



# ALL IN THE FAMILY

## PASSING THE COTTAGE TO THE NEXT GENERATION

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As parents age, they may think about transferring assets and family heirlooms to their children. Often, one such heirloom is the family cottage. Summer vacations at the family cottage are among the most memorable and cherished of times, holding deep sentimental value for parents.

Not surprisingly, many parents want the family cottage to stay in the family for future generations. It's important to understand the issues surrounding the transition of such an asset to the next generation. This article highlights issues to consider, including income tax implications and options available.

Let's use an example for the typical issues parents must consider in transitioning the family cottage. Mary, 68, and John, 65, are married with two adult children. Mary and John own a family home and a cottage, which was purchased 22 years ago. Recently retired, they are considering options to keep the cottage in the family, ensuring their legacy lives on.

## FAMILY CONVERSATION

First, Mary and John need to have a conversation with their children to determine what is in everyone's best interests. Are the children interested in keeping the cottage? Will they be able to pay the costs to maintain the cottage? What if only one child is interested in the cottage but cannot afford the costs? What if both children want to share the cottage? How can Mary and John ensure the enjoyment and costs are evenly divided between the children? How can conflicts be resolved?

Mary and John must have an open discussion with their children, expressing their desire to keep the cottage in the family as their legacy. At the same time, Mary and John need to listen to their children's wishes regarding the cottage. The costs and responsibilities associated with cottage ownership must be discussed, especially if the parents will not be financially contributing to cottage upkeep. Assuming Mary, John and their children all agree the cottage should remain in the family, several options are available to transition the cottage to the children, each with its own tax implications and other considerations.



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## GIFTING

Mary and John could consider gifting the cottage while still alive to their children. This can be accomplished in different forms, including:

1. **Partial gift**
2. **Outright gift**

### Partial gift

This can be accomplished by transferring the title into joint ownership with the right of survivorship. Under this option, the children jointly own the cottage; when one joint owner passes away, the cottage transfers to the other joint owner, thereby not passing into the deceased's estate. This strategy avoids having to pay probate tax upon the death of one joint owner.

For Mary and John, the initial transfer of the cottage title to the children will trigger a disposition for income tax purposes, as they are viewed to have sold a portion of their interest in the cottage at fair market value. Mary and John will realize a capital gain (assuming the cottage has increased in value since initial purchase), taxed at the rate of 26.77% (in Ontario). Mary and John could shelter the capital gain from income tax by using their principal residence exemption.

### Outright gift

This can be accomplished by transferring title of the cottage to the children today. Like the partial gift, upon transfer, the children will own 100% of the cottage. It will no longer be an asset of Mary and John. As such, there will be no probate tax extinguishable on the cottage upon their death.

The transfer of the cottage will trigger a disposition for income tax purposes to Mary and John and, like the partial transfers, they will be considered to have sold the cottage to their children at fair market value. Mary and John will realize a capital gain taxed at 26.77% (in Ontario). Mary and John could shelter the capital gain from income tax by using their principal residence exemption. They may be eligible to claim a capital gain reserve and be taxable on the capital gain over five years, instead of paying the capital gains tax in the year of the gift, assuming no principal residence exemption is claimed on the cottage.

Since Mary and John own a family home, they must decide whether to use the principal residence exemption on the disposition of their cottage or keep it for their home. The principal residence exemption can only be used to designate one property for each year Mary and John own both the family home and cottage. Analysis is required to determine the higher capital gain over the period of ownership to see how many years, if any, should be designated to their cottage as the principal residence.

Under the outright gift option, Mary and John relinquish control of the cottage to their children, exposing the cottage to the children's creditors. Without ownership and control over the cottage, Mary and John would need to consider whether the children would still permit them to use the cottage. This option may be best suited for when Mary and John are no longer able to use the cottage due to health reasons, and are ready to fully pass the cottage on to their children.



## TESTAMENTARY GIFT

Mary and John could transfer the cottage after their passing to their children, who could own the cottage jointly. Alternatively, a testamentary trust could own the cottage. Under either joint ownership or testamentary trust, a co-ownership agreement stipulating who is responsible for maintenance costs would be needed. The advantage of this option is Mary and John can, during their lifetime, use the cottage and maintain control of it.

Upon the death of Mary or John, the cottage automatically transfers to the surviving spouse without any income tax or probate tax consequences. When the surviving spouse passes away, the cottage would be deemed to have been sold and reacquired for its fair market value at that time, and any accrued capital gain would be taxable. The capital gain could be sheltered by the principal residence exemption, depending on the capital gain on their city home. The value of the cottage would be subject to probate tax.

Upon death of the surviving spouse, the cottage would be transferred to a testamentary trust with the children as beneficiaries. There should be a mechanism in place to ensure cottage upkeep and maintenance. The cottage will be subject to capital gains tax on the 21st anniversary of the testamentary trust, with the principal residence exemption unavailable to the trust to shelter the capital gain.

