

Capital Gains Taxes - Hull on Estate and Succession Planning Podcast #73

Posted on August 14th, 2007 by [Hull & Hull LLP](#)

Suzana Popovic-Montag: Hi, and welcome to Hull on Estate and Succession Planning. You are listening to Episode #73 of our podcast on Tuesday, August 14th, 2007.

Welcome to Hull on Estate and Succession Planning, a series of podcasts hosted by Ian Hull and Suzana Popovic-Montag, that will provide information and insights into estate planning in Canada, from the offices of Hull Estate Mediation in Toronto, Ontario, Canada. Here are Ian and Suzana.

Ian Hull: Hi Suzana.

Suzana Popovic-Montag: Hi there Ian, how are you?

Ian Hull: I'm just terrific thanks.

Suzana Popovic-Montag: That's good.

Ian Hull: We have been working our way around this potentially thorny issue of the family cottage. And while we have not pretended for a moment that we have great tax expertise, we wanted to today talk a little bit about the capital gains tax, what you need to know about capital gains taxes and some of those issues relating to the family cottage.

Suzana Popovic-Montag: Ian, you might recall during our last podcast, we were talking about the fact that family dynamics and emotions play such a strong role when we deal with these cottage issues in estate litigation matters. But I think that next to that, that family dynamic component to it, the other most significant issue really is the capital gains taxes that arise from these kinds of recreational properties.

Ian Hull: And while you can buy or sell your principal residence, the home or the condominium that you might live in without paying capital gains taxes in Canada, on that increased value, you do have to pay capital gains tax on secondary cottages, properties such as the cottage or the chalet or other recreational properties.

Suzana Popovic-Montag: The key exception, though, is when you actually leave this property to your spouse, so that the taxes in that case are actually deferred until your spouse dies. And I know that this is referred to as a spousal rollover.

Ian Hull: But except for that exception, if your vacation property has appreciated in value and your estate may, of course, face a significant tax bill. What we want to talk about a little bit is, you know, what if that tax liability isn't covered. What do we do?

Suzana Popovic-Montag: And Ian, do you think it would be helpful maybe just to talk a little bit about how that capital gains calculation is actually done on a property?

Ian Hull: For sure, because let's just use an illustration. Because, of course, if your beneficiaries have to sell the property to pay the taxes, then your estate plan may not be exactly what you had hoped it to be. So here's an example of how you might calculate a capital gains tax on a property.

Suzana Popovic-Montag: So if you start, let's say, with a property that was purchased back in the 1970's. Let's say that the cottage was actually bought for \$50,000.

Ian Hull: So in 1985 though, of course, you've had to spend some money upgrading. And let's put a number of, say you paid \$50,000 for the cottage and you spent by about 1985 about \$30,000 in upgrading it, putting a little addition on it and that sort of thing.

Suzana Popovic-Montag: And then you look at what the property is actually worth the day you want to sell it and that's the fair market value of the property. And let's suppose that now the property has been very successful in appreciating in value and now it's worth \$600,000.

Ian Hull: So you take the sale price of the \$600,000 and then you take off from it what we call the adjusted cost base.

Suzana Popovic-Montag: And that adjusted cost base is comprised of, you know, what that property actually cost you when you originally bought and what value you've added to it since you purchased it. And that, in our example here, we talked about the \$50,000 being the purchase price and the additional, you know, upgrades to the property of \$30,000, for a total of \$80,000 in terms of the cost base of the property.

Ian Hull: So you're allowed to deduct that cost base off the \$600,000 sale price, leaving you with a resulting capital gain, not a capital gains tax, but a capital gain of \$520,000.

Suzana Popovic-Montag: So since you've purchased that property, it's technically appreciated in value by, you know, \$520,000. And so if you look at the current capital gains tax rules, at least here in Ontario, 50% of that increase in value, that capital gain, is gonna be taxable.

Ian Hull: So just using our example here, remember we said that there was a capital gain of \$520,000, 50% of \$520,000 would be \$260,000.

Suzana Popovic-Montag: And that \$260,000 then becomes taxable at your highest marginal tax rate.

Ian Hull: So if the highest rate, for example, would be 45%, you'd have to pay a tax of \$117,000 in capital gains tax.

Suzana Popovic-Montag: And that, of course, raises the question at the end of the day as to whether or not your estate has sufficient cash to pay that tax liability without maybe having to sell that property or coming up with the cash some other way.

Ian Hull: 'Cause if not, you're potential heirs and the family could lose what is often a cherished asset that you never intended to have sold on the day of your death.

Suzana Popovic-Montag: But the good news, though, is that, you know, with some advance planning, turning your mind to these possibilities and the fact that this could arise, you can actually arrange to cover that anticipated tax liability with some creative estate planning.

