



# PASSING ON THE COTTAGE:

## A Guide for Families

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# Introduction

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After years of enjoyment, many people reach a point where they no longer have the desire or capacity to maintain a second property. Deciding how – and to whom – to transfer one’s cottage isn’t an easy undertaking.

This guide is designed to help cottage owners who want to keep the cottage in the family for future generations to enjoy.



## The family cottage

For many families, time spent together at the cottage is among their most cherished memories. But when it comes time to pass on the cottage, emotions can run high. If not properly handled, family conflicts over what to do with the property can leave emotional and financial scars.



## Talk through your options

The golden rule when it comes to deciding on the future of the cottage is to discuss the issues openly with everyone involved as early as possible. Family meetings are the best way to understand where each member of the family stands. Options should be considered with a view to preserving family harmony.



## Seek professional advice

It’s essential to understand the financial, legal and tax implications of the various options before choosing the one that’s best suited to your family. Throughout the decision-making process, you and your family members should seek external advice to help you avoid costly mistakes.

# Part 1 – Communication is Key

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For your family, the special characteristics of a cottage can make the thought of losing it a flashpoint for emotions. The potential for conflict grows the more children you have, the longer the property has been in the family and the more expensive it is to maintain. However, you owe it to your family to devote the time and energy it takes to make the transition as smooth, equitable and harmonious as possible.

## Family dynamics: 4 potential sources of conflict



### 1. Emotional attachment

Memories of carefree vacations spent with the family can create a powerful emotional attachment to cottages. This attachment can complicate decisions when it comes time to transfer ownership from one generation to the next or sell the property.



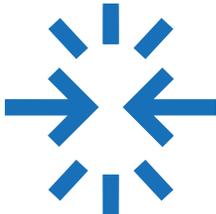
### 2. Misalignment of resources

Family members rarely have equal financial resources to devote to a recreational property. Taxes, maintenance and renovation costs may be beyond the means of some. Others may want or need to sell the cottage to meet different financial goals.



### 3. Role of significant others

An important but often overlooked factor in family dynamics is the role of significant others. They may not have the same emotional attachment to the cottage as family members who have grown up there and may have different vacation interests and financial goals for their family.



### 4. Existing conflicts

Arrangements for passing on a cottage can aggravate existing tensions within a family. Sibling rivalry, divorce and plain old incompatibility can complicate plans for handing down the property or selling it.



## Why early family discussions are so important

Family cottage succession can be a difficult topic for families. Too many avoid the discussion until it's forced upon them, leading to impulsive decisions, family disputes, and in some cases, permanent ruptures.

The best way to avoid those outcomes is to begin thinking and talking about cottage succession early on, when everyone can openly explore the issues. It takes time to come to a consensus on an action plan and get financing in place, if necessary. An early start is crucial to success and that can mean starting the conversation a decade or more before the transfer occurs.

## Identify where family members stand

On a summer long weekend, everyone loves to be at the cottage. But how about when it's time to take out the dock? Make repairs to a leaky roof? Or pay for the installation of a new septic system? What happens when you need to schedule in multiple families and their guests over a short vacation season? It can be expensive, time-consuming and stressful to own a cottage. It may not be for everyone. Differing incomes, wealth and interest in using and maintaining the cottage can lead to conflict during a succession if not discussed and dealt with early.



**Here are some questions to help you assess where family members stand on cottage ownership:**

### **1. Who is interested?**

Some family members will likely have more interest in the property than others, whether because of proximity, lifestyle, income or other factors.

### **2. Who has the financial means?**

It is unlikely that everyone will have the money to pay their share of the taxes, utilities, maintenance and renovation projects. Unless there are ample funds in the parents' estate, one member of the family may have to step up and take on more of the financial burden.

### **3. Who has the time?**

Beyond the money, it's a significant time commitment to coordinate the upkeep and use of a property.

The only way to know for sure where family members stand on cottage ownership is to have a family meeting about it.

# Part 2 – Hold a Family Meeting

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Open communication is critical to resolving conflicts, making fair decisions and taking action on your cottage succession.

