What’s up dock? Tax & estate planning for your vacation property

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Many families spend time together away from the hustle and bustle of daily living and retreat to one of the “four Cs”: the cabin, condo, chalet or cottage. Unbeknownst to you, however, is that lurking under the surface of your idyllic retreat may be a host of tax and estate planning issues that, if not tackled early on, could not only cost you (or your heirs) a lot of cash but, in extreme cases, could force the sale of the recreational property that may have been in your family for generations. With some professional advice and some advance planning, however, you may be able to mitigate some of these potential problems.

Income tax planning

Perhaps the biggest tax issue associated with a vacation property is the potential for capital gains tax upon either the sale or gift of the property or upon the death of the owner. As a general rule, if you sell or gift the property while you are alive, you will be taxed on the difference between the amount you receive (the “proceeds of disposition”) and the adjusted cost base (ACB) or tax cost of the property. Note that it’s important to keep receipts for all improvements and renovations made to the property, as these expenditures can be added to the ACB of the property, thus potentially reducing the amount of capital gain upon sale, gift or death.

The main exception to this general rule is if the property is gifted to a spouse or partner[1], either during your lifetime or upon death. If that's the case, then the property is deemed to automatically "roll over" (be transferred to the other spouse or partner at its ACB), so no gain will be immediately reportable. While many parents may wish to give the vacation property to their kids, either while they are alive, or upon death, doing so will result in a capital gain at the time of the gift or on death if the property has gone up in value since the date of acquisition. Here we explore some tax planning strategies to either permanently avoid the capital gains tax or defer paying it as long as possible.

Principal residence exemption

The principal residence exemption ("PRE"), if available, can shelter the gain on a principal residence from capital gains tax.

A principal residence can include a vacation property, even if it's not where you primarily live during the year as long as you, your spouse or partner, or child "ordinarily inhabit" it at some point during the year. A cottage is considered to be ordinarily inhabited by someone, even if that person lives in that property for only a short period of time during the year (such as during the summer months), as long as the main reason for owning the property is not for the purpose of earning income.

Even if you rent it out occasionally, the Canada Revenue Agency ("CRA") has stated that incidental rental income won't prevent a cottage from still qualifying as a principal residence. For more information about rental properties, see the CIBC report So… you wanna be a landlord?

Note that the home does not have to be located in Canada to qualify as a principal residence. The only requirement is that the individual who claims the PRE must be a resident of Canada for each year of claim. As a result, a US vacation property, for example, owned by a Canadian resident may be eligible for designation as a principal residence for the purposes of claiming the PRE. Of course, whether or not it's advisable to do so may also depend on both the income and estate tax considerations of the other country. (See "US Vacation Properties" below).

Prior to 1982, it was possible for each spouse to own a property and designate it as his or her principal residence, with the resulting capital gains being tax-free upon disposition. But now, for years of ownership after 1981, a couple can only designate one property between them as their principal residence for any particular calendar year. When a couple owns more than one home, they may be forced to choose, upon the ultimate sale of the first one, which property will be designated the principal residence for each year during the period of multi-home ownership. You must report the disposition of real estate, even if you are claiming the PRE to shelter all capital gains on the property from tax.

As a result, when you sell one of your personal residential properties, you'll need to decide which property should be designated your principal residence, so that the capital gain on that residence will be sheltered from tax. Doing so will preclude you from using the PRE in the future on the sale of your other property, at least for the overlapping years.

Generally, the decision to claim the PRE when you sell your vacation property as opposed to "saving it" for the disposition of your other property will depend on a number of factors, including: the average annual gain on each property (being the gain on each property divided by the number of years each was held), the potential for future increases (or decreases) in the value of the unsold property and the anticipated holding period of the unsold property.

Non-economic factors may also come into play as you may be more concerned about a current, immediate tax liability today versus a tax liability payable later on (say upon death, by your estate) on the sale of your other property.

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1 In this report, spouse refers to someone to whom you are legally married. Partner refers to a common-law partner under the Income Tax Act, which means someone who cohabits with you in a conjugal relationship, provided the two of you have cohabited for the past 12 months or are jointly parents of a child.

