



Easing cottage capital gains

The vacation home your family loves has grown in value over the years and now you wonder if transferring its ownership will attract punishing capital-gains taxes. Here are some ways to minimize the hurt and maximize the pleasure.

For Canadians, cottage time means family time. Whether it's a chalet in the Eastern Townships, a cabin on British Columbia's Sunshine Coast or a converted Ontario farmhouse overlooking Georgian Bay, they all usually mean one thing: family memories. To ensure that your children enjoy similar memories, you should plan ahead before transferring ownership of the cottage to them, since a capital-gains tax applies on the transfer of recreational properties in Canada and the levies can be considerable.

Your first step should be to ensure your recreational property is left to your spouse on your death. This means the tax bill will be deferred until your spouse sells the property or passes it on when he or she dies.

You could also give or sell the property to your children (or grandchildren) during your lifetime. When you transfer ownership of a second property to your children, Canada Revenue Agency (CRA) will impose a capital-gains tax on 50 per cent of its appreciated value at the same rate as you pay income tax. Your children may also have to pay a provincial land-transfer tax on the cottage. The appreciated value of the property is calculated by determining the difference between the cost of purchasing or its value in 1971 (if purchased prior to 1972), the year the capital-gains tax was introduced, and its current value, minus any capital investments such as additions, boathouses, decks, etc.

While transferring the cottage to your children today may seem attractive, you should be aware that there are some risks. The main advantage is that you relieve your children of the probate fees on the cottage upon your death, enhancing the size of your legacy. Even if you give it to them or sell it at a nominal price, the only benefit of this strategy is that you may reduce or eliminate the provincial land transfer tax. Ottawa will charge its capital-gains tax-based on the property's



fair market value, regardless of the price you and your children agree upon. Further, when your children eventually sell or pass on the cottage, the government will calculate its capital gain based on the low or non-existent price your children paid to you, resulting in double taxation.

In fact, says Toronto real-estate lawyer James Naumovich, “We advise clients to push up the appraised value as high as possible when they transfer ownership. This may increase the land-transfer tax,” says Naumovich, “but it’s cheaper to pay land-transfer tax than capital gain.”

If you decide to sell the cottage to your children, you should consider taking back a mortgage. You may not avoid paying the taxes completely, but you can at least spread them over a few years. In such a situation, CRA allows you to report the taxable capital gain over a maximum of five years. When you die, you can forgive the mortgage in your will and your children will acquire the cottage with no debt or taxes payable (assuming you have already paid them).

TRUST IN TRUSTS

Rather than transferring ownership of the property directly, you may prefer to set up a trust for your children while you are living. As trustee, you still maintain control of the property. This will allow you to preserve your principal-residence exemption on your home and the trust can claim the principal-residence exemption on the cottage as long as at least one adult child beneficiary of the trust ordinarily inhabits the cottage.

You can also set up a trust that takes effect when you die. This enables you to set conditions on the property such as who gets to use it and when and the procedure involved in selling the property. Regardless of the type of trust you set up, you are deemed to have sold the property at its fair market value and CRA will tax the capital gain as soon as you transfer the property into the trust.

If your recreational property has gone up in value at a rate that eclipses the appreciation on your home, it may make sense to designate your cottage as your principal residence. Canadian adults are allowed one principal residence unless they are part of a family unit, which is defined as a married or common-law couple and their children under the age of 18. In that





case, the family unit can claim only one principal residence. The benefit is that when your principal residence is sold, the profits (the capital gain) are not taxed.

“If you have more than one property eligible as your principal residence, you should consider designating the one with the higher annualized capital gain as your principal residence,” advises John Natale, a member of the Tax and Regulatory Services group at Manulife Investments in Waterloo, Ontario. “As the calculations can be quite complex, especially for properties owned before 1982, you may want to consider consulting a tax professional.”

EASE THE WAY WITH INSURANCE

If you leave the cottage to your children in your will, CRA will still tax 50 per cent of the capital gain on the property and the bill will have to be paid out of your estate. In some cases, if the value of your cottage has soared, there may not be enough assets in your estate to pay the taxes.

To guard against your children having to dip into their pockets or sell the property, consider purchasing a life insurance policy that pays out when both you and your spouse die. What makes this attractive is that the proceeds from a life insurance policy aren't taxed; they can go directly to covering any tax triggered by leaving the cottage or cabin to your children in your will.

Whether you opt to transfer ownership of your recreational property to your children today or leave it to them in your will, there is no question that planning ahead will reduce some of the taxes.



COTTAGE LIFE IN CANADA

Number of Canadian households that owned a vacation home in 1977:	464,000
As a percentage of all households:	6
Number of Canadian households that owned a vacation home in 1999:	823,000
As a percentage of all households:	7
Percentage of vacation homes owned by urban dwellers:	90
Average age of a vacation homeowner:	52
Percentage of vacation homeowners who have children:	26
Percentage of vacation homeowners who have owned their cottages for more than 10 years:	57
For less than two years:	7
Percentage of vacation homeowners who bought for the peace and tranquility:	50
For the quality family time:	38
To party and let loose:	9
Percentage of vacation homeowners who value their property at more than \$500,000:	3
At less than \$50,000:	33
Percentage of vacation homeowners who plan to sell their properties within the next three years:	13
Percentage of Canadians who plan to buy a vacation home in the next few years:	6

Percentage of prospective vacation homeowners who say they would rent out their cottage to cover the costs:	40
Percentage of actual vacation homeowners who rent out their cottages when not in use:	10
Percentage of prospective vacation homeowners who would drive a maximum of two hours to a vacation home:	59
Percentage of vacation homeowners who are in fact within a two-hour drive of their homes:	66

Sources: realtytimes.com, royallepage.ca and the Survey of Financial Security, Statistics Canada, 1999.

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