



Snapshots™

FAMILY COTTAGE ISSUES: TRANSFERRING TO A FAMILY MEMBER

WHILE SELLING A COTTAGE TO A STRANGER OR THIRD PARTY IS FAIRLY STRAIGHTFORWARD, HANDING DOWN YOUR PROPERTY TO FAMILY MEMBERS RAISES SOME CRUCIAL ISSUES.

It may be important for you to pass on the cottage to continue a family connection, but you should carefully consider your plans so that you avoid future complications. There will be tax issues, certainly, but typically more far-reaching and significant are the emotional and personal implications for your family. There are many true stories of families where disputes and misunderstandings about the future of the family cottage have caused permanent rifts between family members. Planning ahead is extremely important and, ideally, all of the interested parties should be brought into the discussion upfront so that you can reach some sort of consensus together.

Transferring a Cottage to your Spouse

Transferring a cottage to your spouse through your estate is usually only a temporary solution since it doesn't resolve the issue of who will get the cottage in the next generation—but it can certainly be done. Under tax law, when one spouse transfers property to the other spouse, there are no immediate tax consequences. This is also the case where the cottage is jointly owned.

For example:

Toni and Michael Gomes purchased a cottage jointly in 1976 for \$50,000 (\$25,000 each). In their Wills they specify that all assets should flow to the other upon the first death. In 2011, Michael dies at the age of 78, and his assets, including the share of the cottage, flow to Toni, who is 74 at the time. At the time of Michael's death, the cottage was appraised at \$300,000. Toni now owns the cottage with an Adjusted Cost Base (ACB) of \$50,000 and a Fair Market Value (FMV) of \$300,000. While there are no immediate income tax implications due to the spousal rollover, Toni would now need to consider what would become of the cottage upon her death.

Transferring a Cottage to your Child or Children

If there is no surviving spouse, then assets, including a cottage, are considered to be sold at their FMV at the time of death. In most cases, this results in a taxable capital gain to the deceased's estate. The beneficiaries receive the property at the FMV and that is their ACB for future reference. Who the beneficiary or beneficiaries are is determined through the Will. We will consider the tax and then the personal/family implications by expanding on the case of Toni and Michael Gomes introduced above.

Tax Issues

Assumptions:

Toni Gomes, a widow, dies at age 80

She has two surviving children:

- Agatha, age 50 - Agatha has two children: Irene, age 25, and Paulo, age 23
- Peter, age 52 - Peter is a lifelong bachelor with no children

Toni has left her cottage to Agatha and Peter jointly through her Will.

At the time of her death, the cottage is valued at \$400,000 with an Adjusted Cost Base (ACB) of \$50,000.

The Implications for Toni's Estate

For tax purposes, the cottage is considered to be sold at its FMV of \$400,000. With an ACB of \$50,000, this triggers a capital gain of \$350,000 (\$400,000 - \$50,000), and a taxable capital gain of \$175,000 (\$350,000 x 50%). Assuming a marginal tax rate of 45%, the Executor of Toni's estate will be responsible for a tax bill of approximately \$78,750 (\$175,000 x 45%). The Executor would not legally be able to distribute any estate assets until this tax is paid. This could be a challenge if the estate does not have sufficient cash to pay the tax, which might force the inheritors to have to sell some assets.

Planning Point - It is important to plan ahead to deal with estate taxes to avoid a situation where your beneficiaries have to sell estate assets to pay the taxes. One obvious solution would be for Toni to have taken out some sort of permanent life insurance with her estate as the beneficiary. This would have provided a death benefit sufficient to pay the estate taxes. For example, if she had taken out a policy on her own life when she was 50, or even 60, for \$100,000, the death benefit could have been used to cover the tax bill on the estate transfer.

The Implications for the Beneficiaries

After Toni's estate is wound up, both Agatha and Peter have a 50% interest in the cottage. For tax purposes, they both have an ACB of \$200,000 (\$400,000/2).

Reducing the Tax Burden on your Beneficiaries

There are ways to reduce or eliminate the tax burden on your beneficiaries when passing down the cottage. One valuable and flexible solution is to transfer the cottage into a trust, either when you are still alive or after you pass. We can discuss whether a trust can help you meet your overall financial planning and estate objectives.

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