Investor Insights

How to Pass on the Family Cottage

Canadians adore their escapes from the city. And what's not to love? Not only is a cottage a great getaway, bringing joy to families and friends for generations, it's also proven to be a profitable investment for many who purchased their property decades ago.

It may be hard to believe, but this cherished home away from home that has brought your loved ones together over the years can also cause strain on family relationships in the future. When you pass away, an inherited cottage often becomes a source of sibling friction as disagreements arise about how to share it, whether to sell it and what to do about the capital gains that's accrued on it. That's because, unlike a principal residence, which isn't subject to capital gains, second homes are considered investment properties, and capital gains tax is owed when an estate is transferred from parents to children.

The only way to avoid the tax — and only for a finite amount of time — is to roll over the deed to a spouse, as you would with an RRSP or RRIF. That's not possible to do with children, so eventually, taxes must be paid.

There are four main strategies for passing a secondary property like a cottage to the next generation:

Gift it now instead of later

A popular way to deal with the capital gains tax conundrum, especially if you only have one child, is to gift the cottage to them while you're still alive. Doing so means you can pay capital gains based on the property's value today, which makes sense if its value keeps rising.

To minimize the capital gains tax burden from the transfer, you may want to consider stretching out the gift over five years. Keep in mind that doing so might push your annual income into a higher tax bracket each year, instead of just once. And that means the government may claw back income support like Old Age Security.

Don't forget about renovations

Capital gains tax is calculated based on the adjusted cost base of the property. That means you can count any major renovations you've made to the property over the years. This raises your "starting" purchase price and reduces the gain you've made, so you may be able to reduce your taxes. As always, it's best to speak with an advisor and a tax professional to decide if this option makes the most financial sense.

Consider life insurance

Purchasing a life insurance policy that covers future capital gains your heirs will have to pay once you're gone is another option. The policy may even be set up to cover other taxes — like those payable on the disposition of your RRSP, RRIF and other taxable investments. Finally, with enough life insurance, your children could also have enough to fund ongoing maintenance on the property.

Sell it

It's worth having a frank discussion with your children about what they may want to do with the cottage after you pass on. Parents often assume their kids will want to keep it in the family, but the reality is that many children would either prefer to buy one for their own spouse and children or aren't interested in the upkeep once the property becomes their responsibility. Another possibility is that one child may be more attached to the cottage and want to preserve its legacy while another may prefer instead to inherit some other portion of your estate.

If you decide to sell, you may choose to do so while you're still alive or you can stipulate in your will that the property be sold after your death, with taxes and transaction costs paid by your estate and the remaining funds shared by your heirs. While selling it may be emotionally difficult for you and your family, it may also be the most straightforward solution.

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