Ian Hull: Alright. Why don't we talk about those? And let's start with the first. You know, we've got to really essentially manage the taxes. So the first idea is, and we've used this example in the past, is the idea of life insurance.

Suzana Popovic-Montag: And life insurance, Ian, really is one of the most I'd say straightforward methods of trying to cover your vacation property tax liability when you die. Because what you're doing is you're purchasing life insurance for that very purpose.

Ian Hull: So your estate would receive as a death benefit, a tax free death benefit, the life insurance proceeds. And those proceeds can be used to pay the capital gains tax liability and any other administrative fees and expenses that are associated with settling your estate.

Suzana Popovic-Montag: And the clearest advantage of that then is that you have the comfort of knowing that your family's not going to have to sell your cottage or your vacation property and that at the end of the day, they'll actually receive a larger estate.

Ian Hull: Now in terms of managing taxes, there's another sort of series of steps that you can think of. And we sort of qualify them under transfers during your lifetime.

Ian Hull: And so Ian, as you say, it's another way of actually managing the issue by proposing to deal with your property during your lifetime as opposed to transferring it on death. And it has some advantages do that kind of operation as well.

Ian Hull: So besides selling the property maybe to your family members outright, there are several ways to consider transfers during your lifetime that will help manage the tax.

Suzana Popovic-Montag: And one of the clearest examples that comes to mind is actually gifting the property to the people you intend to get it.

Ian Hull: Another example is making one or more of your children joint owners of the property with you.

Suzana Popovic-Montag: Or even by transferring the property to a trust where you can actually name your children or the other family members as beneficiaries of that trust.

Ian Hull: So if we step back with these three different options and we'll work through these in some detail. But all three options will trigger an immediate capital gain in your name.

Suzana Popovic-Montag: So when you do transfer the property during your lifetime, suddenly that tax liability is gonna be crystallized and it's gonna be your responsibility as opposed to that of your beneficiaries.

Ian Hull: Alright. Let's turn to the gift idea. So if you can afford to pay the capital gains tax yourself that's been accrued to death, and we'll come back to our example before. It's a significant number, it's \$117,000 on what is a \$600,000 property. And you can afford to pay that capital gains now and you want to sort of defer the future gains to the next generation. You may want to consider gifting the property to your children.

Suzana Popovic-Montag: And the effect of gifting the property really is to trigger an immediate capital gains tax that, as we said, you know, would be your responsibility to pay that, which is gonna be taxable in your hands.

Ian Hull: So the long and short of it is you gift it, you pay the tax, you better have the dough at the time you're gifting it or else this plan doesn't really work.

Suzana Popovic-Montag: The good news, though, is that the future capital gains on that property, so if it continues to appreciate in value, that future gain is going to be the responsibility of your children. And it's not going to be taxable until they in turn either die or sell the property. So your death is not going to trigger any tax liability to them.

Ian Hull: So an added bonus is that Land Transfer Tax...there's an extra tax that often applies when you transfer properties. But it doesn't apply when there's gifts and when there's an estate in that situation.

Suzana Popovic-Montag: And there's the added benefit also to your estate of avoiding probate fees at the end of the day which, you know, in most provinces here in Canada, are payable based on the value of your estate.

Ian Hull: Alright, let's turn to the idea of a sale.

Suzana Popovic-Montag: Well, Ian, you can certainly choose to sell your property to, you know, a non-family member or even family members during your lifetime.

Ian Hull: So if you do this, it is usually best to sell the property at fair market value from a tax standpoint.

Suzana Popovic-Montag: And why do you say that Ian?

Ian Hull: Well because you'll still be charged the capital gains tax on the full market value even if you sell it for less. So if you try to give your child a benefit of a lower price then the differential between the actual fair market value and the lower price that you give to your child will be taxable like the gift that we just talked about.

Suzana Popovic-Montag: And in addition to that, the adjusted cost base that we talked about, you know, the original cost of the property plus any value that you've added to it, that adjusted cost base is going to be what your family members are going to be presumed to have paid for it. And it's not the fair market value that they're going to have attributed to them. So they could possibly end up paying a hefty capital gains tax bill down the road.

Ian Hull: So you're sort of, you know, you don't get that far ahead if you try to do the sale route from the tax standpoint. But anyway, why don't we at this point, wind up our podcast for today. We've touched on some of the issues and there are more issues to address in the context of the transfer of the cottage property and we'll save those for our next podcast.

Suzana Popovic-Montag: Okay. Well thanks very much, Ian. I look forward to our next podcast.

Ian Hull: Thanks Suzana.

You've been listening to Hull on Estate and Succession Planning with Ian Hull and Suzana Popovic-Montag. The podcast you have been listening to has been provided as an information service. It is a summary of current legal issues in estates and estate planning. It is not legal advice and you are reminded to always talk with a legal professional regarding your specific circumstances.

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