Details of the sale of a principal residence by an individual must be reported on Schedule 3 – Capital Gains of their income tax return, as well as Form T2091 – (IND), “Designation of a Property as a Principal Residence by an Individual.

Life insurance

Although numerous planning ideas are available to reduce or defer the tax liability on the transfer of the cottage, one of the most common ways to deal with it is to fund the payment of the tax through life insurance proceeds. You can purchase a life insurance policy that may help to offset the tax liability upon death.

Depending on the product, and the age and health of the insured, life insurance may be a cost effective solution to help cover the potential tax on the capital gain.

Take Drew, for example. He owns a cottage that he purchased for $500,000, which is now worth $900,000, so there is an accrued gain of $400,000. He wants to pass the cottage on to his kids on his death, and is considering purchasing a life insurance policy to help cover the tax liability. Approximately how much life insurance would he need to cover this expense? Taxes may be up to about 26% of the capital gain itself, depending on the total amount of the gain and territory or province of residence. Drew may, therefore, want to obtain life insurance with a death benefit of at least $100,000. Also consider that should the property further appreciate in value while Drew owns it, additional insurance coverage may be required in order to provide funds to cover the tax liability on those future gains.

The cost of this insurance will depend on factors including age, health, smoking status of the insured individual and the type of insurance policy. Practically speaking, life insurance may not always be feasible. For example, you may not be eligible to obtain insurance coverage based on your age or health, or the premiums may be prohibitively expensive. You should consult with an insurance advisor to determine the type of insurance that may be suitable in your particular circumstances.

You may also consider who should fund the insurance cost? Might it make sense for the ultimate beneficiary to shoulder some of the cost or is it a cost that you are willing to bear even though you won't actually be there when the proceeds actually get paid?

Use of a corporation

It’s generally not advisable to hold a personal residence inside a corporation. The main reason is that under the *Income Tax Act*, the value of the rent-free use of the corporation’s residence by the shareholder is considered to be a taxable shareholder benefit and must be included in the owner’s personal income. The value of the benefit will generally be equal to a market rate of return multiplied by the fair market value of the vacation property, less amounts paid for the use of the property.

The other problem with a corporation holding the property is the inability to claim the PRE on the sale, gift or transfer of the property or the shares of the corporation.

Use of a trust

One of the most common alternate ways to own a vacation property is through a trust. This is often done to avoid the deemed disposition of the property upon the death of the owners. A trust is not a legal entity but rather a relationship that separates the legal ownership of property from the beneficial use and enjoyment of that property.

In Quebec, a trust is a “patrimony by appropriation,” autonomous and distinct from that of the settlor, trustee or beneficiary and in which none of them has any real right.

In a typical scenario, the property's current owner (the trust's "settlor") would transfer the property to a "trustee," perhaps the owner's spouse or partner, who would administer the trust and its property for the benefit of their kids (the "beneficiaries.") The problem with using a trust for a property you currently own is that a transfer of the property to a trust may trigger immediate capital gains tax. There are specific exceptions (such as a transfer to an "alter-ego trust," discussed below under the heading "Probate Fee Planning".)

On the other hand, if you are purchasing a new property or own one that has little or no accrued capital gains or even a loss, you may wish to purchase the property through the trust or transfer the existing property into a trust today so that any future capital gains tax that arises can be deferred until the trust's beneficiaries (generally the children) ultimately sell the property. (Note that a loss on a transfer of a residence to a trust is considered a loss from the sale of "personal use property" and cannot be claimed as a capital loss.)

The trust deed may permit you to enjoy the use of the property during your lifetime. It could be set up so that later on, if you found you were no longer using the property as much, it could be distributed from the trust to the appropriate beneficiaries. When the property is distributed from the trust, it can generally be "rolled out" to the beneficiaries at the original ACB of the property, and thus tax would be deferred until the property is sold by the beneficiary.