It may not be tax advantageous to hold the cottage in a testamentary trust unless there are non-tax considerations, such as protecting spendthrift children, marriage breakdown or children's creditors.



## INTER-VIVOS TRUST

Mary and John could consider transferring the cottage to an inter-vivos trust – an alter-ego trust or joint spousal trust. Transferring the cottage to the trust will occur on a tax-deferred basis, provided the income and capital during the lifetime is distributed to Mary and John as trust beneficiaries. To qualify for an alter-ego trust, the trust contributor must be at least 65 years of age, which Mary and John are. Mary and John would control and manage the cottage through the trust as trustees.

Mary and John can name their children as the ultimate beneficiaries of the trust upon death of the surviving spouse. Since the cottage is owned by the trust, when the surviving spouse dies, the cottage will not be included in the estate and, as such, not subject to probate tax.

Upon the surviving spouse's death, the cottage will be subject to deemed capital gains tax, to be paid by the trust. The trust will qualify for the principal residence exemption to shelter capital gains. Analysis of whether to claim the principal residence exemption on the city home or cottage will be required. Any capital gains is subject to the highest marginal tax rate, and cannot be allocated to a beneficiary.



## SELLING THE COTTAGE TO THE CHILDREN

Mary and John could simply sell the cottage to their children. At the time of sale, Mary and John will have a disposition for income tax purposes and be subject to the capital gains tax. The sale must occur at a price they would sell to an arm's-length third party, or current market value. If Mary and John sold the cottage to their children below market price, they would still be considered to have sold the cottage at current market value. Again, if it is beneficial to claim the principal residence exemption, the capital gain could be sheltered.

Note that selling the cottage below market value could result in double taxation, as the children will retain the cost equal to the purchase price of the cottage even though the parents are deemed to have sold the cottage at current market value. A better option would be for Mary and John to sell the cottage at current market value to their children for a promissory note forgivable upon death.

If Mary and John sold the cottage to their children with the sale price to be paid over five years, Mary and John may be eligible to claim a capital gain reserve. This will allow them to spread tax payments on the capital gain over five years instead of paying the capital gains tax all in one year, assuming the principal residence exemption is not used for the cottage.

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## FINANCING UPKEEP

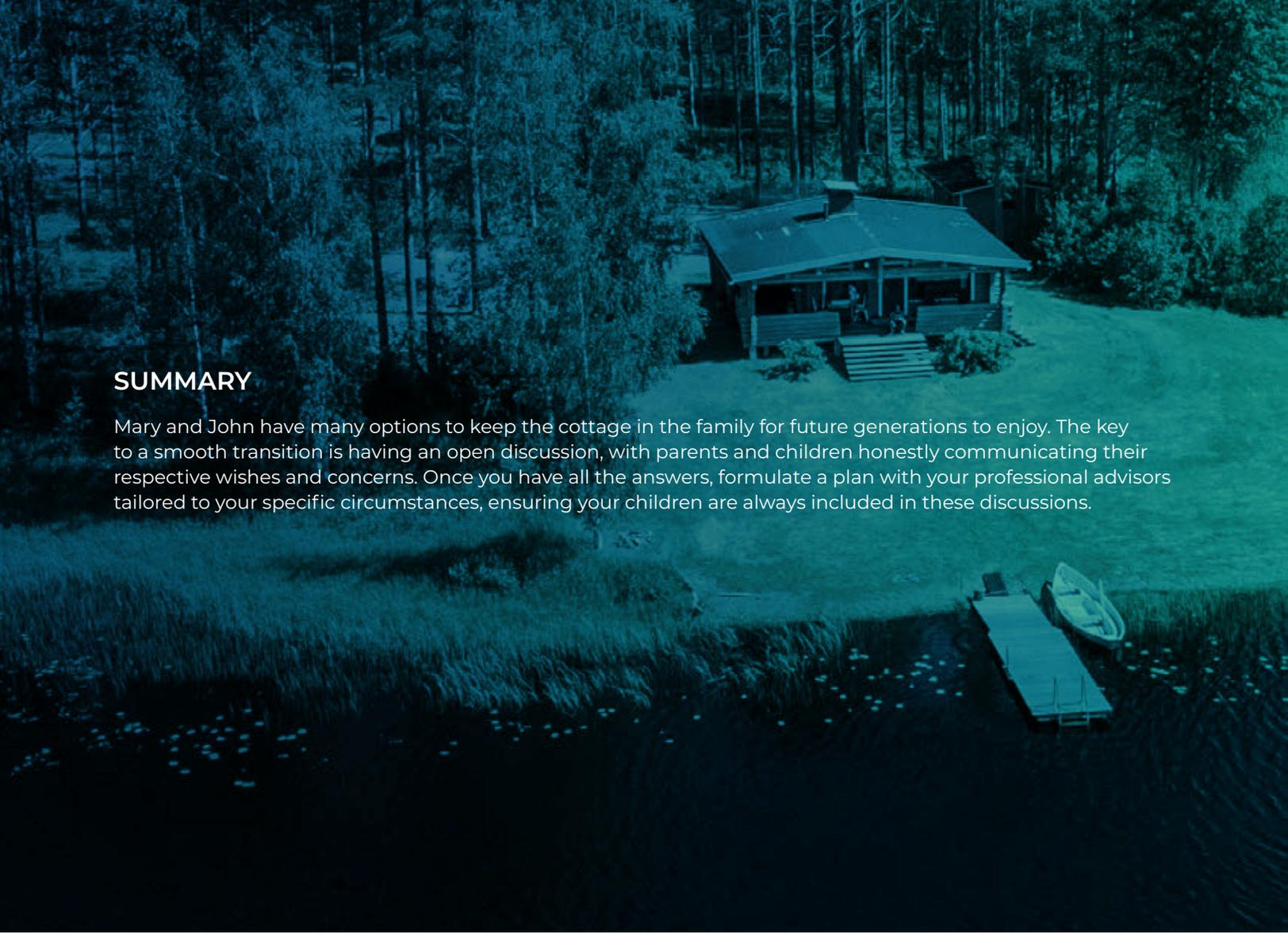
Another option Mary and John might consider is establishing a testamentary trust to finance cottage maintenance and property taxes. Upon passing of the surviving spouse, a testamentary trust could be funded to assist the children with the costs of maintaining the cottage. The executors will invest the funds and use the income and capital of the trust for cottage upkeep.

