May 2023 Financial Planning Email Update

As the warm weather arrives our thoughts turn to summer activities. Many of us have a family cottage. While the parents are alive and involved, they usually provide the leadership and guidance for the family. If there are competing wishes for usage periods or different ideas for improvements, the parents will normally make the final decision. From habit and respect, the children generally go along. Cottage life proceeds peacefully.

When the parents are no longer involved, then differences of opinion may escalate to disputes and result in deadlocks. If all kids are equal owners, then no one can outvote the other. A disgruntled child may decide to sell his or her interest to a third party to be rid of the problem, or even force the sale through court action. The following are potential solutions gathered from several on line continuing education courses offered by Dynamic Funds.

Creating a Cottage Agreement

A Cottage Agreement negotiated and implemented while the parents are active can make all the difference between a short and unhappy period of sibling ownership, and a stable and continuing structure for future generations to enjoy the cottage.

The Cottage Agreement fulfils two important purposes:

1. It is a transition vehicle, safely passing the cottage ownership and control from one generation to the next, retaining the rights and pleasures of the parents while ensuring that the children will be the stewards for the next generation.
2. It is a structure for the children when the parents are no longer involved in the cottage, ensuring that the financial responsibilities, sharing usage issues, division of labour and a fair, mutually agreeable method of dispute resolution is in place to steer clear of the inevitable rough waters.

Sharing the Joy

With shared usage comes the need to address some significant questions, such as:

- Can all children use the cottage all the time, or will there be periods of exclusive usage for each child?
- If there are exclusive periods, how or by whom are those periods allocated?
- Can children bring friends as guests, or will it be family members only?
- Can a child rent the cottage during his or her turn, if he or she cannot use the cottage personally?

The Cottage Agreement process brings such topics to light, permits discussion among the family members, and formalizes the terms that all agree can be accommodated and accepted as a natural consequence of shared usage and overlapping interests.

Sharing the Burden

Maybe your children always agree on everything, but many families risk running into serious difficulties among themselves sooner or later. Some of the issues will be mundane, others will be major. All these considerations have the potential to create friction:

- Who will open and close the cottage?
- Who is responsible for making sure the utility bills, municipal taxes and insurance premiums are paid on time?
- Should the ongoing costs of the cottage be shared in proportion to usage or adjusted for affordability, or simply split evenly?
- How are collective decisions made for changes, improvements or additions?

The Cottage Agreement process will sort out the tasks, fairly distribute the burdens, ease constructive decision making and reduce possible resentments.

Sharing the Costs

Children are not all the same, and children's pockets are not all equally deep. This reality can lead to real problems. For example, if the septic system packs it in there's no choice but to repair or replace it. The cost may be many thousands of dollars. A brother may be able to pay his share out of petty cash, while his sister may be too strapped to contribute. An uncomfortable dynamic arises:

- Does the cottage go unused until the struggling one saves up enough money?
- Does the strapped one have to take out a loan to contribute?
- Does the better off sibling pay for both?

Any of these approaches can lead to dissension, resentment, guilt and hard feelings. Again, the Cottage Agreement provides a structure to deal with these issues in a fair, predictable and business-like way, preserving family harmony. A discretionary reserve built into the ongoing cottage budget can relieve the strain when an unexpected expense hits home.

Keeping it in the Family

Passing on legal ownership isn't the point of the cottage succession process, only a milestone along the way. It's just as important to make sure it stays in the family afterwards. Should a disgruntled or financially strapped child be able to sell his or her share to non-family without involving the other siblings?

Without a Cottage Agreement, any owner can apply to Court to have the property sold and his or her share paid out. With a Cottage Agreement the owners agree to give up this legal right to force a sale for their mutual protection and benefit, and accept other provisions to withdraw.

One approach is to prohibit the sale entirely, but that may be too arbitrary. A child/owner may have a legitimate need to be released from cottage ownership. A preferable approach is to create a responsible exit strategy like providing for a right of first refusal by the other owners, and a reasonable payout mechanism.