For any gain accrued until the end of 2016, the beneficiary of the family trust who received the property was deemed to have owned it since the trust acquired it for the purposes of claiming the PRE upon its ultimate sale. This allowed a child who was the beneficiary of a trust that held the vacation property and who did not own another home while the property was in the trust, to use the PRE to potentially shelter the entire gain from the date of original purchase by the trust to the end of 2016.

Perhaps the biggest problem stemming from using a trust to hold the vacation property, however, is the "21-year rule." This tax rule states that there is a deemed disposition of the trust's property on each 21st anniversary of the trust, which could result in a capital gain on property held in the trust. This could accelerate the tax liability, which otherwise may have been deferred until the last-to-die of the parents who originally owned the vacation property.

It may be possible to avoid the tax obligation from the 21-year rule by distributing the property to the trust's beneficiaries within the 21 year period, as discussed above. The 21-year rule will create difficulties where the beneficiaries are too young to receive a share of the property within that timeframe. While the trust may be able to claim the PRE to shelter any gain accruing until the end of 2016 on this disposition, that may cause problems if the children who are beneficiaries of the trust also own their own homes as it would preclude them from using the PRE to shelter a gain from the sale of those homes. Similarly, if any beneficiary has used the PRE on another property, the trust cannot designate the property as a principal residence for those years.

Effective for years after 2016, only certain personal trusts are able to use the PRE. These "eligible trusts" must have at least one beneficiary who is resident in Canada, and must fall under one of the following categories:

- Certain life interest trusts where the settlor and / or the settlor's spouse or partner have use of the property during their lifetime and, after the death(s) of the settlor and partner, another beneficiary (or beneficiaries) is entitled to the property;
- Qualified Disability Trusts, which are certain trusts established on death where at least one beneficiary is entitled to claim the disability tax credit; or
- Certain trusts for minors whose parents are deceased.

Certain "grandfathering rules" apply for trusts that are not one of the eligible trusts listed above, but were otherwise eligible to claim the PRE for 2016 or previous years. So long as the trust owned the property at the end of 2016, and continued to own it until it was disposed of in 2017 or a later year, the gain accruing until December 31, 2016 will be eligible for the PRE.

Personal trusts that do not fall into any of the above categories cannot claim the PRE for years after 2016.

In addition to tax planning, properly structured trusts may also be used for other non-tax reasons, such as asset protection or minimizing provincial probate fees, as will be discussed below.

Probate fee planning

Upon death, each province and territory (except Manitoba and Quebec) levies an estate administration tax (probate fee) on the value of assets passed through the estate. That probate fee ranges from 0.4% in Prince Edward Island to 1.695% in Nova Scotia. Only Alberta and the territories have maximum caps ($525 in Alberta, $435 in Northwest Territories, $425 in Nunavut and $140 in the Yukon).

For example, the estate of an Ontarian with a $1,000,000 Muskoka cottage would face a probate or estate administration tax bill of about $14,000. There are some common planning techniques that may be helpful to reduce or eliminate probate fees payable upon death.

Joint ownership

One common probate-avoidance technique is to register title of the property in joint tenancy with right of survivorship (JTWROS), whereby each joint owner has an undivided interest in the entire property. This type of joint ownership means that upon the death of one owner, the property is owned solely by the surviving joint owner, bypassing the estate and therefore, not subject to probate. JTWROS is not available in Quebec.

Joint ownership, however, is mired in a plethora of other problems, some of which may be more significant than the probate bill. The biggest problem, and the subject of two 2007 Supreme Court of Canada cases, is proving the transferor's true intention — was it a gift or merely an estate-planning strategy?

For example, say Jack transfers his $1 million Whistler condo to joint title with his adult daughter, Jill, whose family vacations there on weekends in summer and skis there for two weeks during Christmas. Jack’s other child, Jane, lives in Halifax, and does not use the property at all. Upon Jack’s death, title to the property can be placed directly in Jill’s name. This may mean it bypasses the estate and avoids B.C. probate fees of about $14,000. But did Jack really intend for Jill to inherit the entire value of the condo, to the exclusion of Jane? What if the condo was the only major asset owned by Jack upon his death and there was little else left in his estate for Jane?

