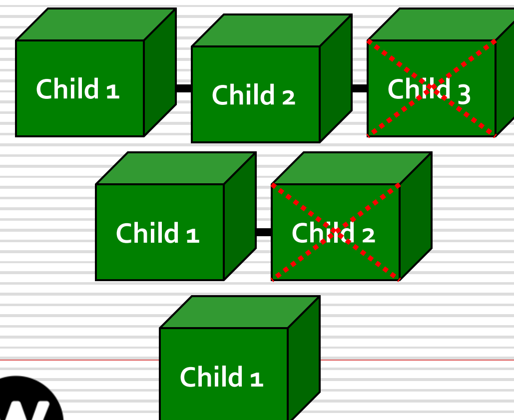
#1: Gifting a Cottage

This will eliminate probate fees upon death since ownership has been transferred. However, when the gift is made to someone other than a spouse, a disposition is triggered at market value, possibly resulting in a capital gain for tax purposes.

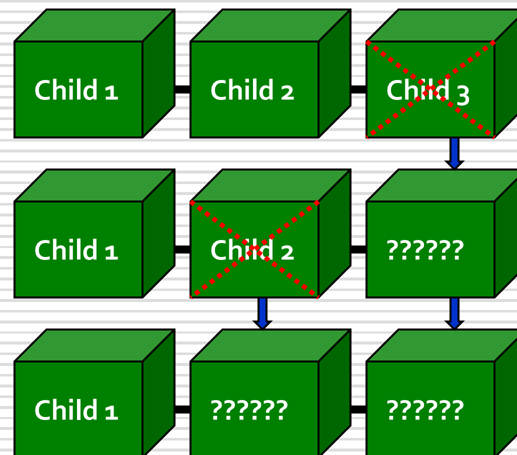
#2: Changing Title

Can avoid probate fees by changing title on the property to either Joint Tenancy with Right of Survivorship, or Tenants in Common.

With JTWROS when the original owner dies, the property will pass to the other owner(s) who were added to the title. The deceased's estate would not longer have any interest in the property. The property would eventually pass to the estate of the last surviving owner (along with the final tax liability).



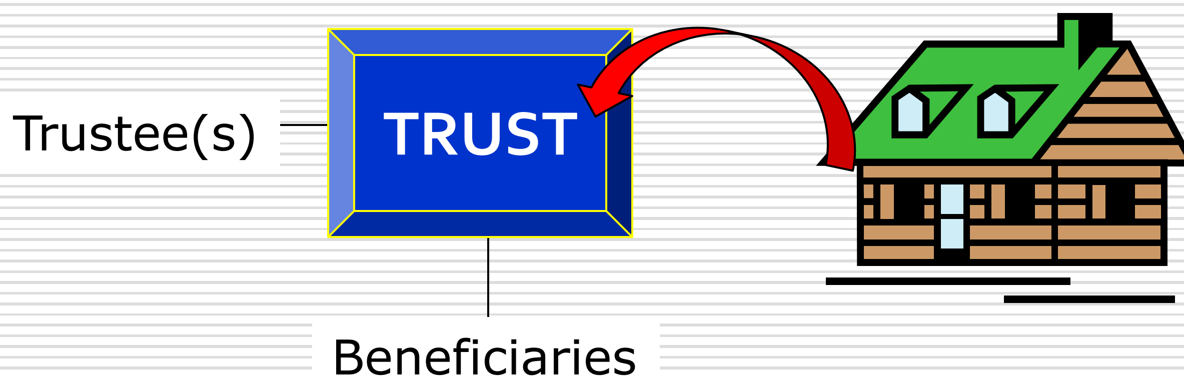
With TIC when an owner dies the estate is free to dispose of their share how they see fit. Usually agreements are in place to control outside ownership etc.



The drawback to changing title is that it triggers a disposition at market value at the time of title transfer.

#3 Establishing a Living Trust

This can avoid probate fees (since the original owner does not possess the cottage on death, there is no probate).



If the trust is set up for the benefit of someone other than a spouse, the transfer will trigger a deemed disposition with capital gain implications.

Also, every 21 years, a trust is deemed to have disposed of its assets, including cottages, at fair market value.