Family meetings are the best forum for airing concerns and hashing out problems. While meetings take work and patience, the payoff can be huge when everyone is on the same page and feels their concerns and needs have been taken into account.

## Here are four tips on how to hold productive family meetings:

### 1. Choose a chairperson

- By consensus, select a respected family member to organize and chair meetings.
- This person should call meetings, set agendas and manage the proceedings. Allowing enough airtime for each family member to express their hopes and concerns, without letting the meeting get derailed, is a delicate task.
- The chair should also consult experts as necessary and gather facts and figures.

### 2. Let everyone express their feelings without judgement

- What does the cottage mean to you?
- Do you want to keep it or are you open to selling?
- How do each of the siblings' significant others feel about owning the cottage?
- How do you see dividing up use of the cottage or proceeds from a sale?

### 3. Explore practical issues

- How much does it cost annually to run the cottage (utilities, taxes and ongoing maintenance)?
- What is the current value of the cottage and the capital gains tax liability?
- Are there any required renovation projects in the near term?
- Who has the interest, time and means to take on ownership/upkeep?

### 4. Narrow down your options

- Can the cottage be gifted or is the capital needed to fund retirement?
- How many children want the cottage?

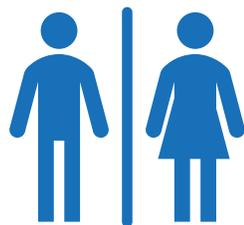
That's a lot of territory to cover and it will require multiple meetings. It's important for each person to come to meetings as prepared as possible to discuss potential issues and find solutions. After each one, prepare a summary of the discussion and ask family members to come back with thoughts, comments and suggestions.



## Part 3 – Succession Options

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There are several options to consider during your family meetings regarding what to do with the cottage. The following list is meant as a guide to get the conversation started, which you can then further explore with your financial planner, accountant, lawyer and/or notary before making the best decision for you and your family.



**Gift the cottage to your children**



**Leave it to your children in your will**

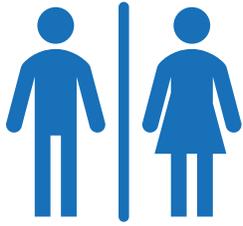


**Place the cottage in a trust**



**Sell the cottage**

# Option 1 – Gift the cottage to your children



Parents can gift the cottage to their adult children. This is a good option if the parents are comfortable with giving up control over the cottage. However, you have to be careful about how you do this to avoid paying double capital gains tax.

## Here are some tips on gifting the cottage to your children:

### Proceed cautiously

An outright gift of the cottage or sale for \$1 will trigger capital gains tax for the parents as if it were sold for its fair market value. And if it isn't done correctly, the Canada Revenue Agency (CRA) could deem the cost base for the new owners (the children) to be zero or one dollar, meaning they would pay tax on the same gains all over again when they eventually sell the property.

### Use a promissory note

A better way is to get an experienced lawyer (or notary in Quebec) to draw up a promissory note in exchange for "selling" the cottage at the fair market price to the children. While the note is deemed payable by the new owners on demand, it can be forgiven or equalized in the parents' will. Under this arrangement, the adjusted cost base to the new owners for capital gains tax is set at the fair market value at the time of the transfer. For the parents, tax on the "sale" can be paid over a five-year period rather than all in one year, using what's known as the capital gains reserve.

### Encourage siblings to sign a cottage agreement

To limit conflicts among siblings, many parents ask their children to sign a cottage agreement that outlines rights, rules and responsibilities that flow from owning the property. Some key elements of a cottage agreement are discussed in Part 4.

### Compensate any non-owning children

Typically, siblings not participating in ownership of the cottage are equalized for their part of its value by getting a greater share of the parents' estate. This can also include an extra sum to recognize that the cottage-owning siblings got a portion of their inheritance early and thus the non-owners need to be compensated for the time value of money for receiving their inheritance later.

# Option 2 – Leave the cottage in your will



Parents often opt to leave the cottage to their children in their will. Ideally, the succession has been thoroughly discussed with everyone and carefully planned, such that the will simply reflects what has already been agreed. If ownership is divvied up in the will without prior discussion, it can provoke serious conflict within the family.