If the two Supreme Court cases (see "Lessons from the Supreme Court of Canada" below) are any indication of what might happen in this hypothetical example, Jane would likely hire a lawyer and sue her sister for half the value of the condo, arguing that the transfer into joint ownership was merely an estate planning ploy meant to avoid probate. Surely, Dad didn't intend to disinherit Jane — or did he? If he didn’t intend to give the condo to Jill on his death, it might in fact still form part of his estate. And if probate was otherwise required for other assets, the value of the condo might have to be included in the probated estate value in any event.

There are other issues that arise from JTWROS. The original owner gives up sole control of the property and would need the other owner’s permission to mortgage or sell it. As well, the property could be subject to the creditor and family claims of the new joint owner.

Given the high value at stake, it is best to obtain legal advice about the pros and cons of JTWROS and what can be done to make sure the structure properly reflects your intentions.

Lessons from the Supreme Court of Canada

In May 2007, the Supreme Court of Canada (SCC) released simultaneous judgments in two Ontario cases: Pecore v. Pecore (2007 SCC 17) and Madsen Estate v. Saylor (2007 SCC 18). What was at issue in both cases was the meaning of "joint ownership with rights of survivorship" of investment accounts and the true intentions of the original owners when the joint accounts were established.

In the first case, Edwin Hughes, father of Paula Pecore, put nearly $1 million of mutual funds into joint ownership with his daughter Paula. Upon Mr. Hughes' death, the assets in the joint account were transferred into Paula's name. Two years later, Paula and her husband, Michael Pecore, separated and, in the course of the divorce, Michael tried to go after the assets in the joint account since he was a beneficiary under his ex-father in-law's will. His argument was that the transfer of the joint account into Paula's name was not a true gift since it was done "for probate purposes only". Both lower courts disagreed and found that Paula legitimately owned the account absolutely on her father's death through JTWROS.

The second, very similar case, involved Michael Madsen who named only one of his three children, Patricia Brooks, as the joint owner of his investment accounts. After Michael's death, Patricia's brother and sister sued and claimed that their late father only named Patricia on the account "for convenience purposes" and thus no true gift was made. As a result, the monies in the joint accounts should be distributed in accordance with the will, with both siblings receiving a portion of the funds. Both lower courts agreed. The SCC saw no reason to reverse either of these lower courts' decisions. The court found that due to the presumption of resulting trust, the onus falls on the surviving joint account holder to prove that the transferor intended to make a gift of any remaining balance in the account.

Factors that should be considered to determine the transferor's intent include: wording in any financial document used to open the account, control and use of the funds while the transferor was alive, whether a power of attorney was granted, who paid the tax on the account and any other evidence the court finds necessary to establish intent. As a result of these two cases, it may be a good idea to document your intention when making your vacation property JTWROS. One way to do so is by signing a "Declaration of Intention" for joint assets. Legal advice is warranted here.

Trusts, including "alter-ego trusts" and "joint-partner trusts"

Using trusts to hold vacation property can help to avoid probate fees upon death since property inside a properly drafted trust would not be included in the value of your estate. As discussed above, however, transferring the vacation property with the accrued gain into the trust could give rise to immediate capital gains tax.

That being said, if you are at least 65 years of age, you may wish to consider transferring the vacation property into an "alter-ego trust" or a "joint-partner trust", which can be done without having to pay immediate capital gains tax on the transfer. In order to qualify as an alter-ego trust or joint partner trust, you (or you and your spouse or partner, in the case of a joint partner trust) must be entitled to all of the income and no one other than you (or you and your spouse or partner) can be entitled to capital of the trust during your lifetime. You can continue to maintain control of the property through the trust if you are the trustee. In Quebec, you cannot be the sole trustee; you would have to appoint someone else to be trustee or you could appoint yourself and other person(s) as trustees and share control with the other trustee(s).

You can name your children or others as the ultimate beneficiaries of the trust and they would be entitled to the property upon your death (or upon the second death of you and your spouse or partner, in the case of a joint partner trust). Since, at the time of death, you no longer own the property (it's owned in the trust), the property is not included in the value of your estate (or your spouse's or partner's estate, in the case of a joint partner trust) for the purposes of calculating probate fees. And it likely won't be held up in any delay that may arise from administering your estate.