No one lives forever, so the Cottage Agreement should provide for a safe inheritance path upon the death of an owner:

- Does the share go to the surviving spouse, who may later remarry?
- Or is it preferred that the share passes to the deceased owner's children?
- Should the surviving parent have a life interest, ensuring his or her continued right to use and enjoy the cottage?

A critical goal is to retain the cottage for future generations. The Cottage Agreement can effectively address the inevitable issues of inheritance.

Avoiding Adversity

No matter how co-operative the children are, it is inevitable that some issues will arise that result in different opinions. A prime purpose of the Cottage Agreement is to provide ways to prevent a difference of opinion developing into sibling friction or escalating into a deadlock or full-blown family dispute.

When there are choices on how to proceed, and differences of opinion among the owners, some matters may be best dealt with by a simple majority. This would work well for non-critical decisions such as redecoration or usage. Larger and more complicated issues may require unanimous approval, such as additions to the cottage or a sale to non-family members.

The Cottage Agreement will clearly identify those issues which will be resolved by simple majority, and which ones need unanimous agreement. It may also provide for amicable approaches such as mediation in certain circumstances.

It's unrealistic to pretend that differences of opinions will never arise, or that such differences will always be defused by family goodwill. With a Cottage Agreement providing structure and dispute resolution provisions, most issues can be resolved long before they become problems. Although every child may not be equally happy with the outcome, he or she will at least accept the result as fair because all children agreed beforehand on the method of resolution.

Minor matters, like not leaving perishable food in the frig or empty gas tanks for the next sibling's turn can be avoided with Rules and Regulations that clarify expectations and prevent inadvertent and unnecessary irritations.

Family Council

Many Cottage Agreements provide for a Family Council, a routine time or date for the family members/owners to get together to discuss and decide upon cottage matters. Often these are annual meetings, usually in the winter off-season. Important business items include setting a budget for payment of the operating expenses and agreed upon necessary or desirable repairs and improvements. Each family member/owner will know how much must be contributed to the cottage coffers to keep everything ticking along for the rest of the year, and can adjust his or her own finances accordingly.

If the Cottage Agreement provides for periods of exclusive usage, then the Family Council is the most appropriate time and place to figure out who gets which block of time. Considering significant matters like the need to repair cottage problems or the wish to improve cottage facilities can be covered during the Family Council, with the budget taking these into account.

And the Council can decide how to allocate the responsibilities for the upcoming year, as to the payment of bills, opening and closing, organization of chores, etc. As a welcome bonus, the Family Council provides a regular opportunity for busy children and their families to get together to co-operate positively – and reinforcing family ties and spirit is always a good thing!

Getting Started

Parents are stewards, maintaining the cottage for their generation and nurturing the next one to take over in turn. It's important to have the cottage capital gains tax and financial aspects sorted out of course. It's equally important to take all available steps to ensure that the cottage succession doesn't clear the financial hurdles only to take a tumble over family issues. Taking the lead on getting a Cottage Agreement with the kids is a critical part of the parents' legacy.

It's often essential for parents to initiate the Cottage Agreement process, but consultation and involvement with the children is a crucial component. Imposing the parents' well intentioned vision of how the cottage should operate when they're no longer involved seldom leads to real "buy-in" by the children which is necessary to make a lasting success of the cottage succession.

Achieving a Cottage Agreement may seem like a complex and daunting task, but the process can be broken down into bite-sized pieces. Setting a realistic timeline to check off the stages helps keep the Cottage Agreement process moving along in the right direction and to a successful conclusion.

Expert legal assistance to start the process and keep it heading in the right direction saves time, trouble and increases the chance of success. And there's no better time to start than today!

Home Free

The Cottage Agreement process provides another crucial family benefit, as a reliable indicator of the likelihood of success of the ownership by the next generation. The Cottage Agreement will add value while the parents are alive and participating, but it's critical function is to keep the cottage on track when the parents are no longer involved.

