

# TAX & ESTATE PLANNING



## What is the best way to pass on the family cottage?

Several factors can influence the transfer of the family cottage. Before deciding to transfer ownership to the children, we must consider how inheriting the cottage will affect them.

### **This matter needs to be discussed with the members of the family**

You will have to ask yourself whether potential conflicts could arise between the siblings if they were to share the cottage and its related maintenance costs. The transfer of the cottage will have to be discussed with the children prior to any planning to ensure the cottage does not become a source of family conflict.

The main points to be addressed are as follows:

You will first need to determine if you have enough cash to meet your retirement needs if the cottage is kept, or whether you need capital to fund your retirement. You will also need to determine whether all the children want to keep the cottage or if some would rather sell it and keep the money. Finally, you will need to determine whether the children who will inherit the cottage will be able to pay the property taxes and related maintenance and upkeep costs.

Also keep in mind that if the children live far apart, it may be difficult for them to share the cottage fairly. Sharing the cottage could also be difficult if the children do not get along.

If ownership of the property is transferred to your children, it would be appropriate for them to draft a joint ownership agreement. This agreement will determine in advance how they will share the family cottage, which will help to avoid conflicts later.

### **Various options for transferring the cottage**

#### **Transferring the cottage while you are still alive**

There are several options for transferring the cottage while you are alive. For example, you can gift or sell the cottage to your children. Each option has its own characteristics. The advantage is that your heirs will not have to pay death taxes because the cottage will not be part of the estate. Also, the heirs will not have to pay probate fees in some provinces outside Quebec. The disadvantage is that you no longer have control of the property.



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### Living trust

Establishing a trust is a popular option for transferring assets to the next generation. A trust is used to separate an asset's title from its control and management. A living trust allows you to transfer ownership of your cottage to your beneficiary, usually your children, while retaining full rights to it during your lifetime.

When you transfer your cottage to a trust for your children, you trigger a deemed disposition at fair market value (FMV). You might decide to shelter any gain from tax by using your principal residence exemption. Similarly, every 21 years there will be a deemed disposition of the property in trust regarding the FMV. Taxes will then be paid on the gain accrued at that time if the trust is still the owner of the cottage. If you are over 65, a transfer to an Alter Ego Trust is an exception to these two deemed dispositions. You should consult a tax expert regarding the issues involved in establishing and administering a trust.

In order for trusts to provide the desired benefits, they must be well-structured. They must include guidelines on the use of the cottage, funding and payment of expenses and treatment of beneficiaries (the children) in case of death. As mentioned above, you should consult a tax expert when establishing a trust.

### Gifting the cottage to your children while you are alive

Another option to consider is transferring ownership of the cottage directly to your children while you are alive. Gifting the cottage to your children usually constitutes a disposition for tax purposes and will trigger a capital gain if the property value has increased. The transfer of ownership could also trigger a land transfer tax, as well as legal fees related to the transfer.

Before deciding to gift the family cottage, it is best to perform a cost benefit analysis to determine whether it is worthwhile.

### Selling the cottage to the children while you are alive

You might also consider selling the cottage outright to your children. In this case, the accrued gain will also be taxable when you sell the property to your children. Since this is a non-arm's length transaction, the taxable capital gain will be calculated based on the FMV of the property regardless of the actual sale price to your children. Therefore, if you sell your cottage to your children for less than FMV, you not only pay tax as if you had sold it at FMV, but your children will incur a tax cost equivalent to the amount they actually paid for the purchase (double taxation).

The capital gains provision is frequently used as a planning strategy. You could divide the gain on the sale equally among your children over a period of five years. The capital gain and tax are spread over a period of time, and therefore the tax does not have to be paid on the entire gain in one year.

### Transfer on death

You may want to transfer ownership of the cottage to your children only on your death. Depending on your will, you can transfer the cottage directly to your children or through a testamentary trust. In either case, the cottage will be part of your estate and therefore, taxes will be payable at death. At the time of your death, you will be deemed to have disposed of the cottage at its FMV and your estate will pay tax on the accrued gain when it is transferred to your children. The principal residence exemption could be used by the estate to shelter all or part of the taxable capital gain.

### Establishing a testamentary trust

A testamentary trust is created under your will and takes effect on your death. It can be used to transfer ownership of the cottage to your children on your death. The testamentary trust becomes the owner of the cottage. The property held in trust is a separate inheritance from your children's personal inheritance.

As mentioned above, in order for trusts to provide the desired benefits, they must be well-structured and provide clear guidelines on the use of the cottage, payment of expenses, treatment of beneficiaries, etc. You should consult a tax expert when drafting the trust under will.

### Life insurance

If you decide to leave the cottage to the children on your death, you might consider buying a life insurance policy to pay the taxes payable on the deemed disposition on your death.

Life insurance can also enable children who are not interested in inheriting the cottage to receive a sum of money via the life insurance policy instead.

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