Tax and estate planning for your vacation property

July 2024

Jamie Golombek
Managing Director, Tax and Estate Planning, CIBC Private Wealth

Summer is a great time to enjoy a vacation property with family and friends. With real estate values increasing significantly, and notably so for vacation properties, it's also a good time to do some estate planning for the potential transfer of your cottage, chalet or cabin[1] to future generations. This report will focus on tax and estate planning strategies for Canadian vacation properties.[2]

Income tax considerations

One of the primary considerations for transfer of your family cottage, either during your lifetime or upon death, is the capital gains tax that could be payable upon transfer. As a general rule, if you sell or gift the property while you are alive or if you own the property when you die, there will be a disposition for tax purposes, possibly resulting in an immediate capital gains tax if the property has gone up in value since you acquired it. The difference between the amount you receive (the "proceeds of disposition") and the adjusted cost base ("ACB") or tax cost of your property will be a capital gain or loss.[3] When you gift your property to a non-arm's length person, such as your child, for tax purposes your proceeds of disposition will be equal to the fair market value ("FMV") of the property. Note that it's important to keep receipts for all improvements and renovations

1 We generally refer to a vacation property as a cottage in this article.

2 For U.S. vacation property planning, please see our report Your US vacation property could be quite taxing.

3 If you own a property in Canada for less than 365 consecutive days prior to its disposition, the "flipped property" rules may apply so that any gain realized is taxable as business income and not as a capital gain. As such, the PRE will not be available, and the entire gain is taxable as 100% business income. Exceptions exist for a number of life events including the death of the individual or a related party, an addition to a household, breakdown of a relationship, a threat to personal safely, serious illness or disability, work relocation or termination, insolvency or destruction or expropriation of the home.

made to your property, as these expenditures can be added to the ACB of the property, thus potentially reducing the amount of capital gains upon sale, gift or death.

There is an exception to this general rule if you gift the property to your spouse or partner[4], either during your lifetime or upon death. In this case, the property is automatically “rolled over” (transferred at its ACB) to your spouse or partner and no gain will be immediately reportable.

Example 1

Bob and Cathy purchased their Muskoka cottage for $2.4 million. Since then, they spent $600,000 in upgrades and renovations, including building a garage and a new boathouse. They are considering gifting the cottage to their three adult children. A recent appraisal for insurance purposes put the FMV of the property at $5 million.

If Bob and Cathy simply gifted the cottage today to their kids, there would be a deemed disposition of the property at its FMV of $5 million, which would be the proceeds of disposition. Adding the $600,000 of renovations to their $2.4 million purchase price would bring their ACB to $3 million, resulting in a capital gain of $2 million ($5 million minus $3 million). At Ontario tax rates, taxes on the gain would be about $692,000[5], payable on April 30, 2025.

Let’s take a look at some tax strategies to either permanently avoid the capital gains tax or defer paying it for as long as possible.

Principal residence exemption

The principal residence exemption (“PRE”), if available, can shelter the capital gain on a principal residence from 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, or your spouse, 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 (for example, 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 has stated that incidental rental income won’t prevent a cottage from still qualifying as a principal residence.[6]

Prior to 1982, it was possible for each spouse or partner to own a property and designate it as their 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. This becomes a challenge when a couple owns more than one home and is 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. As a result, you should make a conscious decision when you sell one of your personal residential properties whether to designate that property as your principal residence, so that the capital gain will be sheltered from tax. Doing so will preclude you from using the PRE in the future on the sale of any other property for the designated years.

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 gain on each property, 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 your other property, upon sale or upon your death.

---

4 In this article, 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.

5 This assumes taxation at the highest marginal tax rate effective from June 25, 2024 in Ontario and no other capital gains in the year. The tax rate is 24.77% for the first $250,000 of total capital gains realized in a year and 35.69% for the portion of total capital gains over $250,000.

6 For more information about rental properties, see the CIBC report So… you wanna be a landlord?

Life insurance

One of the easiest ways to plan for the tax liability on your vacation property upon death is to fund the payment of the tax through life insurance. You could estimate the current tax bill and buy a permanent life insurance policy today to fund the estimated tax bill. Keep in mind, however, that should the property further appreciate in value, additional insurance coverage could be required in order to provide funds to pay the tax liability on that future gain.

Practically speaking, however, life insurance may not always be feasible. Cottage owners in their seventies (or older) or those in poor health may be uninsurable or the premiums may be prohibitively expensive. You should also consider who should fund the insurance cost. It may make sense for the ultimate beneficiaries (in other words, the kids) to shoulder some of the cost of the insurance as they will ultimately be inheriting the property.

Ownership through a family trust

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 a trust, or transfer the existing property into a trust, so that any future capital gains tax that arises can be deferred until the property is ultimately sold.

In a typical scenario, you would transfer your property to a "trustee" (perhaps your spouse or partner) who would administer the trust and its property for the benefit of other individuals (such as your children). This may provide some degree of control over the property in the future as you can specify terms in the trust agreement that govern how the trustee must administer the property.

