

Maintain family harmony while reducing taxes

Many families own a vacation property or would like to purchase a second property as a family cottage in Canada or a winter home down south. If you would like to know how the purchase of a vacation home for a certain amount impacts other financial goals such as your retirement goals, then speak to your advisor about incorporating this purchase into a financial plan. The following are some key issues and planning ideas you need to be aware of related to owning a vacation home.

VACATION HOME PURCHASE STRATEGIES

Before committing a large amount of money to purchasing a second property, consider renting in a few desirable areas for a period of time to test the location and neighbourhood. Once you are comfortable with the location and have selected an appropriate property to purchase or build on, the next major decision is how the property should be financed.

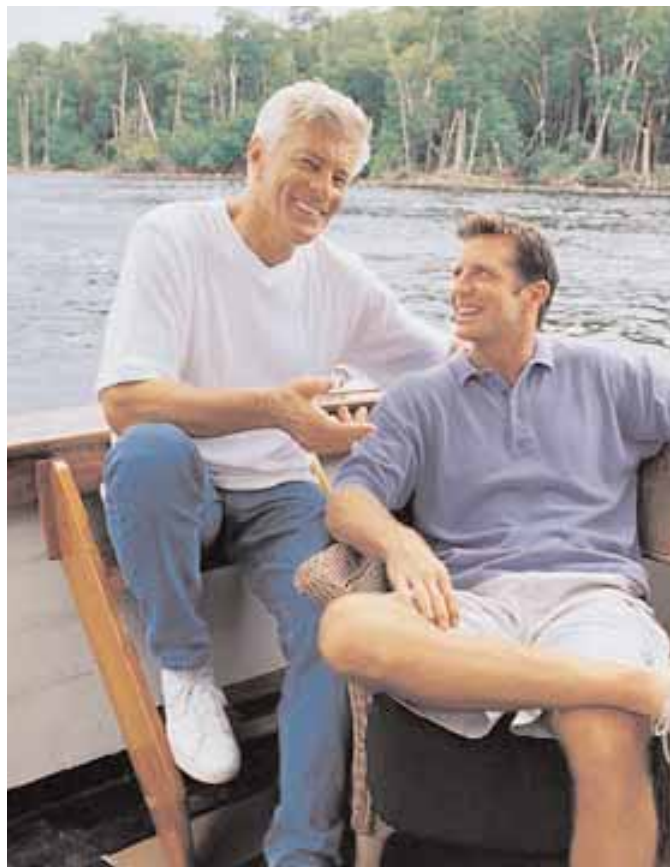
If you require a mortgage to assist in purchasing the property, speak to your advisor. The mortgage interest will not be deductible if the property is used strictly for personal purposes. In order to make the loan interest deductible, consider the following two-step strategy:

1. Use existing cash or investable assets to purchase the property
2. Take out a line of credit to purchase income-producing investments

In this case, since the loan was used directly to purchase income-producing investments and not the personal property, the interest on the loan is potentially deductible.

SUCCESSION PLANNING

In straightforward situations, a person often acquires ownership in a vacation property either solely or jointly with their spouse for control and simplicity reasons. As people get older and no longer actively use the vacation home, people sometimes decide to transfer the property



to their children. However, if the transfer of the property is not structured correctly, disharmony amongst family members can occur.

Here are some succession planning strategies to consider related to a family vacation home:

- › If your children will inherit the property and you expect it to significantly appreciate, consider gifting the property to the children today either directly or through an inter-vivos family trust if you wish to maintain control. Although this results in a disposition at market value, triggering accrued capital gains to you today, the future capital gain tax is deferred and probate taxes are avoided. If the property is sold to the children, your capital gain can be spread over five years in some cases.

VACATION HOME PLANNING

- › For additional tax deferral, speak to your tax advisor about the advantages and disadvantages of transferring the property to either a Canadian corporation or to a non-profit corporation.
- › If the property value is high and you are over age 65, consider the cost/benefit of rolling it into an alter-ego or joint partner trust today in order to avoid probate taxes related to the property at death (particularly in provinces with high probate taxes).
- › You may leave the vacation home to one or more family members under the terms of your Will. Some of your options include granting one or more children the option to purchase the property, allowing a child to take the property as part of their share in the estate or creating a trust to hold the vacation home under the terms of your Will. In this case, the capital gains taxes can be payable upon the death of the last spouse.
- › Life insurance can be used to pay any capital gains taxes triggered by the disposition of the property when your estate is settled. It also creates a pool of funds to pay children who are not interested in inheriting the property (alternatively, children who are interested in the property can take out a mortgage to buy out siblings who are not interested). In addition, life insurance can be used to provide the children with the money necessary to pay for the maintenance and expenses related to the property. Since your children will benefit from this insurance coverage, consider asking them to pay the premiums.
- › If more than one child will own the property, they can enter into a co-ownership agreement to determine when and how they can use it, as well as how expenses will be paid.



VACATION HOME PLANNING

Regardless of the succession planning strategy chosen, two strategies to minimize capital gains tax on the disposition or deemed disposition of your vacation home, either during your lifetime or at death, are:

1. Ensure that any vacation home renovation costs are tracked as these costs add to the cost of the property for tax purposes and will reduce any future capital gain.
2. Use your principal residence exemption to reduce or eliminate the capital gains tax on the property. However, only one principal residence can be designated per family unit for years after 1981. So if the principal residence exemption is used for the vacation property to minimize the capital gains tax, then it cannot also be used to reduce tax on the disposition of the city home related to years after 1981.

Speak to your advisor if you require more information on vacation home planning.

U.S. REAL ESTATE PLANNING

The U.S. government has an estate tax on the fair market value of property located in the U.S., even if it is owned by a non-resident. Furthermore, U.S. states may also impose a probate tax at death based on the value of real estate located in that state. To avoid state probate tax, some cross-border experts will recommend owning the U.S. real estate through a revocable living trust.

U.S. Estate Tax ranges from 18-45% of the fair market value of the U.S. assets; however, there are generous U.S. tax exemptions (indicated in Figure 1) that are available to minimize or potentially eliminate the U.S. Estate Tax.

If your worldwide assets are in excess of the US \$2 million exemption and you have considerable U.S. assets, then there are legitimate strategies to minimize or eliminate the U.S. Estate Tax such as:

FIGURE 1

FIGURE 1	
For deaths in 2008, Canadians should keep these two thresholds in mind:	
US \$60,000	If your U.S. assets (typically U.S. real estate and U.S. stock) are US \$60,000 or less on death, then there would be no U.S. Estate Tax payable regardless of the value of your worldwide assets.
US \$2 million	If your worldwide estate is US \$2 million or less upon death, then there would be no U.S. Estate Tax payable regardless of the value of U.S. assets. If your worldwide estate is greater than US \$2 million upon death then there could be U.S. Estate Tax on the value of U.S. assets.

- › Purchasing U.S. real estate (and other assets like U.S. stocks) through a Canadian corporation, trust or partnership. There are pros and cons to all three of these structures but in particular you should be cautious about purchasing new U.S. real estate through a Canadian corporation.
- › Having a “non-recourse” mortgage against your U.S. real estate – this special type of mortgage reduces the value of U.S. real estate subject to U.S. Estate Tax dollar for dollar.

For more information, ask your advisor for a copy of the article titled “U.S. Estate Tax”. Your advisor can also assist you with U.S. banking or mortgage services related to owning U.S. real estate.