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HOW TO ESTATE PLAN THE FAMILY COTTAGE

By: Tim H.R. Brown

When dealing with estate planning, many families spend a lot of time dealing with emotional assets that may not have significant monetary value, and financial assets with significant monetary value, but not so much emotional value. The family cottage is generally an asset with a lot of value and plenty of emotion.

Due to the myriad of other types of planning that do not work well for family cottages, passing the family cottage on to the next generation is exceptionally problematic.

The topics I will address in this memo include:

1. importance of facts and assumptions;
2. importance of pre-planning and planning;
3. main options; and
4. being realistic.

I will address each one of them in turn. For discussion purposes, I refer to all recreational property as the "cottage", but most of the comments apply equally to ski chalets as they do to apartments in Europe or lakeside cottages in the woods or on an island. I have also assumed the cottage has no commercial activity, such as rental or farming.

Also, please note that, if the owner of the cottage also owns a separate principal residence, it is very likely that upon the sale or gift of the cottage, or the death of the owner, capital gains tax will be applied to the increase in value of the cottage. There are ways to reduce taxes, but there is no general exemption for cottages.

1. Importance of Facts and Assumptions

The first two topics are similar in nature. Given the emotional aspect children and grandchildren often feel about a cottage, one should not make assumptions. It is not uncommon for family members who live thousands or even tens of thousands of kilometres away to still feel they should have equal management,

ownership and enjoyment of a property that in all likelihood they will never use as much as the person who lives an hour away.

However, until the faraway relations actually go through the headache and inconvenience of accessing the property, no amount of logic generally will succeed in telling them they cannot have that opportunity.

Key facts will include the following:

(a) Who is the actual registered owner of the property?

(b) What is the legal and civic address of the property and how many legal lots form the property? Are there water rights, easements, mineral claims, grazing rights, dock licenses or fishing rights? If part of a development, do the governing by-laws or co-operative association rules allow for what the owner wants to do?

(c) Is there a beneficial owner of the property that is different to the owner on title?

(d) What was the purchase price of the property? What is the cost of improvement over the years?

(e) Was the property ever used as a principal residence?

(f) What is the current value of the property?

(g) Who is using it now? How are they using it? When is it used most?

(h) How well do the family, be they siblings, cousins, grandchildren and the like, get along now, and how well are they likely to get along when the unifying presence of a key parent or grandparent is no longer present?

(i) What are the financial abilities of the likely future owners to maintain the property without assistance from the current owners or family?

(j) Do the existing owners have the financial ability to leave funds aside for the upkeep, maintenance and preservation of the property, including such things as taxes, insurance, capital improvements, utilities and general hours needed to keep nature at bay?

(k) Is any owner or potential owner a U.S. taxpayer?

(l) Is any owner or potential owner a non-resident of Canada for tax purposes?

(m) Is any owner or potential owner insurable or not insurable for life insurance purposes?

(n) Is any owner or potential owner bankrupt, insolvent or heading that way?

(o) Are non-blood spouses allowed to be owners at all? Even after their blood-related spouse dies? Or as a trustee for a minor child of a deceased blood-related owner? For clarity, legally adopted children are for our purposes, deemed to be blood-related.

(p) Are corporations or trusts allowed to be owners?

(q) Does the property itself allow, or is it suitable for, the potential use of multi-families at one time?

(r) Are there zoning restrictions or other restrictions on the use the property that will affect what the family would like to do now or in the future?

There are more questions that will become obvious when each family presents itself for discussion on this highly emotional topic.

One important lesson I have learned from my years of practice is that, while many current owners love the idea of designing a system where the existing property can be held in perpetuity for their bloodline, a good lawyer should not encourage this. Who is to know now whether some current child's grandchild will be a drug addict or a member of the Hells Angels?

It must be remembered that sometimes a contract or arrangement is only as good as the people who want to make it work. Therefore, designing a plan to deal with ongoing and potentially problematic actions will simply result in the decreased enjoyment for every owner of the property.

Not only are the future owners going to be sharing an emotional asset together, they will also largely be in business together. They will have to agree on paying taxes, improvements, utilities etc. As such, like any good business relationship, and without being too cynical (the same applies for many marriages), it is important to ask hard questions and consider many types of "what-if" scenarios before making decisions on how to proceed.

