



TRANSFERRING THE FAMILY VACATION PROPERTY – A ROADMAP WITH NUMEROUS TWISTS AND TURNS

Peter and Marnie have recently retired. They are looking forward to retirement and plan to use it as an opportunity to check off some of the items on their bucket list, including a lot more time on the golf course and extensive travel. With this new lifestyle, they have started to discuss the future of the family cottage. Although both Peter and Marnie wish to spend some time at the cottage, they anticipate it will be much less than they did in the past.

The cottage was originally purchased by Peter and his first wife when their children were very young. The boys, Bryce and Murray, are now grown and have families of their own. Both boys live within a two- or three-hour drive of the cottage and use it extensively with their own families. Peter's daughter Jenny moved to the other side of the country and gets to the cottage, at most, for one week each year. Marnie loves the cottage but always feels a bit like a visitor as she sees it as filled with memories of Peter's first wife who died only five years ago. Marie only has one child, Terri, who enjoys visiting "the gang" at the cottage but does not have the same emotional attachment to the old place as Bryce, Murray and Jenny.

Peter and Marnie are facing a difficult decision; should they sell the cottage now, freeing up cash to enjoy in retirement, or should they keep it? If they keep the cottage, do they wish to continue to own it or transfer it to the "next generation" (as Peter always calls Bryce, Murray, Jenny and Terri)?

Cottages are a unique asset. Not only do they represent a significant portion of a person's wealth, they also have tremendous emotional and sentimental value. If a couple such as Peter and Marnie decide to transfer the cottage to their children, they must then decide what is the best and most tax efficient method for their family. This article will discuss some of the steps Peter and Marnie might want to

take in determining whether selling, retaining or gifting the cottage is best for them and their family.

CONSIDER YOUR NEEDS FIRST

Before deciding what to do with the cottage, Peter and Marnie should speak with their financial advisor. Their needs are fundamental in deciding if, how and when to transfer the cottage. Their future comfort is fundamental both to them and to their children. Their advisor can assist in projecting whether their retirement nest egg is big enough to provide a secure retirement. This analysis may prove they need, or will need, the equity in the cottage to provide for their future comfort. It may be that transferring the cottage prior to retirement would be beneficial as the ongoing costs associated with cottage ownership, such as property taxes, insurance and maintenance will rest with someone else and thus reduce their monthly expenditures.

The advisor can also help by discussing some non-monetary issues. For instance, transferring the cottage will result in a loss of control. This could be a big issue as they want to continue to enjoy the cottage from time to time. Reviewing these issues before discussing the cottage with the children will go a long way to ensure a peaceful and secure retirement.

BRING THE NEXT GENERATION INTO THE DISCUSSION

After meeting their advisor, Peter and Marnie decide transferring the cottage to the children is a preferable route so long as it can be done while ensuring they can visit the cottage when and if they wish. Being able to continue to enjoy the cottage is particularly concerning to Marnie. If anything should happen to Peter, she worries his children might not feel as accommodating to their stepmother's visits.

Before finalizing plans, Peter and Marnie need to determine how the children feel. Is it time for a meeting with the entire family or, if more appropriate, with each one of the children separately? Are they all interested in cottage ownership? It may be that Jenny who lives thousands of miles away is less interested in sharing a cottage than are the rest of their children who live locally. Terri may have reservations of sharing with Peter's children.

If the cottage is to be shared by various family members can they agree as to how they will share? Can they all afford the upkeep, or will that burden rest on one or two family members? Who will manage the day to day bill payment and other routine aspects of cottage ownership? What will be the rules associated with transferring the family vacation property, housekeeping standards, and use by the third or subsequent generations? Can all parties agree on future renovations to the cottage; is it to maintain its current look and feel or will it eventually be modernized? These are only a few of the issues associated with inter-generational cottage ownership. After this discussion, families often find it a good idea to enter a legally enforceable co-ownership agreement setting out everyone's roles and responsibilities. Such an agreement could create a right for Peter and Marnie to continue to use the cottage.