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## LAND TRANSFER TAX

In any case, Mary and John must consider whether land transfer tax is payable on transfer of the cottage to the children or trust. A real estate lawyer should be consulted.



## SUMMARY

Mary and John have many options to keep the cottage in the family for future generations to enjoy. The key to a smooth transition is having an open discussion, with parents and children honestly communicating their respective wishes and concerns. Once you have all the answers, formulate a plan with your professional advisors tailored to your specific circumstances, ensuring your children are always included in these discussions.

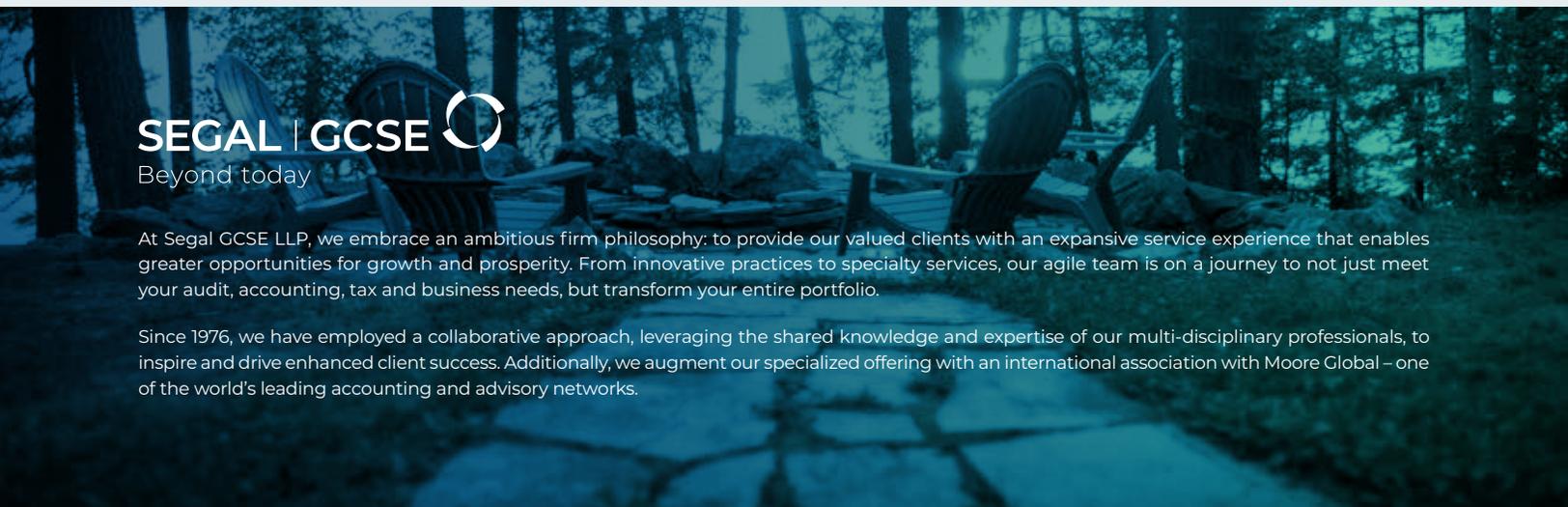
If you have any questions or concerns about transferring family assets, please reach out to our Tax Team.

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