
THE FAMILY COTTAGE

W*hat to do with the family cottage?* For many, the family cottage is the centre of countless good times where family bonds grew closer and the memories amongst siblings overflow.

For some families, the cottage holds such a magical aura that parents can become adamant that a critical estate planning objective is to “*keep the cottage in the family.*” However, this can be problematic because there typically is no simple strategy to accomplish the parents’ objective. Great caution and a keen sense of the pros and cons of selective ownership strategies are required.

Let’s assume that the parents now have joint and last survivor ownership of the cottage. They have unrestricted use of their property, can make changes or additions as they please and sell or mortgage the property if the financial need arises (such as long-term care in an expensive facility). They can provide for the disposition of the cottage in their wills – and are free to amend these provisions later on if the need arises. Disadvantages of this arrangement include the increasing difficulty for an aging couple to maintain the property, probate fees and income tax on the capital gain at the second death.

Another arrangement is for the parents to transfer the property into joint ownership with their children. The parents would retain some control, but also continue to shoulder some responsibilities. Furthermore, any marital problems of their children could expose the cottage to claims by the in-laws.

Where the parents are prepared to give up ownership and control, the general ownership options include: (1) joint title among the children; (2) a trust; and (3) a holding company. Each option has certain advantages and disadvantages.

The primary issues that need to be considered in transferring the cottage to a subsequent generation include: payment of the accrued income tax liability on capital gains, the timing of when the tax must be paid, how the property might move along to subsequent generations and how the family will manage access and expenses of the property.

Where the cottage will be held in joint title by the children, the tax is triggered upon transferring title from the first generation to the second generation. The resulting disposition will be at fair market value. While the first generation may be able to claim the principal residence exemption, tax may become payable on the disposition of their other home later in life.

A decision will have to be made whether to register the property in joint title with rights of survivorship or as tenants-in-common. Joint title with rights of survivorship means that the title of the cottage will pass onto the surviving children until it is eventually owned by the last surviving child. Tenants-in-common means that each child can bequeath his or her interest in the cottage through his or her estate or gift it during lifetime. It should be noted that even though title may pass automatically under joint title, the deceased child will still undergo

a deemed disposition for tax purposes and income tax may become due.

If the first generation wants to be in a position to exercise some control over the property, consideration could be given to selling the cottage to the children and taking back a mortgage registered on the property. The mortgage could be forgiven upon the first generation's passing, but until that time the first generation could use the mortgage to exercise some control over the property.

The second option is to hold the cottage in a family trust. Similar to transferring the property into joint title to be held by the children, moving title of the cottage to a family trust takes place at fair market value and will trigger any accrued taxes. One significant disadvantage of using a trust to hold the cottage property is that the trust is deemed to dispose of all of its capital assets every 21 years. This cycle of deemed dispositions can cause significant cash flow issues for the family at times of rising real estate values. On the other hand, ownership of the cottage could generally be transferred to one or more of the beneficiaries on a tax-deferred basis before the 21-year deemed disposition date.

The biggest advantage of using a trust is that there is better control over the long-term ownership of the property. The trustees control the property on behalf of the beneficiaries. Beneficiaries can be named in the original trust document by name or by class (e.g., children,

grandchildren, great grandchildren) and similarly individuals or groups of individuals, such as in-laws, can be excluded.

The cottage could also be held by a corporation. While this may have worked in the past if the family paid all of the related expenses of the property, Canada Revenue Agency has changed its administrative position and would seek to charge a shareholder benefit for the value received through the use of the cottage. In addition, the principal residence exemption would not be available for a cottage owned by a corporation.

Under all of the above ownership structures, consideration should be given to having all of the parties involved commit to a unanimous agreement that sets out their rights and obligations with respect to the cottage. Examples of important issues that should be addressed in such an agreement include access to the property (e.g., number of weeks per year) and how the expenses are to be funded. For example, funding could be even for some types of expenses (e.g., property taxes and insurance) and on a usage basis for other types of expenses (e.g., some repairs and maintenance expenses).

There are many possible methods of ensuring that the cottage stays within the family. The strategies employed will depend on the facts of the situation and the issues specific to the family.

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INVESTING VIA A HOLDING COMPANY

The idea that a holding company is only for the rich is a misconception. An increasing number of individuals are considering a holding company as an attractive way to maintain ownership of their investment portfolio. Why? From a pure tax perspective, the theory of tax integration should generally make it a non-issue as to whether an individual holds an investment portfolio personally or inside a holding company. Practically, however, differing provincial tax rates can affect the integration results. The ultimate choice of how to hold an investment portfolio will depend upon the specific facts of the situation, including such factors as personal and corporate tax rates.

Consider the following example of two individuals who have exactly the same portfolio:

- 1/3 invested in interest-bearing securities;
- 1/3 invested in dividend-bearing securities; and

- 1/3 invested in equities that return capital gains.

For simplicity within this example, it is assumed that the capital gains on the equities are realized annually.

The first table on the following page outlines how investment income is taxed if the investments are held personally or in a corporation. The tax rates are combined federal/provincial rates assumed for the purposes of this illustration.

Based on the example, it would appear that the investor has lost value by holding the investment portfolio inside a corporation. However, some of the corporate tax is refundable to the extent the corporation pays out a taxable dividend to its shareholder. The refundable tax is equal to 26.67 per cent of the corporation's taxable income plus the full amount of the refundable tax it paid on dividends received.

