Planning for the Family Vacation Property

Many Canadians appreciate the joys of owning a family vacation property and, like any other real estate investment, the value of your vacation home may have increased substantially over the years. It's important to understand the tax consequences and your options for dealing with the eventual sale or transfer of your vacation property to the next generation.

Sale of a vacation property

If you decide to sell your vacation home, you will be required to pay capital gains tax on the increase in the value of the property since its purchase.

Provided that the vacation property is "ordinarily inhabited," meaning you reside at the property for even short periods of time during the year, the Principal Residence Exemption can be applied to a recreational property upon declaration (or election) of that property as your principal residence in the year of disposition. An individual taxpayer or a married or common law couple can only claim the exemption for one property in any particular year of ownership (after 1981). Since both your home and vacation property may have increased significantly in value since they were purchased, you must decide whether it makes financial sense to apply the Principal Residence Exemption to the sale of your vacation property in order to reduce or eliminate the capital gains tax payable.

If you choose not to apply the Principal Residence Exemption to your vacation property upon its sale, you may have the opportunity to reduce the capital gains tax payable by increasing the Adjusted Cost Base (ACB) of the property. This is achieved by adding renovation expenses to the original cost of the property. Therefore, it's important to monitor and update the ACB of your vacation property and keep records confirming the original cost of acquisition or construction, and supporting documents reflecting additional costs for betterment (versus maintenance), improvement and renovation of the property. These capital expenses can be added to the ACB of the property, thus reducing any capital gains at the time of disposition.

Estate planning considerations

Please note that some aspects of the discussion that follows may not apply in Quebec.

For many, passing the ownership and enjoyment of their vacation property to the next generation is an important estate planning goal. However, the capital gains tax due when the property is eventually sold or inherited can be a major concern. Designing a succession plan for the future ownership of your family vacation property can be challenging, especially because the property could hold tremendous sentimental and monetary value. In addition, it is likely that more than one child may want to own it; however the asset cannot be divided. As a result, the desire to keep the vacation property in the family may be impractical or inconsistent with your other estate planning goals.

Get input from your family – Parents often agonize over a complex succession plan for their vacation property, only to learn later that some or all of their children have no interest in owning the property. If your children are unsure, or their lives are unsettled, the succession plan for your vacation property needs to be flexible.

Remember the taxes – The value of the vacation property relative to the value of your entire estate is an important consideration. Over the years, its value may have increased significantly, resulting in insufficient funds in your estate to pay the capital gains and probate tax (if applicable), as well as compensate any children who will not be inheriting the property.

If the vacation property is located in Ontario, British Columbia or Nova Scotia, significant probate tax may apply to the fair market value of the property upon death of the owner, in addition to capital gains tax. Probate tax may be avoided by holding the vacation property in a trust, a corporation (though this ownership

structure is generally not recommended), by way of joint tenancy with right of survivorship, or by gifting it during your lifetime.

If the vacation property is located in the U.S., you may also be subject to U.S. income tax on capital gains when the property is sold. If you own a U.S. vacation property, upon death your estate may be subject to U.S. estate tax on the fair market value of the U.S. property. As cross-borders taxation issues are complex, individuals should consult with a cross-border tax professional before purchasing or selling a U.S. vacation property.

Plan for liquidity – Since most people apply the Principal Residence Exemption to the family home, their estate will be required to pay any capital gains tax owing with respect to their vacation property after their death. However, if your estate has a shortfall of liquid funds to pay the capital gains tax, you'll need to consider ways to provide additional funds in your estate for this purpose. Instead of gifting the property, you can give your children the option to purchase it from your estate, after your death. Your children can use all or a portion of their cash inheritances to fund the purchase. The proceeds of the sale will then be available to the estate to pay taxes and distribute the balance to your beneficiaries.

Insurance can also be used to provide a funding solution. In this situation, your children purchase a life insurance policy on your lives. Your children are both the owners (and pay the premiums) and beneficiaries (receiving the proceeds at death) of the policy. Upon the last parent's death, the proceeds of the life insurance policy provide the funds necessary to pay the taxes owing by the estate, and fund equalization payments to the other beneficiaries, if applicable.

Using a trust to manage multiple users – If several family members will be sharing the recreational property, or if multiple buildings or parcels of land need to be kept together, a trust can provide easier management and fewer risks than co-ownership. Trustees are appointed – usually one to represent each family group – and the trustees decide on time allocations and repairs, as well as paying insurance, taxes and utilities. In this situation, a maintenance fund should be established to provide for major expenditures. The trustees' decisions must be made in accordance with the terms and conditions set out in the trust. Often, the terms of the trust include a requirement for all beneficiaries to enter into a Co-Management Agreement.

One tax consideration of using a trust is the "21-year rule" which deems property in the trust to be sold at fair market value every 21 years, potentially triggering capital gains tax. A common strategy to defer the 21-year capital gains tax from being payable is to distribute the trust's assets (i.e., the vacation property) prior to the deemed disposition date to the (Canadian) beneficiaries outright, at the ACB. The capital gains tax would then be payable by the beneficiaries in the future, when they eventually dispose of the property, or at their death. Children and grandchildren then have the option to enter into their own arrangements for co-ownership, or be bought out. An option to sell the property and distribute the proceeds to the beneficiaries should also be included in the terms of the trust.

Consider a "cooling off" trust – A long-term trust may not be practical if children will not cooperate, cannot afford the long term expenses, or if you know in advance that they will not get along. A short-term trust, one for five years or less can be used as an alternative, in order to give children time to recover from their grief, and examine their own financial situation in light of their inheritance. During this period the children can sort out whether they are interested in continuing to use, or perhaps own, the property. Postponing the decision can be a good way to avoid conflict that may arise in the year after death, when emotions may be running high and children are not yet sure of what they want or whether they can afford to be vacation property owners themselves.

Transfer during life time – It is possible to transfer the vacation property to your children during your lifetime – known as an "inter-vivos" transfer. However, the transfer will trigger capital gains tax on any increase in the value of the property since its purchase. The tax is payable unless, as discussed earlier, you elect to utilize the Principal Residence Exemption at the date of the transfer. This also applies to the transfer to a trust – except an alter ego or a joint partner trust (available only for those who are 65 or older and resident in Canada). One disadvantage of an inter-vivos trust is your loss of control over, and perhaps access to, the property which can lead to problems if your intention is to continue using the property during your lifetime. Another disadvantage is that transferring the property to your children exposes the property to the children's creditors, family law claims, and unexpected events which may make the property vulnerable

Seek professional advice

Every family situation is unique. Tax and estate planning professionals can help you explore all the options available before selecting a solution that produces the right result for your circumstances. For more information please contact your BMO Nesbitt Burns Investment Advisor.

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