The downside, of course, is that there may be income tax consequences associated with the deemed disposition of the property upon your death (or upon the second death of you and your spouse or partner, in the case of a joint partner trust). The property is deemed to be disposed of inside the trust and would be taxed at the top marginal tax rate. In addition, the trust would only be able to claim the PRE for this property in limited circumstances, as discussed above.

There may be administrative tasks and costs to operate a trust, including filing tax returns. You should obtain legal advice before setting up a trust or transferring property to a trust.

US vacation properties

In Canada, upon death, there is a deemed disposition of all your property at fair market value. Any capital gains tax resulting from accrued appreciation (from the date of purchase to the date of death) is payable on your final return.

This is not so in the US where residents for estate tax purposes (including citizens and domiciled individuals) are taxed on the fair market value of all property owned on the date of death under the "estate tax" regime.

Even if you're not a US citizen, the US estate tax could apply to you if you own "US situs property" upon death (which includes US real estate). The top US estate tax rate is 40%.

There is, however, an exemption available for the first USD$13.61 million in 2024 (USD$13.99 million in 2025) of an estate that is available to US residents. Canadian residents who are not US citizens are entitled to a pro-rated credit under the Canada–US tax treaty which is equal to the exemption of USD$13.61 million in 2024 (USD$13.99 million in 2025) multiplied by the ratio of US situs property to your worldwide estate. Thus, if your worldwide estate, including your principal residence, is under USD$13.61 million in 2024 (USD$13.99 million in 2025), you don't need to worry about US estate tax on your vacation property. But even if you're well below the exemption of USD$13.61 million in 2024 (USD$13.99 million in 2025), you should be aware that the exemption is temporarily doubled, effective if you die between 2019 through 2025. After that time, unless permanent legislation is enacted, the exemption will return to the pre-2018 regime (USD$5 million, indexed to inflation and estimated to be worth around USD$7 millionin 2026, which will effectively cut the estate tax exemption in half.

One strategy to help fund a potential US estate tax liability upon death is to purchase life insurance to cover any tax liability upon death. Keep in mind that the value of such life insurance will be included in the value of your worldwide estate for US estate tax purposes.

Another solution is using "non-recourse" debt, which can reduce the value of the property for US estate tax purposes. This is a mortgage in which the lender only has the ability to collect amounts owing from the sale of the property, as opposed to the general assets of the borrower.

Most cross-border tax professionals today are recommending purchasing the US property through a properly established Canadian trust to avoid US estate tax.[2] The planning surrounding this strategy is beyond the scope of this report.

The interaction of Canadian and US taxes can have some surprising effects. For example, gifting your US vacation property can result in double taxation, as described in the CIBC report Your US vacation property could be quite taxing.

Professional Canadian and US legal and tax advice should be sought before pursuing any strategies involving US properties.

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[2] Prior to 2005, U.S. real estate was often purchased through a Canadian corporation to avoid U.S. estate tax upon death; however, as a result of a change in Canada Revenue Agency administrative policy effective for 2005 and later years, a taxable shareholder benefit is now imposed upon the corporation's owner, making this strategy less attractive. (Pre-existing structures were grandfathered.)

Other issues

This report does not deal with other issues on the sale or transfer of your vacation property such as the potential liability for the Goods and Services Tax / Harmonized Sales Tax (GST/HST) and land transfer tax in applicable provinces and municipalities. That being said, a quick word about each is warranted. Generally, sales of personal-use homes by individuals or personal trusts are exempt from GST/HST.

The land transfer tax rules vary by jurisdiction. For example, in Ontario, land transfer tax must be paid when real estate is transferred, based on the value paid to acquire the property. When the property is simply gifted, if nothing is paid, including when no mortgage is assumed, Ontario generally would not charge a land transfer tax.

Getting the right advice

This publication has provided some general information regarding considerations for your vacation property. You should consult with professional legal, tax, insurance advisors to review and implement strategies that are appropriate in your particular circumstances.

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