Obstacles to Overcome

Obstacles of Keeping the Cottage in the Family

- Because of changes in the Income Tax Act, many cottages will have to be sold by executors upon the death of the parents simply to pay decades of accumulated capital gains tax liability.
- A child's separation or divorce may result in the cottage being sold to satisfy the final demands of the divorcing in-law.
- Differences between the children's incomes and expectations may cause such family friction that the cottage is sold by the children themselves within a few years of inheriting.

Differences in Income

What if the cabin is left to 2 siblings with quite different income levels?

- One can easily afford the cottage expenses, the other can't afford any.
- This is a problem for ongoing expenses and especially major ones.
- Can cause enough family strife to cause the sale of the cabin to eliminate the problem.

Differences in Income

One solution is for parents to establish a testamentary trust (established in their will). Would commit funds for the trust which could be used to fund some (or all) of the operating costs of the cabin.

The testamentary trust compensates for the differences in economic positions between the children for the benefit of all.

Areas of Contention

If left to more than one child:

- Who opens and closes the cabin?
- Who is responsible for organizing the payment of bills?
- Should the cottage operating and capital costs be shared equally, in proportion to income, or in relation to use?
- Is the cottage equally available at all time for all siblings, or are they to take turns having exclusive use?

Areas of Contention

If left to more than one child:

- How are the turns to be allocated, and who gets the long weekends? Is use restricted to family only, or can anyone bring along a gang of friends?
- If one of the children has a financial crisis, brought on by loss of a job, or a marital breakdown, or simply too much debt, can that child force the sale of the cottage and a division of the net proceeds?

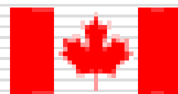
Joint Ownership Agreement

A **joint ownership agreement**, negotiated while the parents are alive and able to assist, can be invaluable in retaining family harmony and enabling successful second-and third- generation cottaging.

Capital Gains Tax Liability

If you do not wish to transfer the cottage to the children now, then serious consideration must be given to funding the Capital Gains Tax liability:

- other assets
- insurance (possibly paid for by the children)



Canada Revenue Agency

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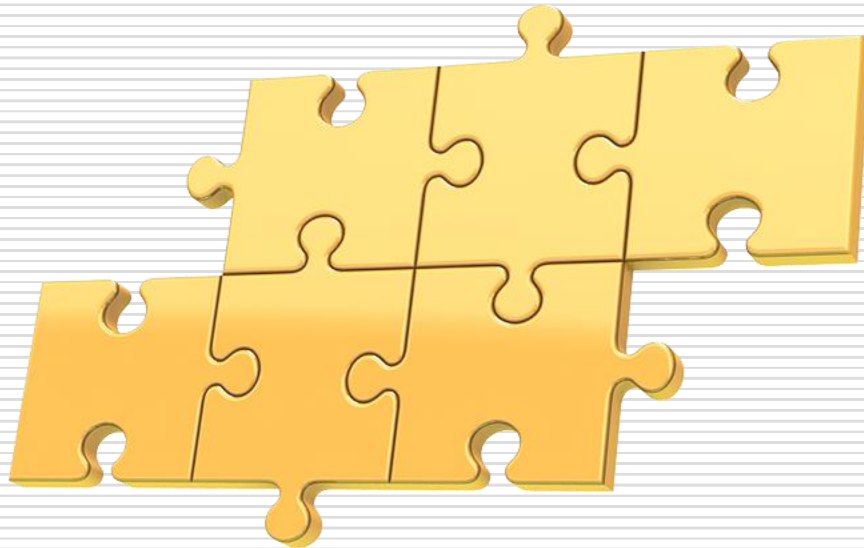
Capital Gains Tax Liability

Capital Gains Tax liability is one of the most serious obstacles in passing the family cottage down to children. This financial problem will only get worse as time goes by.

Parents need to investigate to see if the problem exists and gain advice on how this potentially disastrous problem can be dealt with.

We have outlined the potential problems.



