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Transferring Ownership of Your Cottage: What to Consider

Acknowledgements and disclaimers:

N.B.: The foregoing is our interpretation of the regulations and has no legal standing. It is an interpretation and consolidation of, and sometimes direct quotation from, a number of articles published over the past few years.

The intended audience for this article is the membership of the Lakes Association of Kazabazua (LAK). Our membership is pretty evenly split between people whose primary residence is outside Quebec, mostly in Ontario, and those who are Quebec residents. Most members have their cottage as a secondary residence, for example, their principal residence is in Ottawa or Gatineau. Capital gains tax will be a concern for all those whose cottage is not their primary residence. Should your lakeside property have been your primary residence for a period of time, you will not be faced with capital gains tax for that specific period of time when you are transferring or disposing of this property.

The Need for a 'Quebec Will':

First, let's deal with the particular circumstances facing non-Quebec residents. As privileged as we are to live and work in Canada's national capital region, we are often faced with legal situations involving both civil and common law. Many people live freely in both provinces and often don't realize all of the legal consequences that could occur when they cross the bridge into another province, for example, when an Ontario resident owns a cottage in Québec. Below you will find a few of the main reasons why you should prepare a distinct Will, a "Québec Will", for your Québec property and/or other assets.

Concepts such as "tenants in common", "joint tenancy", and "right of survivorship" do not exist under Québec civil law. As a result, transferring your assets in Québec to your heirs may be a more complex task than you anticipate.

In Ontario, there is a concept known as "joint tenancy". When one of the tenants dies, the survivor receives title by operation of law. In other words, automatically, as soon as one of the "tenants" dies. In Québec, no such concept exists. When one of the co-owners dies, his share in the property is transferred according to his Will, and, in the absence of a Will, according to the law. The transfer is not done automatically. The shares of the deceased must be transferred by means of a document called a Declaration of Transmission, which is then registered on title.

Hence, having a Quebec Will ensures that your shares will be transferred to the people that you want, according to your last wishes.

It is possible that your "Ontario Will" may have to be verified by the Québec Superior Court before your property can be transferred to your heirs or liquidator (estate trustee). This causes extra delays and legal fees that can be avoided.

Wills that are prepared by Ontario's lawyers are signed before two witnesses and usually accompanied by an affidavit of someone who attests to the testator's signature. In Québec, this is a valid form of Will known as a Will signed in the presence of witnesses.

Pursuant to section 772 of the Civil Code of Québec, a Will signed in the presence of witnesses must be "probated". **Probate**, under civil law, is the process of having a Will "verified" before the court in order to ensure its validity. It is not a tax on the value of the estate. The process which takes place in front of a judge, takes, on average, 1 to 3 months to complete, and usually represents a total cost of $2,000.00 in court, bailiff, and legal fees.

The probate process can be avoided entirely by preparing a Québec Will. Not only will you save on the overall time to settle the estate, but you will save the costly process of having your Will probated in Québec. The cost of a Québec Will is much lower than having your Ontario Will probated in Québec. Preparing a Québec Will ensures that your loved ones can spend less time settling your estate and more time enjoying the property that you left them.

What is 'Capital Gains Tax'?

Taxes are typically due whenever you dispose of property you own (this includes sale, transfer, and gifting). Unrealized capital gains will be calculated when you dispose of or transfer the property and the assessed property value is more than your original purchase price. Canada Revenue Agency (CRA) will assess the capital gain on 50% of the difference between the initial value and disposition value. The amount owing can be reduced by means of eligible "improvements" on the property, e.g., most renovations. Your estate executor will have to have access to receipts and any supporting information in order to present a case for reducing capital gains owed by the estate or your beneficiaries. For most individuals when the cottage is disposed of at a value greater than its Adjusted Cost Base (ACB) a capital gain will be realized.

Only 50% of the capital gain is included in your taxable income, unless you are able to claim the principal residence exemption. Please note that for tax purposes, you will be deemed to have disposed of your property at death or whenever you sell or gift the property. Please see the example below.

