



PASSING YOUR COTTAGE ON TO THE NEXT GENERATION? START PLANNING NOW

Many of us enjoy weekend and summer escapes to our cottage where we build memories with our children. If you're planning to pass your cottage on to the next generation, proper planning is required.

In this article we're going to discuss some important points to consider which can help create a smooth transition from you to your heirs.

WHAT IS YOUR MATRIMONIAL REGIME?

Before you think about selling, donating or transferring your cottage property, you must understand that both your home and your cottage are family properties which are used and enjoyed equally by you and your spouse, whether or not you have children and if you are married or in a civil union. In some provinces, if you've been living together in a common-law relationship for at least two years, the law recognizes you and your partner as "spouses", so be sure you both agree on the plan of action.

IS YOUR COTTAGE IN THE U.S.?

Once U.S. non-resident aliens have to be aware of U.S. estate tax implications if they have a U.S. property. U.S. estate taxes arise on the death of an individual at graduated rates to the fair market value of the taxable estate. Along with U.S. citizens and residents, non-residents are also taxed, with the only difference being that they are taxed only on their U.S. assets. If your worldwide assets are worth more than \$11.4 million in 2019, your U.S. situated cottage might be subject to U.S. estate taxes. Also, gifting of a U.S. property will result in a U.S. gift tax, unless the donee is your American spouse who will qualify for the unlimited marital exemption. A non-U.S. citizen spouse will qualify for an annual exemption of \$155,000 for 2019. Gifts made to someone other than a spouse will have a \$15,000 exemption limit.

SOME PLANNING IDEAS:

Selling your cottage to your children:

You can sell your cottage to your children before you die, but if you sell it at a lower price than the fair market value the capital gain will be calculated on the fair market value, and the children's cost of the cottage will be the amount which they paid for the cottage, so be careful with potential double taxation.

You can designate your cottage as your principal residence if you think the accumulated value of the cottage is higher than your current primary residence and if you think by not designating the cottage as principal residence that you would end up paying higher taxes on the capital gain.

The other option is spreading the payment for the cottage over five years, in what's known as a capital gain reserve. A reserve allows you to report only the portion of the capital gain in the year you receive the proceeds of the sale.

Self-benefit or alter ego trust:

A trust separates the control and management of an asset from its ownership. For example, you can rollover your cottage to a self-benefit or alter ego trust without any immediate tax consequences. A self-benefit trust is a trust created by a settlor and to the settlor's exclusive benefit during his or her lifetime. A self-benefit trust has the same characteristics as an alter ego trust, except that the settlor may be under 65 years of age.

In provinces and territories where estate probate fees apply, you can take advantage of having your cottage held in either a self-benefit or alter ego trust and avoid probate fees, which are fees incurred when the will is reviewed. At the time of your death, the cottage would be transferred to

your beneficiaries, presumably your children, and the trust will pay taxes on any increase in value over the adjusted cost base of the cottage.

Effective after 2016, only certain personal trusts can designate a residence held in trust as principal residence; self-benefit, alter ego, spousal and joint spousal trusts are all eligible trusts that can take advantage of this option. The trust may claim the principal residence exemption and therefore the accrued gain will be eligible for a principal residence exemption.

Inter vivos family trust

Transferring your cottage to an inter vivos trust allows you to gift ownership of the cottage to your children as beneficiaries of the trust while you enjoy its continued use. Aside from tax planning, a significant benefit to holding a cottage in an inter vivos trust is that probate fees can be avoided on death in provinces and territories where they apply. When you transfer the property, there will be a deemed disposition at fair market value at that time. The increase in value from the time the property was purchased likely will be a taxable capital gain realized on this transfer. However, you may be able to shelter a portion of this gain from income tax by using your principal residence exemption. Once the property is transferred, the trust will no longer be able to claim principal residence exemption. You also have to keep in mind the 21 year rule. Every 21 years, the property must be deemed disposed and the trust will be taxed on the accumulated gain, unless the property is “vested indefeasibly” with the children. Like a testamentary trust, an inter vivos family trust is not a tax efficient solution, but if the main consideration is protecting the family property and transferring it to the next generation, it might be a valuable planning tool.

Joint spousal trust

You may consider setting up a joint spousal trust if you and your spouse are both over 65 years of age. This will not trigger a deemed disposition as described above, therefore no immediate tax consequence. You and your spouse will have the right to use and enjoy the cottage while your children are the capital beneficiaries. When both you and your spouse pass away, the ownership will pass to the children, creating a deemed disposition and the trust will pay taxes on the increase of the value of the cottage. As explained earlier, a joint spousal trust is an eligible trust for claiming the principal

residence exemption. The trust can use the exemption to eliminate the taxes on the capital gain after the death of the last surviving spouse.

Testamentary trust

To pass ownership of the cottage to your children after you die, you may also consider the use of a testamentary trust, which is a trust created upon your death. When the first spouse dies, the cottage can be transferred directly to the surviving spouse (or to a testamentary spousal trust) on a tax-free basis. When the surviving spouse dies, the cottage will be deemed to be disposed of at fair market value and the estate (or the spousal trust) will pay tax on any gain in value of the property. Should there be a taxable gain, the principal residence exemption may be used to shelter all or a portion of that gain, if available. After your death, the cottage will be an asset of the testamentary trust, with your children as beneficiaries.

However, a testamentary trust cannot qualify for the principal residence exemption unless it is a spousal testamentary trust. On the 21-year anniversary of the trust, the trust has to pay taxes on the accrued gain on the cottage unless it is “vested indefeasibly” with the children. Unless there are non-tax considerations, such as protecting the property from spendthrift children, marriage breakdown, or creditors, a testamentary trust may not be a tax-efficient option.

Joint tenancy with the right of survivorship (co-ownership in Quebec)

This can allow you to minimize probate taxes by directly passing the property to the joint owner at the time of your death. However, many considerations must be reviewed, including the tax implications of such a transfer. The transfer of a cottage into joint tenancy, or in Quebec in co-ownership, will constitute a partial disposition for tax purposes and will generally trigger the realization of a capital gain if the property has increased in value. There is an exemption if you transfer joint tenancy to your spouse. From a legal perspective, you are no longer the sole owner of your cottage.

Whichever option is best suited to your individual situation, planning ahead is the key to achieving your desired result. Work with your legal and tax advisor to ensure you’re considering all options and selecting the best one for you.

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