Examples of important "what-if" scenarios include:

(a) What happens if an owner cannot pay her or his fair share of expenses?

(b) What happens if an owner gets divorced?

(c) How many decision makers are there? Three children, or, three children ***and*** three children-in-law?

Never underestimate the power of “pillow talk”.

(d) What happens if an owner becomes incompetent and their incompetency results in potential damage to the property or unacceptable and surprise costs?

(e) Do non-owners have any rights to use the cottage at any time?

(f) Should non-equal ownership be allowed?

(g) If an owner becomes a non-resident, do they get to stay as an owner?

(h) Is an owner allowed to mortgage their interest in the cottage?

(i) May all owners agree to a mortgage on the cottage? If so, are there equal personal guarantees? Are all guarantors financially on the same footing?

(j) What happens if an owner is bankrupt or has creditors charging the title of the cottage?

(k) What happens on the death of an owner? Do the deceased owners’ children, spouse or grandchildren have a right to be owners? Do the existing surviving owners have a say in whether such a child, grandchild or spouse has a right to be part of ownership? Generally, there are no rules when it comes to step-children. If the step-children were raised by a step-parent since a very young age, it is common to see them treated as children. However, step-children who just happen to be the children of a newer spouse generally are not treated as children. There are no rules. Each family needs to decide what works for them.

(l) How should use of the cottage be regulated? Does everybody get one week at a time? Are there some times of the year where the cottage is far more enjoyable than other types? Is it a ski chalet or a summer cottage on a warm lake? Should people have the same times each and every year or should the there be a rotation through the various times of the year? What is the maximum number of days in a row that someone should be allowed to use it? Should people be allowed to trade their allotted times? Does the cost of upkeep run with the amount of use?

(m) What are the other assets of the current owners that may be more appealing to one or more of the potential future owners? What I mean by this is that if, in simplest terms, a current owner has a cottage in British Columbia and another one in Québec, should the family members who live in British Columbia be allowed to have a portion of ownership of both even if the family who lives in Québec really has no desire to use the property in British Columbia? Also, it may be possible to structure an ownership that only includes local owners who will likely be the heavier users, but for family harmony, allows a more distant family

member the “right” to use the property for say two weeks in July, if they pay, say, $5,000 into the cottage bank account.

(n) What if someone wants out? Do they have a right to be cashed out at fair market value at the time of their choosing? Is there a formula to determine price? Is payment over time? With or without interest?

(o) If there is more than one group of owners that came from a previous generation, do each of those owners have a voice at the “table” or should they be required to appoint just one representative for their family unit?

(p) How much money can any owner spend without getting the consent from any other co-owner?

(q) Should there be a common bank account maintained for the cost of the cottage? If so, how is it funded and what is the balance that should be maintained?

(r) Should there be rules of use of the cottage, i.e. are guests allowed to use it without an owner or an owner’s family member present? Do people have to do the dishes and leave the place in a tidy manner after they have ceased to use it for their allotted time? Instead, may they hire a cleaning service at their own cost? Are people allowed to store personal items at the cottage knowing that they will not be used by others?

(s) Most importantly, what happens when an owner does not abide by the rules and defaults under the agreement? What are the consequences? Are they cashed out? Is she or he fined? Do they get a warning? If yes, how is the warning provided? Is there a vote by the non-defaulting owners? Does it matter if it’s a first default or if there have already been multiple defaults?

Going to court is something most people try to avoid even when they do not know the person they are going to sue and expect that they will never see them again. The reluctance to start inter-family lawsuits is even more extreme. How do you sue somebody that you grew up with and otherwise generally like, and will be having Thanksgiving dinner with? How do you sue somebody who is still going to be in your life after the lawsuit is over?

As such, the remedies allowed for most big financial decisions are not really available for cottages and this is why you should have a clear set of rules that will hopefully allow for the resolution of problems without going to court. That being said, in my years of experience, I have come across families who were otherwise fine, but no longer speak to each other because of the way the cottage was dealt with. This is a very real issue.

In my opinion the best way to avoid the breakdown of the family around the cottage's use and ownership is to be very clear about what the rules are so that people understand them well ahead of time. If possible, the rules should be enforced by the current owner and, ideally, any transition should happen before the passing of the current owners. This will ensure that an established *"course of conduct"* is created and given years of implementation so that, upon the passing of the current owner, nothing changes because "everyone knows the rules".

