

## The Family Cottage and Capital Gains Taxes - Hull on Estate and Succession Planning Podcast #74

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Suzana Popovic-Montag: Hi, and welcome to Hull on Estate and Succession Planning. You are listening to Episode #74 of our podcast on Tuesday, August 21<sup>st</sup>, 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 fantastic.

Suzana Popovic-Montag: That's good. Are you enjoying the summer?

Ian Hull: Yeah it's good. It's, you know, it's been a lot of fun and the weather has been good here in Toronto. And a little hot in downtown Toronto a few days, but managed to get up to a cottage from time to time.

Suzana Popovic-Montag: That's good.

Ian Hull: Speaking of cottages, let's continue on with our discussion about cottages. I know our last podcast, we talked about the cottage experience and really just sort of planning steps. Talked a little bit about what we needed to know about capital gains taxes. Used that illustration, which is important, where we broke down, if we recall, there was a sale price of \$600,000. We took the adjusted cost base of \$80,000. Got it to the capital gain of \$520,000 and then the tax payable on that broken down to about \$117,000 to \$120,000 in tax. Just to remind us because that was sort of our starting point, as to what do we do about this \$120,000 tax payable either on death or before.

And we talked a little bit about the multiple uses that we have in managing this tax and this overbearing amount that has to be funded quickly, either after the transfer or after death. So we used a couple of examples too, about transfers during their lifetime. And we talked about the gifting approach. And we got through part of the sale idea. But let's just recap the sale option and maybe work through it a little more carefully.

Suzana Popovic-Montag: It's a good idea, Ian, because when we were talking, we said that, you know, one of the options available in the circumstances, if the tax liability is going to be too high, is to consider actually selling the property to your family during the lifetime. Because at that point, your going to crystallize the tax liability to you and then

deal with setting up any future gains which would then fall to your children or whoever you ultimately leave the cottage to at the end of the day.

Ian Hull: And we crystallized the tax at that point and that really gives you some certainty, both within your own estate planning standpoint and it allows you to not feel the burden of a major tax hit that'll need to be paid down the road. So one of the things that I've experienced is that if you can afford a recreational property, maybe you can afford to give it away earlier or sell it earlier to the next generation. Maybe you can afford to pay the tax early. And I know that sounds sort of counter intuitive because we live our lives trying to defer tax as long as possible. But in so doing, we also defer the issue. And it may be that now, while you're alive, it's better to deal with it, both from a financial standpoint and from an emotional standpoint and managing the family sort of circumstances. For example, a sale of the property at fair market value to one of your kids might be the answer to bring the whole issue forward. And it can be a useful tool from an estate planning standpoint. You weigh that against the fact that you're not doing the classic "defer the tax until you absolutely last moment in time can". And that's a balancing I think you've got to decide whether it works better or not for your family.

Suzana Popovic-Montag: I think another option to sort of keep in mind too is that if you find that the possibility of having to pay the capital gains tax immediately is gonna pose too much of a cash flow problem to you, then you might consider some, you know, fancy estate planning or *inter vivos* planning in terms of selling or gifting the property in installments over a period of years, as opposed to just an outright sale at one point in time.

Ian Hull: So how does that work?

Suzana Popovic-Montag: Well, what would happen, Ian, is that a portion of the property would be transferred each year and then the capital gains tax payments would then be spread out effectively over a longer period of time.

Ian Hull: So that's a more complex way of dealing with the sale, but maybe manageable, more manageable financially.

Suzana Popovic-Montag: And you could alternatively maybe consider selling the property and then taking a mortgage back from your family as consideration if, you know, there's a fear that they wouldn't necessarily have enough money to fund the purchase. Then you could set up an arrangement where you're taking a mortgage back with or even without interest.

Ian Hull: Okay, so...but what happens if you take the mortgage back and you sell it to your son and you take a mortgage back and there is no interest. Does that create problems though?

Suzana Popovic-Montag: It could because you could be, you know, viewed by CRA, the tax authority, as doing a preferential share which might have some negative consequences to the family members.

Ian Hull: Right, because if the mortgage, if it bears interest, you have to declare the interest on your tax return even if the interest isn't paid. So I know CRA will typically just attribute a value, the typical going rate for a mortgage would be "X" dollars and they'll just attribute that as income to you.

Suzana Popovic-Montag: That's right. It's going to be accrued as opposed to a cash paid basis.

Ian Hull: Alright, what about another option entirely outside of this. And maybe a bit outside of the box of what we've been talking about, but a living or an *inter vivos* trust?

Suzana Popovic-Montag: Well, Ian, if you want to transfer future gains in the hands of your children now, but you're not really ready to give up the control of the property, then one of those options is, as you say, this living or *inter vivos* trust arrangement.

