Insurance

Reflecting on Your Cottage

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You may be part of one of the thousands of families in Canada that will be spending at least some of your summer at the family cottage. Depending on which area of the country you live in, you may not refer to this special place as the cottage, but instead as your summer home, country home, lodge, chalet, camp, cabin or ranch. No matter what you call it, it's likely that countless memories were formed there and it holds a special place in your heart and for your family. If this is true, there are some estate planning strategies that you may want to consider; strategies that will ensure that this asset that holds such significant value, both financially and emotionally, will be enjoyed by generations to come.

Strategy 1: Will Your Kids be Able to Afford the Tax Bill?

If your family property has risen in value since the time you purchased it, and it is not considered to be your "principal residence" for tax purposes, the gain will eventually be subject to capital gains taxes. If you've owned the property for a long time and the value of it far exceeds its original cost, it could equate to a substantial tax-bill.

Consider the example of Joan and Jack Hill, who purchased their family cottage for $50,000 in 1983, when they were both 40 years old. The value of the cottage has grown about 7% annually over the last 20 years and its value today is approximately $200,000. Assuming the property value continues to grow by 7% year-over-year, it will be worth $1,085,486 when Joan and Jack reach their life expectancy in 2028 (at age 85). For calculation purposes, let's assume that both individuals passed away that year.

Since this asset is assumed to have been sold at fair market value immediately before death, the capital gain would be $1,035,486 ($1,085,486 – $50,000). Under current tax rules, half of this amount ($517,743) would be taxable and added to the owner's income in the year of death. Using today's highest tax rate of 46.41%*, this would mean a final tax bill of $240,285 on the cottage only, notwithstanding probate and any other taxes owing from other assets. Where will Joan and Jack's three children get the funds to pay for this tax bill? From their savings? By borrowing? Another unfortunate option is having to sell the cottage in order to pay the bill.

Joan and Jack could take advantage of a simple and cost-effective solution, which involves permanent life insurance such as Term-to-100, Universal Life, or Whole Life, that would ensure that funds would be available to pay the taxes. Since the estimated tax owing at their life expectancy would equal $240,285, Joan and Jack today could purchase a joint last-to-die policy with a $240,000 death benefit, that would only cost them $2,534 per year**. This premium can be paid by Joan and Jack or by their children. Through effective planning, the taxes can be immediately funded for an annual payment of just 1.05% of tax bill or just 0.23% of the projected value of the cottage. Seems like a small price to pay for something that means so much.

** In Ontario*

*** Based on Manulife joint-last-to-die T-100 coverage as of July 4, 2003, for a 60-year old non-smoking couple.*

Strategy 2: Only One of the Kids Wants the Cottage

Another issue that your children could face, beyond the hefty tax bill, is the question of who will inherit the cottage. In many instances, this is a non-issue – your kids will receive equal ownership of the cottage. However, perhaps some of your kids now have a cottage of their own; or maybe some of your kids live overseas or in another part of the country. You may have only one child who has the time or interest in maintaining your family cottage. Whatever the reason, if this situation arises and you wish to leave the family cottage to only one of your children, you will likely want the rest of your children to be treated equally, financially.

Let's look at the Hill family once again, using the figures illustrated in the previous example. From time to time, the entire family (which now includes the spouses and children of three kids – Jason, James and Julia) gets together at the cottage. These weekend get–togethers don't occur as frequently as they used to and Joan and Jack felt it was time to sit down with their kids to inquire about their interest in who would like to inherit the cottage, when that time came.

For various reasons, Jason and Julia were not interested in a share of the cottage. This left James, who was intent on keeping this cottage in the family for future generations to enjoy. Jack and Joan will designate James as the beneficiary of their cottage in their will. By taking an inventory of the rest of their assets, they realized that there would be inequitable inheritances for the children on an after tax basis, as illustrated in the following table:

Example Showing Potential Value of Inheritance

Asset	Adjusted Cost Base (ACB)	Value Today	Value in 25 yrs. (Life Expectancy)	Taxes Payable (46.41%)	Value of Inheritance (After Taxes Paid)	Beneficiary
Cottage	$50,000	$200,000	$1,085,486	$240,285	$845,201	James
Home (Principal Residence)	$65,000	$300,000	$400,000	$0	$400,000	Jason & Julia (equally)
Investment Portfolio	$40,000	$300,000	$800,000	$176,358	$623,642	Jason & Julia (equally)

Source: ScotiaMcLeod

By naming James as sole beneficiary of the cottage and Jason and Julia as equal beneficiaries of the remaining assets, this meant that James would potentially receive a $845,201 inheritance while Jason and Julia would only each receive $511,821 ($400,000 + $623,642 divided by two).

As in the first example, the use of permanent life insurance could solve the dilemma that this couple is facing. At a cost of $6,647 per year***, Jack and Joan can purchase a Term-to-100 policy with a $667,000 face amount, making Jason and Julia equal beneficiaries of it. This amount would be split equally, in addition to the $1,023,642 of other assets that they would split equally. By doing so, Jack and Joan have ensured that each of their three children would receive equal after-tax inheritances of roughly $845,000 each.

*** *Based on Manulife joint-last-to-die T-100 coverage as of July 4, 2003, for a 60-year old non-smoking couple.*

The examples presented on the previous page list two of the scenarios that may arise when thinking about how to ensure that the cottage is enjoyed by not only your children, but their children, and perhaps future generations. The same situation may arise when thinking about your home or even your family business. No matter what your personal situation is, with proper planning you can ensure that most, if not all, of your wishes to leave your loved ones in a secure financial situation, will be granted. Speak to your life-insurance licensed ScotiaMcLeod advisor to discuss your overall situation and see what steps you can take to meet your estate planning goals.