	Personally Held			Held Within A Holding Company		
	Interest	Dividend	Capital Gain	Interest	Dividend	Capital Gain
Invested amount	1,000	1,000	1,000	1,000	1,000	1,000
Pre-tax rate of return	4%	4%	4%	4%	4%	4%
Income	40.00	40.00	40.00	40.00	40.00	40.00
Tax rate	45%	30%	22.5%	48%	33.3%	24%
Taxes	18.00	12.00	9.00	19.20	13.33	9.60
Net cash flow	22.00	28.00	31.00	20.80	26.67	30.40

The following table continues the example by highlighting what happens when the corporation pays out its net cash position and maximizes its refund of refundable tax to fund the payment of the dividend to the shareholder (S/H).

	Held Within A Holding Company		
	Interest	Dividend	Capital Gain
CDA balance	n/a	n/a	20.00
Refundable tax %	26.67%	26.67%	26.67%
Refundable tax \$	10.67	13.33	5.33
Dividend to S/H	31.47	40.00	35.73
Less capital dividend	-	-	20.00
Taxable div to S/H	31.47	40.00	15.73
S/H tax rate	30%	30%	30%
Tax	9.44	12.00	4.72
Cash flow	22.03	28.00	31.01

The above table continues the cash flow by showing how the after-tax investment income of the corporation is paid out to the shareholder. There is no requirement to have the corporation pay out its after-tax investment income; however, as can be observed from the above example, the cash position of the shareholder after a dividend is paid is better than the cash position of the company (and thus there is a slight incentive for the shareholder to trigger the withdrawal of the funds from the corporation).

In the above example, there is only slightly less tax paid if the investment portfolio is held through a corporation versus being held personally. However, this observation is

highly dependent upon all of the assumptions with respect to tax rates at the corporate and personal level.

Beyond simply looking at the tax numbers, advantages to holding an investment through a corporation include:

- being able to “trap” income in a corporation and avoid reporting investment income personally. This could be very important if the individual wants to lower (or smooth out) his or her income in order to avoid social benefits clawbacks (for example, the Old Age Security (OAS) clawback).

- income splitting may be possible. However, great care must be taken to observe the corporate attribution rules that come into play with investment

holding companies.

- probate planning may involve holding an investment that would require a probated will if held personally by the deceased inside a corporation, because the shares of a private corporation do not require a probated will to be transferred.

Planning on how to hold an investment portfolio should take into account the fact that some taxpayers may benefit from inequities in the theory of integration. It is, however, important to note that these inequities may be corrected by future tax rate adjustments. As well, be aware that there may be additional costs associated with holding investments through a corporation.

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SMALL BUSINESS DEDUCTION

The purpose of the small business deduction (SBD) is to allow Canadian-controlled private corporations (CCPCs) to more efficiently reinvest profits back into the business and therefore finance ongoing business operations. In simple terms, the SBD is a form of tax shelter where the government levies a lower rate of tax on a portion of active business income earned within a corporation.

In addition to the low level of taxation offered by the federal government, the provinces have also lowered their tax rates on the first layer of active income. These low corporate tax rates provide a deferral of tax on the income earned within the corporation. (The deferred tax will eventually be collected by the government when dividends are paid out to shareholders of the corporation.)

For income earned during 2005, the corporate federal tax rate is 13.12 per cent on the first \$300,000 of active business income. If a corporation's taxation year straddles a calendar year, the small business limit is pro-rated where the limit was different in the other calendar year. Newfoundland/Labrador, Northwest Territories, Nunavut, Prince Edward Island, Saskatchewan and Yukon all have a \$300,000 small business limit for 2005. Alberta, British Columbia, Manitoba and Ontario all have a \$400,000 small business limit for 2005. New Brunswick and Nova Scotia have increased their limits within the 2005 calendar year and, as at the end of 2005, will have small business limits of \$450,000 and \$350,000 respectively. Until the end of 2005, Quebec has no provincial SBD. (However, Quebec recently introduced an SBD with a small business limit of \$400,000 for the 2006 calendar year.)

The effective corporate tax rate on the first level of active business income (i.e., the lesser of the federal small business limit and the provincial small business limit) for a taxation year ending at December 31, 2005, is as follows:

	Tax Rate		Tax Rate
Newfoundland/Labrador	18.12	Saskatchewan	18.12
Nova Scotia	18.12	Alberta	16.12
Prince Edward Island	19.87	Northwest Territories	17.12
New Brunswick	15.37	Nunavut	17.12
Quebec	22.02	British Columbia	17.62
Ontario	18.62	Yukon	17.12
Manitoba	18.12		

For businesses that operate in more than one province, trying to structure business activities in order to achieve the lowest tax rate is not necessarily an easy matter; a corporation's income must be allocated amongst the provinces in which it operates. Consideration is given to the place of incorporation, the permanent establishment of the business, payroll within

each province and sales/gross revenue earned within each province.

The small business limit is only available to Canadian-controlled private corporations. However, a corporation's small business limit is reduced if the corporation pays Part I.3 (or "large corporations") tax. The reduction for the large corporations tax ensures that very large private businesses (i.e., those with capital in excess of \$10 million) do not get the full value of the small business deduction. The SBD is eliminated completely for businesses with capital in excess of \$15 million.

The corporation's small business limit must be shared with any "associated" corporations. This prevents individuals from multiplying the small business limit by simply incorporating several companies. In general terms, corporations are associated if they are controlled by the same person or group of persons. One planning technique for families to multiply the small business deduction is to have each company owned by a different family member. The primary issue that must be addressed with this strategy is to ensure that each family member is truly managing his or her business and there is

no common management and control by one or a group of family members.

The SBD is an important piece of the support that the government offers to private business in Canada and it is important for every business owner to understand the value and maximize the benefits of the small business deduction.

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