THE
Guardian

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ESTATE PLANNING AND THE FAMILY CABIN

With August drawing to a close, owners of summer properties will soon be locking up and “winterizing” their cabins. Accordingly, we thought it timely to bring to the attention of our readers the estate implications for eventual disposition of a vacation property.

There are tax considerations, personal or emotional issues and estate distribution issues to consider and we will discuss all three.

Tax Considerations:

Unless the property is deemed to be your principal residence, the disposition is subject to capital gains tax. The property is deemed disposed when the property is sold, gifted or at the time of death (if the property is jointly owned by spouses it is rolled over tax-free to the surviving spouse and taxed at the death of the second spouse).

The taxable gain is the market value of the property, less the adjusted cost base (ACB). While the market value is straightforward, the ACB is the cost of the property plus any capital improvements. There are number of planning points around this issue:

i) Designating a principal residence (PR):

If you own a home and a recreational property, it is possible the recreational property has increased in value more than the home. In this case it may make sense to declare the recreational property as the principal residence, thus qualifying for the principal residence exemption (PRE), Assuming you “ordinarily inhabit” the property. CRA does not prescribe a certain number of days so even two weeks a year or a few weekends with allow you to declare the property as your principal residence. Even if you “occasionally “rent the cabin, CRA has stated incidental rental income will not prevent a cabin from qualifying as a principal residence.

The principal residence exemption formula does not dictate that you need to designate all years of ownership to avoid tax on the sale of a property. For example, assume that a person acquired both a home and a cabin in 2009 and sold both properties in 2018. The gain on the home was $100,000 and the gain on the cabin was $150,000. Upon first glance the optimal planning would seem to designate the cabin as the principal residence for all years such that the $100,000 gain on the sale of the home is subject to tax. The following allocation would be a better plan:

- Designate the cabin as a principal residence for the years 2009 through 2017, or nine of the 10 years. The PRE formula allows one additional year to be added to the numerator so that 10/10 of the gain or the entire amount is tax free.

- The home is designated as the principal residence for 2018. Again because the formula allows one extra year, 2/10 or 20% of the gain is tax free. This means that the gain on the home is $80,000 which leads to less tax then if $100,000 of the gain on the home were subject to tax.

ii) Maximizing the ACB

Because capital improvements increase the ACB, receipts should be maintained to validate if necessary the cost of the improvements. As noted above, it is possible that you do not elect your primary residence to be the principal residence for the entire time you inhabit it. Accordingly, you should also maintain receipts for capital improvements on that property. Note you cannot deem your own labour or "sweat equity" as a capital improvement. Only out-of-pocket expenses qualify.

Two final notes on tax issues…

- You cannot claim a capital loss on a personal use property if the property market value is less than the ACB.

- If you sell the property to your children at less than market value, CRA will have deemed you to receive full market value and tax you accordingly. Further, the ACB for your children will be the lower amount you declared as the original sale value.

Personal/Emotional Issues

Do you know if any of your children want the vacation property? Your children may be interested in coming to the property as long as you are there but if they live in another province or are not interested in maintaining the property themselves, you may be surprised to learn that they do not want to keep the property after you are gone.

We recommend a lengthy discussion with family members to ensure all stakeholders can discuss their feelings about the property. It would be helpful if the family's lawyer, accountant or financial advisor was present to provide clarity on some of the financial issues.

Issues that can arise include the following:

- *Maintenance* - Mom and Dad may have maintained the property to a high standard. Children taking over the cabin may have differing views on maintenance, leading to potential conflict.

- *Scheduling* - It is easy to see how conflict arises on the issue of who gets the cabin when. How will new owners deal with a sibling who has an 18-year-old son or daughter who wants to throw a party?

- *Different financial circumstances and residence* - Two siblings having significant differences in their financial circumstances creates a potential source of conflict over contemplated capital improvements, as is one sibling living in close proximity to the family property while the other lives several provinces away.

Estate Considerations

The family discussion may reveal that all children want to receive a share of the cabin. The more complicated scenario occurs when one or more adult children want to maintain the cabin and one or more do not. In this case, it is necessary to look at the value of the property relative to the value of the estate. It is important the estate be viewed from an after-tax perspective. Specifically. It is important to take into account that RRSP and RRIF capital as well as any unrealized capital gains on the property and other capital assets are taxed at death of the second spouse.

Take an example of Bill and Megan with three grown children and an estimated after-tax estate value of $2.5 million, including a summer cabin worth $1 million. A family discussion reveals that one child wants the property and the other two do not. Unless the child who wants the cabin has the financial means to buy out the other two, we have an estate distribution problem. This is where life insurance is an effective estate planning tool. The purchase of $500,000 of life insurance would equalize the estate, ensuring all three children receive 1/3 of the total estate with the one child's entitlement being the property.

Final Considerations

Naming one or more children as a joint owner may work well in some circumstances but there are factors to consider. Namely it will likely trigger at least a partial capital gain. For example, naming two adult children on the property may result in tax on 2/3 of the gain, which must be paid immediately. Further potential complications include possible marital breakdown of one of the children and the spouse making a claim on the property.

If more than one child wants the property, consider a co-ownership agreement. There should be something in writing setting out how the vacation property will be used, who will pay for it, and who will be responsible for its upkeep. One could considering having the children sign a co-ownership agreement as a condition to inheriting a part of the property. In that way, the agreement will be there long before there are any arguments. Once the parties start to disagree, negotiating a co-ownership agreement will become next to impossible. The co-ownership agreement should also specify how the parties can be bought out in case of disagreement and what happens upon death of one of the siblings. Will their share go to the grandchildren or does it go to the surviving children only? Can it be passed to a son or daughter in law? It is best to resolve these issues sooner than later.

Finally, given the complexity of the issue, it is important you seek professional assistance to assist you in this process.

REGISTERED RETIREMENT INCOME FUND (RRIF)
STATUTORY MINIMUM MONTHLY INCOMES BASED ON $100,000
COMMENCING ONE MONTH FROM ISSUE

Best Current Rate: 3.29% [1]

Age	1st Year	TOTAL PAYMENTS TO AGE 100
55	$239.00	$199,780.71
60	278.00	182,899.10
65	334.00	168,250.64
71	440.00	153,667.51

A R.R.I.F. can also be structured to pay a level income for a shorter period. Based on current interest rates, $100,000 will produce the following monthly income.

For 5 years: $1808.00
For 10 years: $951.00
For 15 years: $675.00

MONTHLY ANNUITY INCOMES COMMENCING ONE MONTH FROM ISSUE BASED ON $100,000 [1]

Age	LIFE (Payments cease at death)		LIFE 10 Year Guarantee		JOINT LIFE 10 Year Guarantee
	MALE	FEMALE	MALE	FEMALE	MALE & FEMALE
65	$541.30	$488.18	$523.25	$486.51	$440.41
70	636.54	572.15	596.99	552.32	495.56
75	747.48	680.30	676.37	631.94	570.92
80	932.40	842.18	776.25	725.42	675.77

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Manulife Securities

strong reliable trustworthy forward-thinking

Vancouver: 1100 – 1075 West Georgia Street
Vancouver, BC V6E 3C9
Telephone: **(604) 688-9577**
Toll Free in BC 1-800-663-0644

Website: www.solguard.com
Email: info@solguard.com

North Shore: 200 - 100 Park Royal South
West Vancouver, BC
By Appointment Only

Victoria: 520 - 645 Fort Street
Victoria, BC V8W 1G2
Telephone: **(250) 385-3636**
Toll Free in BC 1-877-500-3636

Manulife Securities Incorporated

[1] CANNEX