> If Tom and Sandy purchased a cottage for $200,00 and disposed of the cottage for $500,000, the capital gains tax would be on half the difference ($300,000), or $150,000. If they have made eligible improvements of $50,000, the tax owing would be on $100,000.

Deemed disposition on death

Upon your death, you are deemed to have disposed of your capital property at its Fair Market Value except where the property is left to a spouse or Spousal Trust in which case it passes at its ACB. In addition, certain provinces and territories in Canada impose a probate fee based on the value of a deceased's estate assets.

In a very limited number of cases, someone may have increased their ACB in 1994 when they had the ability to bump up their ACB by electing to realize up to $100,000 of unrealized capital

gains on their property. If you think that this applies to you, you should review your 1994 tax return, and contact your accountant or CRA to determine whether you made this election.

Family Dynamics

One of the articles suggested that, prior to finalizing the transfer of ownership to children, a number of potential issues should be considered. For example:

Which, if any, of the children would be interested in future ownership/joint ownership?

What is the impact of passing the cottage to certain children in the family?

Are the children/spouses/grandchildren capable of jointly owning the cottage?

Will family harmony be maintained? [Please see Annex A for potential family agreements]

Where multiple children are interested in the family cottage, do they have the financial resources to maintain it? If not, you could consider transferring money or an insurance policy to a trust to provide the necessary financial resources.

Does it make sense to pass on full or partial ownership prior to your death? Some tax and probate fee savings may be realized.

Where you intend to pass the cottage to specific children, are there sufficient estate assets remaining to ensure an equal estate is passed on to the remaining children? If not, you may want to use life insurance to pay for the tax, or to plan for estate equalization for your remaining children.

Are there sufficient liquid assets to sustain your lifestyle until your anticipated death, or would the sale of the cottage provide the resources to maintain your lifestyle?

Multiple Ways to Dispose of Your Cottage:

The method and timing of your disposition/transfer of ownership of the cottage will have varying financial impacts upon your successors, including capital gains tax and the maintenance costs of owning the property. It may be that not all your successors will be equally capable of shouldering these costs. This reality should be borne in mind when choosing the method of disposing of the property or transferring ownership.

1. Sell the cottage

Probably the last thing you could imagine is selling your cottage after all the years of hard work and great memories. However, selling the cottage and dividing the proceeds among your family may maintain harmony. You could sell to a third party, directly to your children or provide them with a right of first refusal. Selling the cottage prior to death will also have the added benefit of avoiding probate fees and settling up the capital gains taxes that would otherwise be payable upon your death.

2. Use of a trust

Another option is transferring your cottage to either a Lifetime (inter-vivos) or Testamentary Trust. A Lifetime Trust could be created by transferring your cottage to a trust whereby trustees would administer the property, within the terms of a trust agreement, for the benefit of certain beneficiaries. A Testamentary Trust would work in a similar manner except the trust would be

created upon the death of the cottage owner in accordance with their will. Where a cottage is transferred to a trust you will be deemed to have disposed of the cottage at its Fair Market Value.

3. Transferring ownership while you're still alive

If you're a parent, you may wish to transfer your cottage to your children while you're still alive, but unfortunately, any gift or sale of the property to your kids will result in a deemed capital gain equal to the fair market value of the cottage, less the original cost of the cottage, and less the cost of any eligible renovations done. In other words, a transfer from parent to offspring while the parent is still alive will create an income tax liability where there is an unrealized capital gain.

Giving or selling your cottage to your kids could be a useful strategy, however, if the gift or sale occurs at a time when there is only a small unrealized capital gain, it could mean that most of the cottage's increase in value occurs after the transfer. Of course, this means that the tax issue isn't eliminated; it's just deferred, and it could be an even larger tax liability for your children down the road.

According to one expert, there's a strategy that may help in this scenario. "One valuable technique is to transfer it in stages, rather than all at once,". "If you transfer 20 per cent each year for five years, the capital gains taxes in each year will be much less."