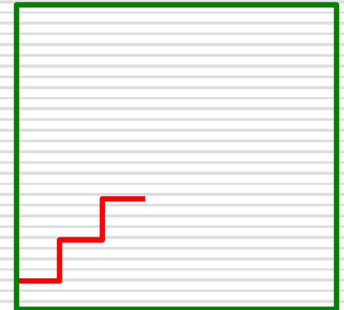
What is the solution?

The Six Planning Steps

1) Estimate the capital gains tax

Regardless if the cottage is gifted to children or sold to others at fair market value, either while the parents are alive or after their deaths, an estimation of the outstanding capital gains needs to be completed.

The Six Planning Steps



2) Reduce the tax bite

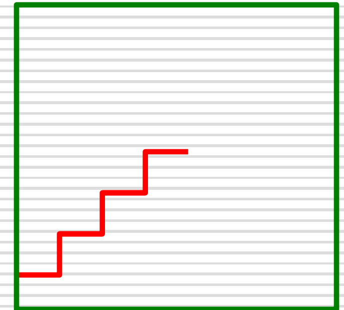
The goal is to pass the cottage over to the children without bankrupting the parents or their estate. This can be done.

One strategy is to transfer it in stages, rather than all at once. I.e.. 20% over 5 years This can spread out the capital gains taxes over each year.

Watch for possible OAS clawback. Aided by transferring over time.

The Six Planning Steps

3) Fund the Capital Gains Tax Liability



If the cottage is to be passed on after your death, look at all sources of wealth to pay the tax – most identifiable source of tax free wealth is your home.

- Look at savings or investments to pay the tax.
- Look at insurance, children could possibly share the cost if it's too high.

The Six Planning Steps

3) Fund the Capital Gains Tax liability

Example: Mom & Dad both 65 –non smokers, good health

Cabin – fair market value:	$400,000
ACB	$50,000
Capital Gains:	$350,000
Taxable Capital Gain:	$175,000
Tax payable at 44%:	**$77,000**

Expense???

$100,000 Joint last to die insurance on Mom and Dad:

$2,014/year

The Six Planning Steps

3) Fund the Capital Gains Tax liability

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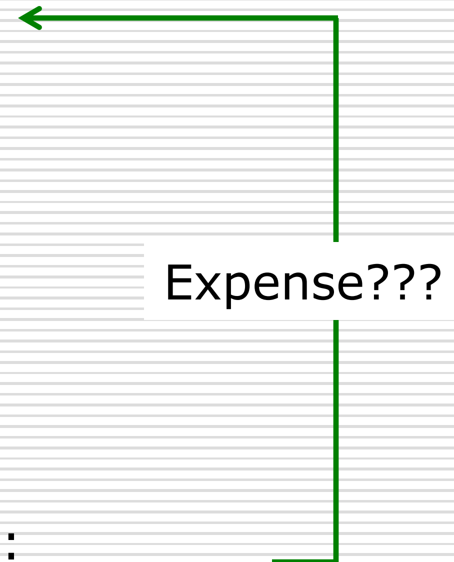

20 Years @ 4% Growth

$200,000 Joint last to die insurance on Mom and Dad: **<u>$3,971/year</u>**

The Six Planning Steps

3) Fund the Capital Gains Tax Liability

Example: Mom & Dad both 65 –non smokers, good health

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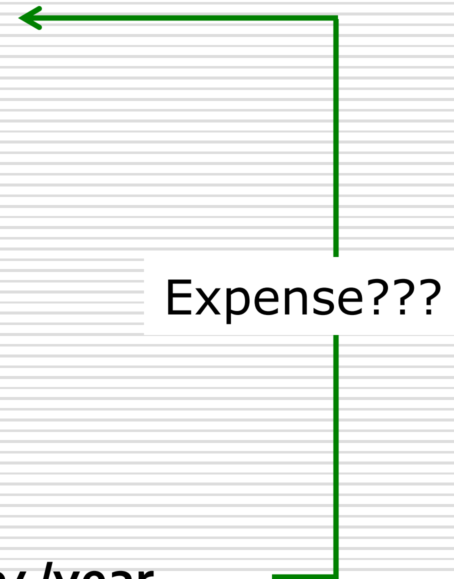


20 Years @ 8% Growth

$400,000 Joint last to die insurance on Mom and Dad: **$7,734/year**

The Six Planning Steps

3) Fund the Capital Gains Tax liability

If the cottage is to be transferred while the parents are still alive, possibly have the children share the cost of the annual tax consequences (if spread over 5 years).