It is also advisable to discuss some of the immediate costs associated with the cottage and settle who will be responsible for them. If the cottage is in a province with a land transfer tax system, is this cost, and other legal costs associated with the transfer, to be Peter and Marnie's responsibility or a cost for the next generation? Although Peter and Marnie are free to gift the cottage to the children, it is deemed sold at fair market value in the eyes of the Canada Revenue Agency and, subject to utilizing the principal residence exemption, any capital gain and the resulting tax associated with it will need to be paid. Legally, this tax liability is Peter's responsibility, but is that fair or should the family agree that liability should be paid by the next generation? Often families appreciate a neutral third-party presence at planning meetings. Again, this is a role for which Peter and Marnie's advisor is well suited.

EQUAL VERSUS EQUITABLE

After a robust family meeting, it was determined that only Bryce and Murray were interested in owning the cottage. Terri and Jenny were not interested. This leaves Peter and Marnie with another difficult decision; can they gift the

cottage to the boys in a manner that is equitable to Terri and Jenny? They are not so flush financially that they can gift the cottage to the boys and equalize with a cash payment to the two girls. Conversely, they could decide to sell the cottage to the boys. However, this was not their original intention and only Bryce's family has an income substantial enough to buy into the cottage. Murray and his wife would not be able to afford it.

There is no requirement that all children need to be treated the same, but if they wish to do so, Peter and Marnie may consider redrafting their wills to provide that Terri and Jenny receive an equalizing payment from their estates. Although this sounds simple, it leads to questions that Peter and Marnie must consider. For instance, should Jenny and Terri be compensated for the fact Murray and Bryce are receiving a great deal of their inheritance now instead of waiting? What are the ramifications if the estate is not worth enough to equalize at the time of death? What if the cottage increases in value at a greater rate than does the equalization stipulated in the wills, is that fair?

At this point, Peter and Marnie may decide that it is better to hold the cottage until their death and either gift it to the boys in their wills or provide them the first right to purchase it from the estate.

UNDERSTAND THE LAW BEFORE ACTING

Provincial family law and land ownership rules will affect a cottage transfer and it's important Peter and Marnie, and indeed the boys, seek professional advice to plan.

Although the cottage is in Peter's name, that does not mean he can ignore Marnie in the decision process. Each province has different rules providing a spouse with protection. For instance, in Quebec, a family house and a cottage are family patrimony which is used and enjoyed equally. In Alberta, a spouse, like Marnie who appears not be a registered owner may have a dower interest; a right to reside in the property if it qualifies as a homestead for the remainder of their life unless she consents to the transfer or waives her dower rights. In many provinces a property cannot be sold or transferred unless the owner's spouse consents.

The other family law question to address is how to protect the family cottage should one of the children experience a marriage breakdown or marries after the transfer. It may be advisable to have all parties enter into cohabitation

agreements with their spouses outlining how the cottage is to be treated if there is a marriage breakdown. Depending on provincial rules, legal counsel might suggest clauses to be included in the transfer agreement to provide some protection, particularly if the transfer of the cottage is a gift.

CONSIDER ANY INCOME TAX IMPLICATIONS

The transfer of real property can have detrimental tax consequences for Peter. The Canadian Income Tax Act provides that, if a property is transferred for less than fair market value, it is deemed to have been sold at fair market value and the transferor will be responsible to pay any tax associated with the capital gain. The Canadian tax system allows the cost of acquiring the property to be increased by capital expenditures that increase the value or extend the life of the cottage. Not all costs qualify; tax rules distinguish between maintenance and improvements. Peter will need to speak to his tax advisor to ensure these amounts are treated appropriately.

A property can be designated as a principal residence if it meets certain requirements. The advantage of doing so is that the capital gain associated with the property transfer

is not taxable. Before transferring the cottage to the next generation, Peter and Marnie should seek professional advice to determine whether it is advisable to designate the family cottage as their principal residence. Several factors need to be considered including whether a cottage designation would create a larger tax liability for any other home they own.

THE END OF THE BEGINNING

Peter and Marnie have come a long way in determining whether to transfer their cottage within the family, but as Winston Churchill famously said, "This is not the end. It is not even the

beginning of the end. But it is, perhaps, the end of the beginning." They have now made some decisions about the best manner of transferring. But there are several questions still to be addressed. Do they sell directly to the boys? Do they transfer the cottage to a trust and, if so, what type of trust? These options are discussed in our whitepaper, "Passing your Cottage on to the next generation? Start planning now."

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