4. Co-own the Cottage with your Kids

To save and defer capital gains tax, you could add your children to the deed, making them co-owners of the property. If the property value has gone up, it would trigger a capital gain on the portion of the cottage that your children now own (at fair market value), and you would pay the tax on that now. When you die, your kids would pay tax on the capital gains from your portion of the cottage they just inherited. The Risks? When you co-own a cottage, it isn't "just yours" anymore. You may not be able to do what you want — since you are no longer the sole owner. And the other co-owner, your child, may have issues that impact you. Sometimes, kids have creditors. So, this is an asset that creditors could go after.

5. Gift It Now

Another option is giving the cottage to your kids right now. That would trigger a capital gain and you would have to pay the capital gains tax up until the time you gave it to them. You'll still pay some of the tax, but if the property values are going up, you'll be arresting the growth for capital gains. One of the risks is that if cottage property values fall, you might be paying more now than you need to. And like before – if your kids own the cottage before you die – they, or someone involved with them (creditors, ex-spouses) may have different plans for the cottage than you do.

6. Spread it Out

By selling the cottage to your children and receiving a promissory note (or an I.O.U. in simpler terms) from them for the price of the cottage, you may be allowed to spread your payable capital gains tax over 5 years. If the note is worded in such a way that says you will collect on the mortgage over a 5-year span, then the CRA will allow you to spread out the tax payable over that time. Your children don't actually need to pay you for the cottage, and you can forgive the debt in the will, meaning that the cottage will be owned by your children with no further taxes owing.

7. Trust the Trusts

If you are concerned about what might happen if your kids own the cottage while you're alive, you may want to look at implementing a trust. A trust is a vehicle which allows a trustee to manage the property and use of it by the beneficiaries. There are trusts that you can use for the cottage while you are alive, or that will go into effect when you die. Whenever transferring the property to a trust, you would still pay capital gains tax as if you sold it at fair market value. But once in a trust, your children could still use the cottage as you see fit. And since a trust is meant to be a temporary arrangement, it will give your children and the trustee a few months or years to decide whether one child will buy out the others, or it will ultimately end up for sale, and all the while, the property will remain protected from creditors. If you think a trust is right for you, talk to a professional who specializes in trusts – as trust planning can be a complex matter.

8. A Slice of Life (Insurance) Can Help

While buying life insurance won't eliminate the tax bill upon death, it can provide needed cash to pay those taxes where the plan is to keep the cottage in the family and not sell it after you're gone. One expert (Ian Lebane, Will and Estate Planner, TD Wealth) suggests "If you are a couple looking to pass the cottage down, you can purchase life insurance called 'joint last to die' on the second death,". "It's economical, and your heirs will receive the benefit when the tax liability is due." You might also consider buying enough insurance to help fund all or part of the annual maintenance costs going forward.

9. Make it a Primary Residence

With the increase in the demand for cottage properties, in some cases your cottage might be worth more than your family home. If that's the case, you may wish to switch your primary residence to your cottage. Don't worry, you don't actually have to move to the cottage; as long as you reside in it for a part of the year, CRA will allow you to use it as your principal residence for tax purposes. The switch will ultimately trigger capital gains tax on your old (previous) primary residence, but it may save you some money in the long run.

Annex A - Agreements to Reduce Conflict

While setting up an agreement will not eliminate conflict, a well thought out agreement can go a long way in reducing disagreements and ensuring summers at the cottage continue to provide memorable moments. When setting up an agreement the following points should be considered:

Scheduling – where families share the cottage you should set up a fair and equitable schedule that outlines how the prime cottage time (typically long weekends in the summer) will be shared. You should also consider allocating the responsibility for performing the annual opening and closing of the cottage.

Financial contributions – outlining the annual costs associated with running a cottage may help children assess whether they have the funds necessary to own/ share a cottage. Annual contributions, even in years where capital improvements are not necessary, may help with cash flow. The funds can be invested until the funds are required for annual maintenance, property taxes, capital improvements, road assessments, etc. Where one family is expected to use the cottage more frequently than others, consider alternative cost-sharing arrangements.