One problem with transferring property that you currently own into trust is that this can immediately trigger tax on accrued capital gains. Another downside of putting the cottage into a family trust is that there's a deemed disposition of the trust's property every 21 years. As of June 25, 2024, two-thirds of capital gains realized in a trust will be taxable, without the one-half inclusion rate that's available to individuals for the first $250,000 of total capital gains. This can accelerate the tax liability that might otherwise have been deferred until you died, assuming you live longer than 21 more years. It may be possible for the trust to avoid the tax obligation associated with the 21-year rule by distributing the property to the trust's beneficiaries within the 21 year period, if appropriate to do so, and individual beneficiaries may benefit from the lower, one-half inclusion rate for the first $250,000 of total capital gains in a year.. This may not be the case if the children are not deemed "ready" to take on ownership at a young age.

An exception to the deemed disposition on transfer to the trust, as well as the 21-year rule, is if you transfer the property to an alter ego trust, spousal or partner trust, or joint spousal or partner trust. You (or your spouse or partner or both of you) would have beneficial ownership of the property during your lifetime(s) and taxes would be deferred until (the last of) your death(s). The property would then be transferred to the remainder beneficiaries specified in the trust agreement, such as your children. This can be an effective method of avoiding probate fees upon death as the property does not pass through your estate. Although this type of trust planning does defer recognition of a capital gain until your death (or the death of your spouse or partner), it does not defer capital gains beyond this time and the two-thirds capital gains inclusion rate will apply.

Example 2

Darren and Matthew, a Vancouver couple in their late 40s, have decided to purchase a $4 million family vacation home in Whistler that they plan to enjoy with their young children for years to come. If they purchase the property in their personal names, there could be tax on any appreciation in the value of the property upon their deaths. They are, therefore, considering purchasing the property via a family trust that would have their children, who are currently 2 and 4 years old, as beneficiaries.

In 21 years, there will be a deemed disposition of the property within the trust, which could give rise to capital gains tax. Alternatively, the property could be rolled out to the trust's beneficiaries, their two children (who will be 23 and 25 years old), at the ACB of the property and defer the taxes. Darren and Matthew should consider whether they'd be comfortable transferring the property to the kids at these ages.

Estate planning considerations

Once you've decided to transfer the cottage to the next generation, either now, or upon death, there are a number of non-tax considerations that should be taken into account.

Do the kids even want it?

Before undertaking complex estate planning for your property, the first step is to sit down with the kids to determine if they even want the property after you're gone. While there may be much nostalgia and emotion connected to the property in your mind, the kids may prefer the cash, especially if they have moved far away from the geographical location of the vacation property and thus will be somewhat limited in their ability to enjoy it in the future.

In some cases, it may make better sense to leave the property to the child(ren) that want it and will use it after you're gone, while equalizing the value of your estate (where desirable) through the bequests of other estate assets, such as cash, securities or life insurance proceeds.

Cottage sharing agreement

If you do decide to gift or leave the property to more than one person, consider implementing a formal, written cottage sharing agreement. This document would cover matters such as financial responsibilities for property expenses, terms of use by the family members and guests, division of labour for maintenance, management of the property (such as bill payments and handling correspondence), whether the property can be rented, and how any income would be allocated.

It would also cover decision making processes, such as what to do if one family member wants to sell their interest while other family members wish to retain theirs. You could also consider including a "shotgun clause" that would provide terms for family members to buy each other out in the event of dispute. In addition, life insurance can be used to buy out a family member who passes away and whose surviving spouse and/or kids want their share of the property in cash.

Sinking fund

You may wish to put aside funds to cover future costs, including maintenance, property taxes and even income taxes upon your death. One way to do this is to contribute amounts regularly to a sinking fund (sometimes called a "reserve fund") that is intended to grow to the estimated future amount of these costs. This can lessen the burden of having to provide a potentially large lump-sum amount in the future to fund those expenses. Life insurance can also be used to provide such a fund in the future.

Getting the right advice

This report has provided some general information regarding considerations for your residential properties. The report What's up dock? Tax & estate planning for your vacation property provides additional information. You should consult with professional legal, tax and insurance advisors to review and implement strategies that are appropriate in your particular circumstances.

Jamie Golombek, FCPA, FCA, CPA (IL), CFP, CLU, TEP is the Managing Director, Tax and Estate Planning with CIBC Private Wealth, Toronto.

jamie.golombek@cibc.com

This report is published by CIBC with information that is believed to be accurate at the time of publishing. CIBC and its subsidiaries and affiliates are not liable for any errors or omissions. This report is intended to provide general information and should not be construed as specific legal, lending, or tax advice. Individual circumstances and current events are critical to sound planning; anyone wishing to act on the information in this report should consult with their financial, tax and legal advisors.

The CIBC logo is a trademark of CIBC.