2. Importance of Pre-planning and Planning

When I prepared these topics, I did not expect to spend as much time on the first one. Clearly the importance of pre-planning and planning is critical.

To me, pre-planning is engaging in family discussion and conversation and, slowly but surely, figuring out where people stand emotionally, physically, financially or otherwise with respect to the cottage.

There is an increasing trend of people having "FOMO", which is the "fear of missing out". However, if one thinks about potential future financial involvement in a cottage they will likely not use that much, they may decide it is better to simply obtain more of another asset or more cash so that they can purchase their own property. Most people do not realize that being a one quarter owner of a cottage for example, is not nearly as convenient or as flexible as being the 100% owner of maybe a smaller and more easily accessible property.

Of course, the smaller and more easily accessed property may not have 30 years of great memories. However, maybe the better investment is buying something locally, and then every once in a while negotiating with, while maintaining an excellent relationship, the local family near the old family cottage, so that the distant relation and their family ends up using and enjoying the cottage without any of the complexities of ownership.

To put things simply, if each of the next generation has a great relationship with each other, the current owners will probably encourage having their siblings and/or nephews and nieces over to the old family cottage to help reinforce the great relationships and memories.

The corollary is also true: should high users and financial owners of the cottage be forced to endure the occasional and unpleasant visits of family with whom they have no relationship? I am not casting fault or blame, but rather just stating that sometimes a relationship between family members depends on effort being made.

Also, those who use the cottage infrequently are less likely to want to invest in improvements that cost a material amount of money. It is very common for family members to disagree on the appropriate amount of financial upkeep of the cottage.

I appreciate that many of the comments so far expressed in this memo do not appear to be overly "legalistic" and are what some people put in the category of "soft issues". However, for my experience, *soft issues* are far harder than the technical issues I normally deal with on a day-to-day basis.

Next are the technical issues.

3. Main Options

I often say that the government would prefer it if you did not do any estate planning, because many government taxes and fees are applicable to what they consider most people will be doing, and estate planning is not as common as it should be.

As cottages are property, each province has rules that govern property ownership, transmission, transfer, taxation, trusts, matrimonial law and creditor law. Most of my comments are based on common law provinces and I do not have much experience dealing with property law in Québec.

When dealing with options, there are essentially two ways I look at things. There is planning to make a change to the ownership of the cottage:

(a) before the current owners die; and

(b) as a consequence of the owners' dying.

Doing the implementation of a change of ownership later is much easier for the current owner because, obviously, they will not actually be part of the process. However, they will also therefore have no control over decisions or adjust for enhanced success. Depending on the current ownership of the cottage, if it is simply in the hands of the current owners in their personal names, it is possible that a will, properly crafted, can deal with many of the options that I will set out below.

If one factors in property transfer tax, income taxes and the control aspects (that I expect most of my clients enjoy) of changing ownership of the cottage, it is preferable to make the change while the current owners are alive and still capable of being part of the process. It is possible to claim some cottages under the Principal Residence Exemption in the *Income Tax Act* and also, property transfer tax exemptions should be examined.

It is important to note that “capable” means mentally capable or having proper incompetency planning set up ahead of time. A typical power of attorney will not do the trick unless a solution is for one or two of the wealthier family members, who have not been appointed as attorneys, to simply purchase the cottage at fair market value. This is often not the plan.

(a) *Inter-Vivos* Family Trust

Due to the effect of s.75 (2) and s.107 (4.1) in the *Income Tax Act*, family trusts are just not a great solution. It is often impossible to stop a beneficiary from financially contributing to the upkeep of the cottage. As soon as two beneficiaries, or two trustees, or one person who is a beneficiary and one person was a trustee, contribute to the upkeep of the property, then there is essentially no ability for the trust to distribute the cottage before the 21st anniversary deemed capital gain date, without triggering the gain. I have seen that happen a few times, but in each case, I strongly suggested that the various beneficiaries and trustees swear an affidavit that they had never once financially contributed to the property. If you are going to do a trust, to me, it is only potentially viable when the family is young and the parents are careful and diligent in being the only ones to pay, and at no time can the parents be the controlling trustees. Generally I advise people not to go down this route. That being said, it seems that I am very much in the minority when it comes to estate planning lawyers valuing the benefit of *inter-vivos* family trusts for cottage ownership.