Ian Hull: So much like a gift of property though, the transfer itself into the *inter vivos* trust, into the living trust, will trigger an immediate taxable capital gains liability.

Suzana Popovic-Montag: But you can have the structure of the trust set up so that you can maintain control of the property during your lifetime and then have the control pass to your children on your death.

Ian Hull: So again, with no immediate tax liability to them in terms of probate capital gains or Land Transfer taxes, but you can manage the control issue and the tax issues in this living trust arrangement.

Suzana Popovic-Montag: That's right. And that's one of the benefits of that is, is as you say, the control. Like, you're dealing with the property, you're effectively, you know, crystallizing the tax liability, paying it, but you're not losing necessarily the control over the property. You can still go to it when you choose to, that kind of idea.

Ian Hull: So another sort of twist on this living trust idea is that the terms of the trust itself could provide a fund for maintenance and repairs to the property.

Suzana Popovic-Montag: And if you do think about setting up this kind of fund, you want to include in that terms that are going to allow the fund to actually grow over time. So that you do in fact provide a sufficient maintenance fund in the future.

Ian Hull: So it's sort of like a living trust within a living trust. We've got, maybe you put the property into one trust and then you throw some cash into another trust so that it can generate enough money to pay the expenses over time, and that way perpetuate the

ownership of the trust into the next generations without being a tremendous financial burden on the next generations.

Suzana Popovic-Montag: That's right, Ian. That's certainly the idea and, you know, we've seen many of those kinds of arrangements put into place quite effectively.

Ian Hull: So, again without being too overly tax technical about this, what's one of the disadvantages of the living trust from a tax standpoint?

Suzana Popovic-Montag: Well from that perspective, one of the problems with the living trust is that all the income and the taxable capital gains are going to be taxed out. What they call that top marginal rate. And so the capital gain that, you know, likely wouldn't be realized until the property is actually sold, but any income that's going to be generated from investing that maintenance fund is going to be taxed still at that highest rate.

Ian Hull: You know and another issue I was thinking too with trusts is that all the property in the trust is deemed to be sold every twenty-one years for capital gains' purposes. So that, in and of itself, creates us a new layer of bureaucracy in terms of the management of the trust itself. You're always going to be triggering this capital gains every twenty-one years, so you're not going to be able to avoid forever the capital gains within the trust.

Suzana Popovic-Montag: It is generally, though, possible to roll out the property to the trust beneficiaries at the cost base and then avoid any kind of deemed disposition. But that effectively means that the trust then has to be wound up.

Ian Hull: If you're sixty-five years or older, you also could consider getting into the whole sort of realm of setting up an alter ego trust or a joint partner trust or some of the new sort of trust arrangements and transferring of property arrangements that exist in the estate planning world.

Suzana Popovic-Montag: And what would the advantage of that kind of arrangement be, Ian?

Ian Hull: Well if you are over sixty-five and you meet a certain criteria that the CRA will insist on, this will avoid the capital gains being triggered at the time of the transfer. So you are essentially rolling it into a trust that doesn't trigger the capital gains, but your heirs, your ultimate beneficiaries, will have to pay the tax on your death.

Suzana Popovic-Montag: So it's really a deferral it seems, then.

Ian Hull: Yeah.

Suzana Popovic-Montag: And I guess, you know, in those circumstances, you'd be looking to a lawyer to help you deal with these complicated rules that surround these different kinds of trust arrangements and agreements. So that you can come up with

some kind of structure that works really to your best advantage, whether that is, you know, crystallizing and paying the capital gains tax now or deferring it to a later point in time or deferring it even to the time of your death.

Ian Hull: Well I agree and, you know, sort of as we wind up today's podcast, I just...we kind of harkened back to what we sort of see time and time again in estate planning and that is this struggle between dealing with the payment of tax versus dealing with the right, and I say right, the proper maybe, estate planning for the benefit for your family. And the tax benefits don't always equal the estate planning benefits. The family benefits, the idea that, you know, you want to keep harmony and you want to keep balance within the family. And if you are governed, and this is sort of we've gone through these examples so far just in this example, if you're governed by tax avoidance or tax deferral in your estate plan, it can be treacherous because there are so many other factors to consider. And if you have the financial resources for the recreational property, it may be that you should step away from the tax liabilities and exposure and start thinking about dealing with these properties, with your family in mind, not the tax person in mind.

Suzana Popovic-Montag: That's some pretty sound advice, Ian.

Ian Hull: Alright, well listen, thanks very much Suzana and we will go back out into the world of lovely summer here in downtown Toronto.

Suzana Popovic-Montag: Thanks to you Ian. I look forward to our next podcast.

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