If going to multiple children, the cost per year may be acceptable, knowing they will eventually acquire the cottage and not have to deal with a much larger amount in a single year.

The Six Planning Steps

3) Fund the Capital Gains Tax liability

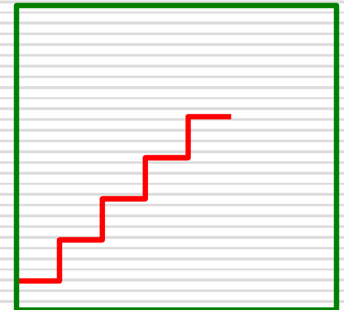
Another option is to look at the cottage itself.

Can the lot be subdivided, and use the sale of the new lot to pay the taxes?

Kids could take a mortgage against the property and pay that off in 5-10 years.

The Six Planning Steps

4) Select your preferred plan



The capital gains tax has been determined, and the funding for it has been established, a plan needs to be put in place to transfer the ownership.

A) Gifting: transferring an interest in the cottage without requiring payment

- Does not save tax as is considered a disposition at fmv.
- Tax costs are the same as a real sale but the parents do not have the sale proceeds to pay the tax.

The Six Planning Steps

4) Select your preferred plan

B) Sell the cottage to the children at market value or less

- Even if sold for less than fmv, the full fmv must be reported for tax purposes.
- Can lead to double taxation as this lower value would be the kids' new ACB.
- Kids need to have the financial capability to pay.

C) Transferring a portion over time

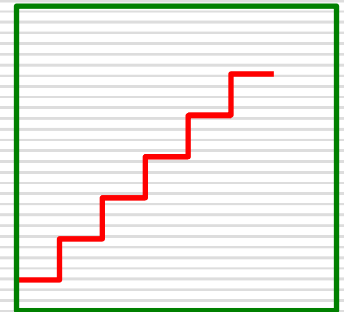
- Would spread out the impact of the capital gains tax over time

The Six Planning Steps

D) Retaining a life interest for parents, whether gifted or sold

- life interest would be indicated on the deed of transfer
- if kids are buying, this would be a condition of purchase
- entitles the parent the right of lifetime usage of the cabin, not
- relying on the goodwill of the children (new owners)
- prevents the children from “cashing in” on the cottage by selling
- it or mortgaging against it, without the involvement and consent of the parents
- this life interest could be released at any time should the parents
- either not have an interest in the cabin or fear the children would cash it in

The Six Planning Steps



5) Agreements avoid adversity

Now you are dealing with family dynamics

What happens when parents are no longer involved?

- Who will open and close the cottage?
- Should the ongoing costs of the cottage be shared in proportion to usage by kids, or split evenly?
- Who decides if improvements or additions will proceed?
- Who is responsible for making sure the utility bills, taxes and insurance premiums are paid on time?
- Can all the children use the cottage all the time, or will there be periods of exclusive usage for each child? Who decides these periods?
- Can children bring friends as guests, or will it be family members only?

The Six Planning Steps

5) Agreements avoid adversity

- Can a child rent the cottage during his or her turn, if he or she cannot use the cottage personally?
- Can child in need of money force the others to buy his or her share? Can a child sell the share to a third party without the consent of the other siblings?
- What happens if child/owner dies? Does the share go to the surviving spouse, who later remarry?

What is the solution?