Section 105(2) of the *Income Tax Act* can also be a problem as it may create taxable income where none was thought to exist.

(b) Private Corporations

Due to the shareholder benefit rules in the *Income Tax Act*, having a corporation as a beneficial owner in a personal use property is problematic, to say the least. The CRA is fully aware of this problem and has experience and the desire to enforce the shareholder benefit rules (largely under section 15 of the *Income Tax Act)*. As such, I would never, and I mean never, recommend that a private corporation, especially one funded by business revenue taxed at a corporate tax rate, be the beneficial owner of the cottage where family members related to the owner of the corporation have the right or potential right to enjoy it.

Having a corporation as the registered owner on title, but not as a beneficial owner, may provide some relief to provincial property taxes and probate fees. Although in British Columbia, there is less and less of a likelihood that this will work due to the current government’s desire to fully disclose the true beneficial ownership of all properties and increase the property transfer tax, speculation/vacancy tax and similar types of taxes. However, having a corporation as the registered owner, but not the beneficial owner, is still a good

planning option.

Although rare, I am aware of a few corporately owned personal use properties that remain beneficially owned by the private corporation. What makes these properties special is that at no time was the company funded other than by after-tax dollars paid by the family members. The corporation in question never did anything other than simply own the property, and there is simply not a lot of value or recent activity that would give rise for concern. That being said, a CRA auditor may well still take exception to the structure and apply a section 15 benefit to the shareholders. However, this is a risk that the shareholders may wish to take if the value of the property is nominal.

(c) Co-ownership

This is my preferred option for most families. It comes with its own risks and rewards but, in my experience, has the biggest upside and potential to avoid problems, and allows for the potential of decades of ownership without unexpected and surprise taxation.

The good news about co-ownership agreements is that they can be, and generally are, customized to each family's situation. This means that the agreements, especially where there is buy-in from all signatories to the agreement, will lead to success.

So as not to duplicate material covered above, ideally most of the questions raised both in terms of facts and assumptions as well as the "what if" questions, will be asked and dealt with prior to the drafting of the co-ownership agreement. There will of course be follow-on questions and others that will likely be relevant to each family's situation. Many of the questions discussed above were taken out of my co-ownership agreement precedent.

It is beyond the scope of this paper to go through all the "bells and whistles" of what is in a co-ownership agreement, but suffice it to say, that we have a "well oiled" agreement that is flexible and will generally cover such things as:

(i) default by an owner;

(ii) funding of ongoing costs;

(iii) allotted times of use of the property;

(iv) restriction of ownership to blood family members;

(v) when the agreement terminates;

(vi) special protections for the original owners (i.e. the parents);

(vii) death of an owner;

(viii) life insurance on owners and how to deal with the proceeds of life insurance;

(ix) divorce of an owner;

(x) disability of an owner; and

(xi) enforcement of the terms of the agreement.

The one key take away I have here is that I generally draft the agreement so that the existing owners (likely the parents) have special rights and are required to generally pay for everything while they are alive and competent, and the next generation have a right to use of the property, but upon the death of the next generation owners, they have no right to pass it on to their children.

If a deceased owner wants her or his children to have a right to buy in to the cottage and obtain the benefits and responsibilities of being an owner, it is incumbent on that child to show the surviving owners of her or his parent's generation, that she or he, or they, will be an excellent owner and a real contributor to the ownership, maintenance and enjoyment of the cottage. Any right drafted now that gives a young adult or child the right to be an owner, for example twenty years in the future, is exceptionally problematic, because nobody knows what this young person will be like at that time. Even if they are loved, maybe their spouse and children are not.

No solution is perfect and the biggest negative of the co-ownership agreement is the amount of time, effort and (sometimes) legal fees that go into drafting, designing and implementing a solid agreement. I was once tasked with drafting a co-ownership agreement for a cottage on the lake that gave rights of ownership for an unlimited number of generations to come. After 17 hours of drafting, I managed to get down to six generations before the whole thing blew up. I ended up writing off most of my time and advised the client to keep it to one or two generations at most and eventually the agreement was approved by that current group of owners, who were siblings. Like most things, if the owners are engaged and efficient, the cost and headache of drafting a proper co-ownership agreement will be minimized. However, all it takes is one or possibly two people to drag their heels and the costs go up.

