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Pass down the recreational property, not the taxes

Recreational properties are known by many different names in Canada, such as cottage, cabin, chalet, bungalow or lake house. Regardless of what they're called, these wooden-clad structures are more than just an asset to their owners; they're a home of cherished memories. An asset Clients want to keep in the family. Thanks to Canada's recent housing boom, this generous intergenerational gift has likely increased in value. But this exacerbates the tax obstacle the family must overcome to retain the property.

Capital gains tax on secondary properties

A principal residence is immune to capital gains tax, but secondary properties aren't. If the owner dies and leaves it to anyone but their spouse, the tax authorities consider it a sale. The profit – the difference between the sale and original purchase price – is treated as a capital gain. Half of that gain is taxable.

Increasing Canadian property values

Canadian residential real estate values were reasonably stagnant between 1850 and 1950 but have increased exponentially since then. According to the Canadian Real Estate Association, Canadian residential real estate has seen average annual growth of 7.5% since 2005.[1] An increase in interest rates or the capital gains tax inclusion rate could negatively impact real estate returns, which in turn could dampen price growth. A prudent approach would be to prepare for this tax liability by running various scenarios for property values, interest rates and capital gain taxation inclusion rate.

[1] Canadian Real Estate Association, Home Price Index, Aggregate values, https://www.crea.ca/housing-market-stats/mls-home-price-index/hpi-tool/

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Planning for the taxes: a case study

Gary and Barb are 70 years old. They bought their vacation property 25 years ago for $100,000. The property's current market value is $1.26 million and they expect it to increase 5% per year. They want their kids to inherit it, but worry about the growing tax bill. This table shows the projected tax liability.[2]

Year	Age	Property value	Capital gain tax
1	71	$1,260,000	$290,000
5	75	$1,531,538	$357,884
10	80	$1,954,674	$463,668
15	85	$2,494,714	$598,678
20	90	$3,183,957	$770,989
25	95	$4,063,626	$990,905
30	100	$5,186,331	$1,271,583

[2] These values assume 50% marginal tax rate, 50% capital gains inclusion rate and a joint life expectancy of 20 years.

The tax liability on their $1.26 million vacation property is $290,000 today. In 20 years, it will climb to $770,989.

Those values could change if we assume the following:

- the appreciation rate increases to 7.5% (the historical average over the last 50 years)
- the capital gains inclusion rate increases to 75%

With those increases, the tax liability at year 20 would be $1.88 million – more than double the original estimate.

Planning for an increase in the capital gains inclusion rate

The formation of the minority Liberal government in 2019 caused partnerships to form across party lines. One topic likely under consideration for the Liberal government is the capital gains inclusion rate. The New Democratic Party (NDP) ran on increasing this rate to 75% from 50%.[3] And if the Liberal government wants certain measures passed, this increase may appear in a future federal budget.

[3] The Navigator, Planning for a possible increase to the capital gains inclusion rate, https://ca.rbcwealthmanagement.com/documents/320080/320096/Planning+for+a+possible+increase+to+the+capital+gains+inclusion+rate.pdf/26c81538-b189-4536-9f70-e77573e87702

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The options

Option 1

Sell the property now

- **Sell it outside the family.** This means the family can't continue to enjoy it, or benefit from future increases in its value.
- **Sell it to the kids.** This keeps it in the family. It allows them to defer taxes associated with future increases in value until the next intergenerational transfer. Tax authorities will consider the property sold at a reasonable appraised value, even if Gary and Barb chose to sell it to the kids at $0. The family may wish to secure a mortgage to pay the immediate capital gains tax charge if they have insufficient cash.

Option 2

Transfer the property to their kids at death

a) Leave the kids to deal with any tax liability

- **The kids could sell the property to a third party.** This generates cash to pay the taxes, but requires time and effort during a period of grieving. It's also not aligned with the parents' wish to keep it in the family.
- **The kids could borrow money to keep the property in the family.** Unpredictable factors could result in undesirable loan terms by the time the transfer occurs, such as interest rates and financial circumstances.

b) Prepare in advance so the kids won't face a tax liability

- **They can create a dedicated savings account.** The investment may struggle to keep up with their property value. A punitive taxation structure could further reduce net returns. It could take many years to accumulate enough money to cover the taxes.
- **They can buy permanent life insurance.** It solves their immediate coverage need and offers tax-free growth of the death benefit. Policy cash values provide liquidity. Sun Life's three permanent life insurance solutions (Sun Universal Life, Sun Permanent Life, and Sun Participating Whole Life) offer variety to meet unique Client needs, with a creditor protected, tax- and probate-free death benefit.

Speak to a Sun Life representative to learn about our **Recreational property calculator**. This Excel tool could help you forecast the liability of a Client's recreational property, including tax and mortgage. It may assist in determining the insurance need.

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