The Six Planning Steps

5) Agreements avoid adversity

The solution is a written **Cottage Co-Ownership Agreement**

- Is a contract, so is legally enforceable
- Details worked out before children take over
- Parents may have to encourage this, and facilitate compromises
- Some action may be majority (redecorating, usage), others unanimous agreement (additions, sale to non-family members)

With an agreement, most issues can be resolved before they become problems

- Not every child may be happy with an outcome, but all have agreed to the method of resolution

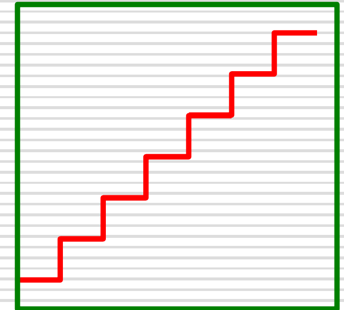
The Six Planning Steps

5) Agreements avoid adversity

Cottage Co-Ownership Agreement

- Is essentially a business partnership agreement
- Decision making procedures and disposition of interests by partners are similar
- Is the bet insurance against loss of family harmony and the cottage itself
- May never be accomplished if left to the kids to work out after the parents are gone

The Six Planning Steps



6) Level the financial playing field

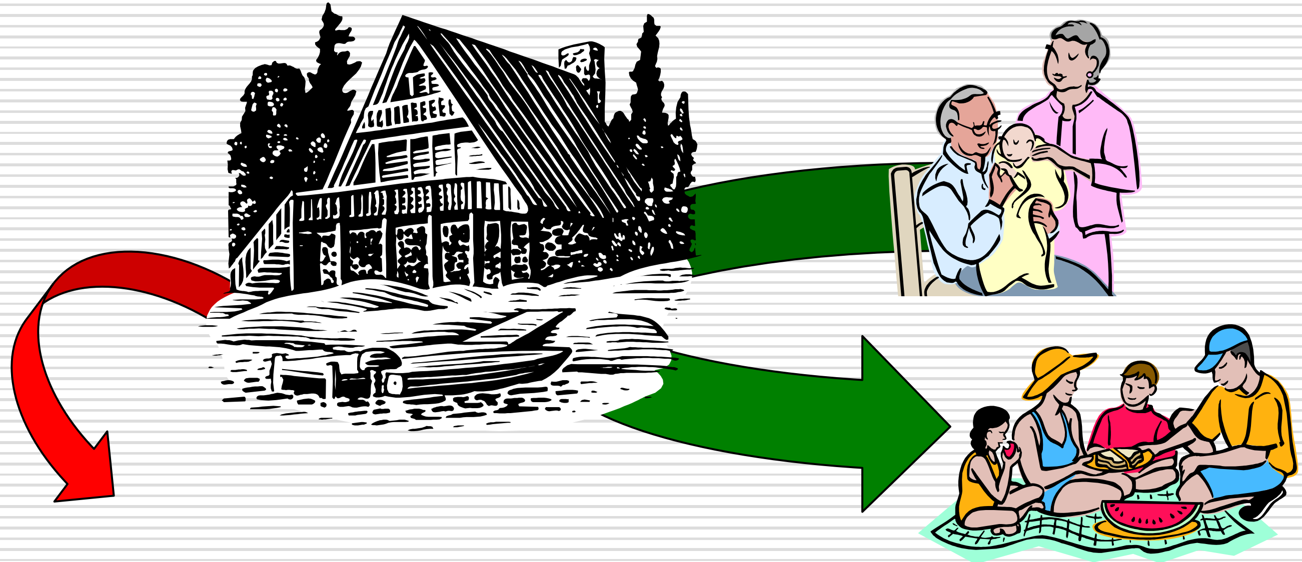
In every family, there will be differences in incomes and wealth among the children. How is this dealt with?

What happens if cottage owners cannot come up with his or her share of the taxes, the insurance, or for major capital expenditures?

Parents can set money aside in a special trust. These funds would be invested and administered by the executor child or
children, and reserved for cottage use only. Would be used to contribute to the annual carrying costs of taxes, insurance and electricity.
This would reduce the amount each child has to pay out of pocket each year. Could also be accessed to cover some or all of the cost of major projects.

You can now choose the succession plan that best suits the family situation.
Work with the children on a Cottage Co-Ownership Agreement
that anticipates, avoids or resolves inevitable issues.
You have done your best to ensure the family will enjoy the cottage for
many generations to come.

The Hidden Tax Time Bomb



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Transitioning the family cabin with the lowest tax payable and the fewest possible family disagreements

Questions?

For taking the time out of your busy day to learn a little bit more about how to keep your family cabin in your family.

Please contact your financial advisor for further information or to put a plan in place for your cabin.

Thank You!!!