To me, the most efficient manner in which to implement a co-ownership agreement is for the current owners to design something that they like and then allow their children to purchase the cottage at a set price, with certain payment terms that are generally very favourable and also minimize taxes, but a condition of the

purchase is that the purchaser sign on to the co-ownership agreement approved by the parents. If the purchaser does not want to sign, then the purchaser does not purchase.

(d) Post Death Planning

This option is common due to procrastination. Sometimes post-death planning is the only option, because no other planning has happened.

If the will is drafted correctly, while there would likely be no minimization of probate fees or property transfer tax, the executors or trustees may have been given the power to design a co-ownership agreement and then give options to beneficiaries if they wish to buy in. If they wish to do so, they must sign the agreement that the executors have crafted.

Most times I have implemented post death planning for a cottage, there are no rules set out in the will and suddenly the executors find their options are limited in number and generally not great, especially when there's been no discussion ahead of time as to what people are thinking.

I would generally encourage the trustees to get consensus from the beneficiaries as to ownership, and failing consensus, simply allow each beneficiary the right to bid on purchasing the property. This may lead to multiple transactions, because maybe one child has a lot of money, and then right after they acquire from the estate, they then sell a portion of it to one or more siblings that they enjoy and want to co-own with. It is very important that the executors of the estate respect their fiduciary duty to each and every beneficiary and in fermenting a solution.

(e) Playing Favourites

While it is generally not a good option for executors to play favourites with beneficiaries, there are generally far less stigma or problems if a current owner plays favourites with their beneficiaries. This means that it is possible that, without any family discussion, the current owners simply choose one or two family members to become the owners of the property during their lifetime. Then, when the current owner dies, the non-chosen children are generally out of luck. And annoyed. This type of co-ownership planning may be by way of joint tenancy or tenancy-in-common, or may or may not be tax efficient.

If the planning was done without prior discussion and disclosure to other family members, and the cottage is as much of an emotional asset to the non-lucky beneficiaries, then the chances of the family being less close is exceptionally high.

Of all the options that can happen, we have no problem with a current owner deciding what is best when it

comes to their own assets, but we strongly recommend they communicate their desire to all children so that there is no doubt that it was the un-pressured desire of the parents to make the decision. Otherwise, what often happens is that the children who did not have the right to buy firmly believe that the one who did buy put undue pressure and misled the parents because there is “no way mommy or daddy would cut me out without being bullied”.

4. Being Realistic

For most of my clients, the goal is to pass on the love, enjoyment and well-being that come from owning a multi-generational cottage to the future generations. I have experience with some families whose siblings would never hesitate to give the shirt off their back to the other siblings and of course the exact opposite, too. Most families are, of course, somewhere in the middle. Where there are more than two children, it is common to see two siblings united against the third.

The main take-away for this part of the paper is not to fight against reality. The value of a cottage is the enjoyment that comes from using it. Even if the current owners love the concept that all of the children would be equal owners and users of a cottage, I strongly, without reservation, recommend that the current owners look deeply into the relationships of their children and also factor in how that relationship will change once the parents die, before making assurances or fermenting an estate plan with respect to the cottage.

Even the most cohesive family units can sometimes find that having family groupings in a cottage at the same time – assuming it can handle that many – is problematic, even in the best of circumstances. It may be as simple as certain people’s preferences for a clean kitchen and others thinking that dishes can be done the next day after they “drip dry”.

Conclusion

Although this is long, I hope I have touched upon many of the important issues that come to your mind when you are thinking about dealing with your cottage. Like anything, there is a pro and a con to each option and there is no perfect solution. Also, like most things, an ounce of prevention is worth a pound of cure, and those who fail to plan, plan to fail.

At the risk of ending with too many platitudes, my other favourite one is: “success is relative; the more success, the more relatives”. And there is nothing like a really nice marquee cottage on a beautiful, private, serene lake to create an emotional need to always be part of it, even if that emotional need is completely unrealistic.

If you have any questions or comments, please do not hesitate to contact your favourite lawyer at Richards Buell Sutton LLP, and failing her or him, please contact me, Tim Brown, at tbrown@rbs.ca or at 604-661-9225.