## Here are some things to consider before bequeathing your cottage:

### Update your will

You will need to update your will to reflect your decision to bequeath your cottage. You should also discuss the more detailed succession issues with a lawyer or notary. For example, if one of your children unexpectedly passes away before you, would your grandchildren inherit their parent's share of the cottage?

If your cottage is in a different province or country than your primary residence, consider drafting a second, complementary will in that jurisdiction to deal specifically with the cottage. This often simplifies settling your estate and depending on the province in question, can avoid probate costs.

### Plan ahead for capital gains and differing interest in ownership

Ideally, there are enough assets in the estate to cover the capital gains tax owed and the parents already know who among the children is interested in owning the property. The children who aren't interested can be compensated for its value by getting a greater share of other assets in the estate. Alternatively, the siblings who are interested in keeping the cottage can buy out the others, assuming they can afford to do so.

If there's not enough money to cover the capital gains tax and/or equalize the non-owning children, a sale of the cottage will likely be triggered after the death of the last surviving parent. If this is a possibility you want to avoid, you should consider other options, such as buying life insurance to cover the capital gains tax or creating a trust.

### Limit the time to settle ownership

If your children can't agree on who should get the cottage ahead of time, set a time limit in your will after your passing for the children to decide who is interested in the cottage, have it appraised by an independent third party and settle ownership. If no agreement is reached after the specified time limit, the property is sold, and the proceeds divided equally. Typically, this is one or two years from the date of the second parent passing away.



## Option 3 – Place the cottage in a trust



A more complicated solution is to place the cottage into a trust either while you're alive (an inter-vivos trust) or in your will (a testamentary trust). This creates a separate entity through which the cottage's affairs are conducted at the direction of the trustees, who are often also its beneficiaries. In this way, it is possible to put money into the trust to pay for maintenance, taxes and other bills. This ensures the cottage will stay in the family and the children who might not otherwise be able to afford it can continue to use it.

## Here are some pros and cons of using a trust for cottage succession:

### Consider the capital gains implications

There are different types of trusts depending on your age and province of residence. They have different implications for when the capital gains tax must be paid. In general, the gain in value will be taxed either when the cottage is first placed in the trust, or upon the death of the second parent who placed the cottage in the trust. However, once the capital gains tax is paid, the tax on any growth in value thereafter will accrue to the trust or its beneficiaries.

After 21 years, by law, there is a deemed disposition of the trust property at its fair market value. Unless this deemed disposition tax is planned for, the trustees may have to move the cottage out of the trust and into the beneficiaries' names to avoid triggering a hefty tax bill.

### Gain protection from creditors

Putting the cottage property into a trust may protect the cottage from creditors and other claims from bankruptcy or marriage breakdown involving the children or grandchildren. It can also save you probate fees in provinces where these fees apply.

### Beware of the costs in both time and money

Trusts are costly to set up and maintain, so you should have clear goals for taking this route. The trust must file its own tax return every year, even if it made no income, and the trustees and beneficiaries have to be identified as part of this filing. It is also a best practice to document the decisions made by the trustees in a minute book, in case they should ever be disputed.

### Potential for sibling disputes

Whether siblings are jointly managing a cottage as trustees or co-own it outside a trust, the risk of sibling disagreements or disputes is probably the same. Advance discussions among siblings on how they will work together is key to preserving family harmony.

Trust law and the accompanying tax and financial planning issues are complex. Make sure to get advice from experienced legal, tax and financial planning professionals to help you make the best choices in this area. A poorly executed trust will simply kick today's problems into the future, so be sure you have a clear understanding of why you are choosing this option.



## Option 4 – Sell the cottage



Despite emotional ties, the logistical and financial realities of passing down the cottage may be insurmountable. After discussing all the details with your family, you might decide the best solution is to sell the property. A recreational property is a valuable asset; the proceeds from its sale could make the difference between just scraping by and a comfortable retirement.

