

VACATION PROPERTY INCOME TAX AND ESTATE PLANNING

Special thanks to Jamie Golombek, Managing Director, Tax and Estate Planning, CIBC Private Wealth Management, for this summary of income tax and estate planning issues associated with ownership of a vacation property.

Now that summer is here, attention turns to vacation properties. For those who don't have ready access to a property, thoughts can turn to acquiring one.

INCOME TAX PLANNING

If you sell or gift a vacation property while you are alive, for example to your children, you will generally 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 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 common-law partner, either during your lifetime or upon death. If that's the case, then the property is deemed to automatically transfer to the other spouse or partner at its ACB and no gain will be immediately reportable.

It is important to explore some tax planning strategies to either permanently avoid the capital gains tax or, at the very least, to defer paying it as long as possible.



PRINCIPAL RESIDENCE EXEMPTION

The principal residence exemption ("PRE"), if available, shelters the gain on a principal residence from capital gains tax. A principal residence can include a vacation property or cottage, even if it's not where you primarily live during the year as long as you "ordinarily inhabit" it at some point during the year.

Even if you rent the cottage occasionally, the CRA has stated that incidental rental income won't prevent a cottage from qualifying as a principal residence. 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. A U.S. vacation property, for example, owned by a Canadian resident may be eligible for designation as a principal residence. Of course, whether or not it's advisable to do so will depend on both the income and estate tax considerations of the other country. (See "U.S. 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 tax-free upon disposition. The change of rules means that for years of ownership after 1981, a couple can only designate one property between them as their principal residence for any particular calendar year.

Generally, the decision to claim the PRE when you sell your vacation property as opposed to "saving it" for the disposition of another property will depend on a number of factors, including: the

average annual gain on each property (i.e., the gain on each property divided by the number of years each was held), the potential for future increases (or decreases) in value of the unsold property and the anticipated holding period of the unsold property.

LIFE INSURANCE

Although numerous planning ideas are available to reduce or defer tax liability on the transfer of the cottage, one of the most common is the use of life insurance.

You can, when feasible, purchase a life insurance policy to offset the tax liability upon death.

Take Drew, for example. He's 50, and owns a mountain chalet that he purchased for \$400,000, which is now worth \$900,000. He's sitting on an accrued gain of \$500,000, of which only 50% is taxable. How much life insurance does he need to cover off the tax liability when he transfers the cottage to his kids.

Using Ontario's top marginal tax rate of about 46%, Drew's current tax liability to be insured is \$115,000 (46% of \$250,000). The cost of a term-to-100 insurance policy varies by provider but averages about \$1,100 a year if Drew is in good health.

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

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a taxable 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.

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.

In a typical scenario, the property's current owner would settle the property with a "trustee," perhaps the owner's spouse or partner, 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 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.

The trust deed may permit you to enjoy the use of the property during your lifetime. Later on, when you find you are no longer using the property as much, it can 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.

The beneficiary of the family trust who receives the property is deemed to have owned it since the trust acquired it for the purposes of claiming the PRE upon its ultimate sale. This allows a child who is 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.

Perhaps the biggest problem, however, stemming from using a trust to hold the vacation property is the "21-year rule." This 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, accelerating the tax liability which otherwise may have been deferred until the last-to-die of the parents who originally owned the vacation property. Note that tax obligation occurring as a result of the 21 year rule can be avoided by distributing the property to the trust's beneficiaries within the 21 year period, as discussed above.

PROBATE TAX PLANNING

Upon death, each province (except Quebec) levies a probate fee on the value of assets passed through the estate. That probate fee ranges from 0.4% in Prince Edward Island to 1.5% in Ontario. Only Alberta and the territories have maximum caps of \$400 (\$140 in the Yukon). For example, an Ontarian who wills her \$500,000 Muskoka cottage to her kids would face a probate bill of about \$7,500.

In fact, without proper planning, a vacation property could be subject to probate tax twice: once on the death of the original owner and, if left to a spouse or partner, again on the death of the survivor.

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. This type of joint ownership with right of survivorship means that upon the death of one owner the property is simply transferred directly to the surviving joint owner, bypassing the estate. 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 to a specific party or merely an estate-planning strategy?

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TRUSTS, INCLUDING "ALTER-EGO TRUSTS"

Using trusts to hold vacation property can help avoid probate fees upon death since property inside the trust is not 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 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 be an alter-ego trust or joint partner trust, no one other than you (or you and your spouse or joint partner, in the case of a joint partner trust) can be entitled to the income and capital of the trust during your lifetime.

You can continue to maintain full control of the property through the trust, but you can name your children as the ultimate beneficiaries of the trust, who would then inherit the property upon your death. Since at the time of death you no longer own the property - it's owned by the trust - it's not included in the value of your estate for the purposes of calculating probate tax.

The downside, of course, is that there may be income tax consequences associated with the deemed disposition of the property upon death as the property is deemed to be disposed of inside the trust, which is subject to the top marginal tax rate. The trust, however, may be able to claim the PRE for this property, as discussed above.

U.S. 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 is payable on your final return.

Not so in the U.S. where citizens and green card holders 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 U.S. citizen, the U.S. estate tax could apply to you if you own "U.S. situs property" upon death, which includes U.S. real estate.

Estate tax rates for 2009 begin at 18%, and quickly rise to 45% for U.S. situs property above US\$1.5-million.

There is, however, an exemption available for the first US\$3.5-million (2009) of your estate, but it is only available to U.S. citizens. Canadian residents who are not U.S. citizens are entitled to a pro-rated credit under the Canada-U.S. tax treaty which is equal to the US\$3.5-million exemption multiplied by the ratio of U.S. situs property to your worldwide estate. Thus, if your worldwide estate, including your principal residence, is under US\$3.5-million, you generally don't need to worry about U.S. estate tax on your vacation property.

Note that at the time of writing, the future of the entire U.S. estate tax system, rates and exemptions for years after 2009 is uncertain. Close monitoring of U.S. developments in the future will therefore be critical to ensure your planning is up to date.

If, however, your worldwide estate is worth more than US\$3.5-million, it's a good idea to do some advance planning.

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.

Another solution is using "non-recourse" debt, which can reduce the value of the property for U.S. 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.

One recommendation is to purchase the U.S. property through a properly established Canadian trust to avoid U.S. estate tax. The planning surrounding this strategy is beyond the scope of this newsletter and Canadian and U.S. legal and tax advice should be sought before pursuing this strategy.

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We would also like to take this opportunity to wish everyone a safe and enjoyable summer!