Decision making – outlining how decisions are to be made (consensus, majority rules, tie-breaking mechanisms, etc.) may eliminate the concern that certain parties to the agreement (such as overly aggressive siblings/spouses) may overstep their bounds without such an agreement.

Future sale of property – while a parent may wish for their children to own the cottage, circumstances may change (i.e., children move, get divorced, die prematurely, children require funds, etc.) such that a child may need to sell their portion of the cottage. An agreement that would resolve this decision such as right of first refusal to other family members could avoid conflict among the children. You may also want to consider including in your Quebec will a provision, or having an agreement signed by spouses, that the cottage will not form part of a marital property claim, if allowed under matrimonial law.

Annex B - Effective Use of a Trust

Using a trust to hold the family cottage may be appropriate in certain circumstances including the following:

A. Where parents would like continued access to the cottage throughout their lives but would like to pass on the increase in value, as well as the related tax liability, to future generations. The trust Agreement should contemplate the ongoing management of the property and who will be responsible for any costs. As part of the trust, the parents may also choose to include a sum of money for the upkeep of the cottage. This contribution to the trust could make up for any of the children who may not be able to pay their share of expenses.

B. Where parents feel the children are not able to handle the financial responsibilities, or have concerns over existing or potential creditors. Where a trust is considered discretionary, no single beneficiary will own the cottage and therefore does not have the ability to sell the cottage. Creditor protection may also become particularly important where any of the children have marital difficulties. If properly structured the trust may prevent the cottage from being considered a marital property asset.

C. Decision making can be simplified by having the trust in place and having the trustee make the decisions as to use, upkeep, and eventual disposal. This would simplify the process of having consensus on sensitive issues.

As a general rule, note that for tax purposes a trust is considered to dispose of all of its property at Fair Market Value on its 21st anniversary and pay all taxes relating to the disposition. However, prior to the 21st anniversary, a trust may "wind-up" by transferring the property directly to its beneficiaries on a tax-deferred basis. The individual beneficiaries will then own the property. Probate fees will be avoided on death of the original owner because the cottage will be owned by the trust and not the deceased.

Annex C – One Possible Scenario for People with Primary Residences in Ontario

1. Upon the ultimate transfer of the property, there will be capital gains tax owing. If the transfer is prior to your death, the taxes would be due immediately. If the transfer follows your death, the (Ontario) estate liquidator ('executor') can be given the authority and responsibility for paying the taxes due, along with any other outstanding obligations, through the Ontario estate.

2. You would need to ensure that there are sufficient funds in the Ontario estate to cover capital gains taxes, etc., and, if feasible, to assist your individual successors to pay their share of ongoing property taxes and maintenance costs.

3. It is critical to have a clear and accessible record of capital gains deductions (major renovations) for both the cottage in Quebec and the primary residence in Ontario, as the Executor will want to satisfy themselves as to which property would be most advisable to declare as the principal residence. Given the currently comparable purchase prices and anticipated selling price in Ottawa and lake country, the main differential may be the amount spent on improvements (capital gains exemptions). This may argue for the cottage being the secondary residence with attendant payment of capital gains taxes.

4. There is a difference between transferring ownership and delegating management responsibility. You can transfer responsibility for managing the property prior to your death, without necessarily transferring ownership (thus triggering payment of taxes) at the same time. You may want to maintain ownership and control of the property past the point where you are no longer physically or mentally capable of maintaining the property (i.e., in order to pay taxes, etc. out of the Ontario estate). Many people have established general powers of attorney in their Ontario wills in the event that either spouse becomes incapable of making competent decisions. In Quebec, this is referred to as a "mandate in the case of incapacity". When and if it becomes necessary to put such a mandate into practice, it must be probated by a judge in Quebec, and this can take up to 6 months.