### Sell to a family member

You may find that not all your children are as excited about the prospect of owning the cottage as you imagined, especially if they have to pay fair market value for it. If a family member does want to buy it from you, there are ways to help them finance the transaction through a private loan or a phased buy-out. Any internal sale should be discussed openly at the family meeting, so it is not perceived as unfair and to avoid any conflict down the road.

### Sell to an external buyer

It might not be feasible for your children to purchase the family cottage. Your best option might simply be to sell to an external buyer.



## Part 4 – The Cottage Agreement

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“Good fences make good neighbors” said Robert Frost in his famous poem *Mending Wall*. If your family decides to own the property jointly between siblings or cousins, a cottage agreement is critical for achieving the peace and harmony that everyone seeks. Like in Frost’s poem, the act of building the agreement together is the most important part of the process.

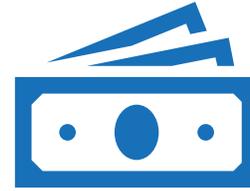
A cottage agreement sets out the ground rules and responsibilities for sharing ownership of the family cottage. A clear document that everyone has signed will help avoid unfairness, disputes and hurt feelings. Ideally, the document is drafted by, or with the support of, a notary or lawyer.

## Here are the key areas your cottage agreement should cover:



### Cottage use

- How will time at the cottage be divided? Can anyone come anytime or will there be a schedule? Can guests be invited during joint use times or only during exclusive use times?
- What are the general rules for things like keeping the cottage clean and stocked with basic supplies?
- What about weekly, monthly and annual chores, like yard care?



### Expenses

- How will costs be divided for ongoing maintenance, utilities, property taxes and major renovations?
- Who will manage day-to-day maintenance and pay the bills? How will the budget be set?
- Should a reserve fund be established to pay for major projects?



### Governance

- How will major renovations and improvements to the property and other key issues be decided on?
- Will a simple majority vote suffice, or does it have to be unanimous?
- How will agreement be reached in case of conflict?



### Succession

- How will proposed sales of ownership shares be handled?
- Under what circumstances will one owner be able to buy out others?
- Can owners leave their share to spouses upon their death or only to children?



## Part 5 – Understanding Taxes and U.S. Considerations

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### The capital gains tax

The capital gains tax often emerges as a central issue in the transfer of a cottage from one generation to another, especially because the increase in property value has meant a corresponding increase in the tax liabilities on recreational properties.

When a property is sold or transferred upon the death of the owner, half of the increase in value is subject to tax at the owner's marginal income tax rate. An exception is made when the property is gifted to or willed to the owner's spouse. In that case, the capital gains tax is ultimately payable when the surviving spouse sells the property or passes away.

### The principal residence exemption

There is no capital gains tax to be paid on a property that is designated as your principal residence. Since 1982, a couple can designate only one home as their principal residence for any given year.

A cottage can be designated as a principal residence so long as it is "ordinarily inhabited" at some point during each year for which the exemption is claimed. This includes living in the cottage for only a short period of time (i.e. a few weeks a year) as long as the main reason for owning it isn't to earn income. The decision on whether to designate the city home or cottage will depend on their relative increase in value in the years they were both owned.

### Points to remember about the capital gains tax:

- **You can't avoid it by gifting the cottage to your children.** And you can't reduce it by selling it to them at a low price. The CRA charges the tax based on the fair market value of the property, regardless of what price you and your children agree upon.
- **Renovations or improvements can decrease the capital gain.** It's important to keep records of all improvements to your cottage. You can't add the cost of regular maintenance to your cost base to reduce the gain, but you can add any renovations that increase the value of the property. For example, painting the house wouldn't qualify, but adding a deck where there wasn't one before would.

### An example of capital gains tax in a cottage succession

In this example, Mr. Smith and Mrs. Smith are considering selling the family cottage and want to know how to use their principal residence exemption most efficiently.

They jointly bought their house in the city in 2004. In 2017, Mr. Smith bought the cottage in his name. In this scenario the cottage increased in value between 2017 and 2023 from \$550,000 to \$900,000. Their city home increased from \$550,000 to \$1.2 million between 2004 and 2023. Here are the relevant details:

Place	Owner	Purchase Year	Purchase Price	2023 Fair Market Value
Cottage	Mr. Smith	2017	\$550,000	\$900,000
City home	Mr. & Mrs. Smith	2004	\$550,000	\$1,200,000

Capital gain on cottage from 2017-2023:  $\$900,000 - \$550,000 = \$350,000$   
 Capital gain on city home: 2017-2023:  $(\$1,200,000 - \$550,000) \times (2023-2017) / (2023-2004) = \$205,260$

To calculate the gain on the city home from 2017 to 2023, you have to pro-rate the total gain by the number of years both homes were owned divided by the total years of ownership of the city home. In this case, the number of years both were owned is 6 (2023 minus 2017) and the total years of ownership are 19 (2023 minus 2004).

The gain on cottage is much larger than the pro-rated gain on the city home for the overlapping years of ownership. Therefore, the Smiths would be better off using their principal residence exemption on the sale of the cottage. As well, the gain on the cottage would all be taxed in Mr. Smith's name, while the gain on city home can be split 50/50 between the Smiths, potentially leading to a better use of each of their progressive tax rates.

# Tax issues for Canadians handing down a U.S. cottage

## U.S. capital gains tax treatment

If you are a non-resident of the U.S., the sale of a U.S. property requires the buyer to withhold tax from the purchase price and remit it to the Internal Revenue Service (IRS). This withholding tax is typically equal to 10% or 15% of the sale price. This is known as the *Foreign Investment in Real Property Tax Act (FIRPTA)*.

You will have to file a tax return to the IRS and to the relevant state for the calendar year in which you sell your U.S. property. If you've owned your cottage for more than a year, the tax rate on the capital gain in the U.S. is 20% of the gain or less. The difference between the amount that was withheld under FIRPTA at the time of the sale and the actual capital gains tax you owe will be refunded to you after you file your U.S. tax return.

You are likely to have to pay capital gains tax in Canada on the sale of your U.S. cottage as well. The Canada-U.S. tax treaty allows you to claim a foreign tax credit to reduce your Canadian tax bill by the amount you paid to the IRS when you filed your U.S. tax return. Since Canadian tax rates are typically higher than U.S. tax rates, you will be required to pay the difference to the Canadian government.

## Estate tax considerations

When you pass away in Canada, the Canadian government deems you to have sold all your assets immediately before your passing. This is what gives rise to the capital gains tax on your cottage when you pass away. However, the U.S. and many states charge an estate tax on the full value of your cottage after your death. That said, your estate will be subject to the U.S. estate tax only if your worldwide assets exceed US\$12.92 million in 2023. This U.S. estate tax exemption limit increases with inflation every year.

For U.S. property owners it is important to stay abreast of the U.S. estate tax exemption limit. The current exemption is scheduled to end after 2025, unless the U.S. Congress passes legislation to amend it. If new legislation isn't passed, the exemption limit will be cut in half for 2026.



## Conclusion

### Communicate

In estate planning, the worst outcome is to surprise your children with the decisions you've made. That's why it's so important to have clear, comprehensive and open discussions about these issues with the whole family as early as possible.

### Start early

Planning and executing the transfer of a cottage in a way that's perceived by all to be fair will reduce the risk of conflict in your family. However, it's complex and time-consuming work. The depth of emotional attachment, the breadth of family relationships and the complexity of the financial and legal considerations create a puzzle that will take time to piece together.

### Get professional advice

It's essential to get advice from experienced professionals. They can explain the pros and cons of different options and navigate the legal and tax implications to help you and your family find the best solution for your situation.

I sincerely hope this guide helps you get started down the right path to seeing generations of your family enjoy the treasured piece of the world that is your family cottage.

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Peter Guay has helped many clients successfully navigate the transfer of a family cottage or other recreational property to the next generation. Peter and his team have the experience to help you identify the best options, guide you through the process and make the right decisions for your family now and in the future.

Peter joined PWL Capital in 2004 and learned the firm's client-first philosophy from the ground up. Nineteen years and many designations later, he is now a seasoned Portfolio Manager and Financial Planner working with families across the country.

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