The children must accept the approaches, since it's the children who will live with the results. If despite everyone's best efforts to obtain the Cottage Agreement one or more of the children can't or won't agree with the provisions acceptable to the other owners, it's much better to learn that at an early stage.

Instead of lighting the fuse on a time bomb that now can clearly be predicted to eventually blow up in the face of the owners, the parents with this early warning can rethink and adapt the cottage succession plan to prevent a potential meltdown over the inevitable cottage issues. But once the cottage succession plan is sorted out and the Cottage Agreement is signed up in the healthy spirit of co-operation and compromise, then all family members can be confident that their cherished cottage will remain a family treasure for generations to come.

Cottage Trust

A trust can be a very useful and flexible planning tool when it comes to passing on your cottage to future generations. There are two ways that you can use a trust when transferring a cottage:

Holding the Cottage in Trust

Inter Vivos Trusts

An inter vivos trust is created when you transfer your cottage (or any other assets you have) into a trust while you are still alive. The person you appoint trustee then becomes the legal owner of the property and will manage and deal with the trust assets (which would include the cottage) as you have specified in the trust deed, for the benefit of the beneficiaries named in the trust—such as your children. By establishing a trust, you have some control over how the cottage is managed after you pass. This can ensure a transfer that is fair for all of your beneficiaries and hopefully avoids or reduces disagreements.

Testamentary Trusts

A testamentary trust is established when you die, usually through your Will. In this situation, the cottage is transferred to the trust after your death, according to your (the settlor of the trust) instructions. As with an inter vivos trust, you can establish the terms of the trust to ensure ongoing, equitable treatment for your beneficiaries.

When you transfer an asset such as a cottage is transferred into an inter vivos or testamentary trust, it is considered for tax purposes to have been sold at Fair Market Value (except in the case of a spousal trust). This will most likely result in a taxable capital gain. You may be able to use the Principal Residence Exemption (PRE) to reduce or eliminate the tax payable, but this will depend on your particular circumstances. Otherwise, some tax will have to be paid. Speak with your Advisor for more information on the PRE.

In the case of an inter vivos trust, as the cottage owner you should be prepared to pay the resulting tax. With a testamentary trust, though, your estate will be responsible for paying any resulting tax—which will reduce the the final value of the assets your beneficiaries receive. If you want avoid this situation, you should plan to have enough cash in the estate to pay for the resulting taxes. You can do this, for example, by taking out life insurance and naming the estate as the beneficiary.

Maintenance Trusts

Instead of transferring your cottage into a trust, you might instead transfer the cottage directly to your children and then establish a trust that contains money to pay for the ongoing maintenance of the cottage. This arrangement should avoid many of the problems that can surface when co-owners of a cottage are faced with sharing the maintenance costs.

Alter Ego and Joint Partner Trusts

Alter Ego and Joint Partner Trusts are both a type of inter vivos trust into which you transfer your cottage while you are still alive. An alter ego trust is an inter vivos trust established for your (the cottage owner's) personal benefit. A joint partner trust is an inter vivos trust established for the benefit of both you and your spouse or common law partner. The main advantage of these trusts is that, if they are properly structured and maintained, the transfer of the cottage into the trust is not considered a "deemed disposition", or a sale at its Fair Market Value. This means that you can defer any capital gains on the trust (resulting from the "sale" of the cottage) until your death. There are specific rules regarding these trusts and they should only be established with the help of a qualified professional.

Probate

Probate fees are, essentially, death taxes and are applied to the assets in your estate. All of the provinces except Quebec have probate taxes. One way to avoid probate fees on a cottage is by using an inter vivos trust, since the cottage will not form part of your estate. You should keep in mind that probate taxes are generally not that high when compared to income taxes, so consider whether establishing a trust to avoid probate fees makes sense in the context of your overall financial plan and objectives. In Ontario the probate fee is calculated as 1.5% of the estate's gross value over $50,000.

Professional Assistance

Trusts are very useful and flexible but it is important that you seek qualified legal and tax advice before attempting to establish the trust(s).

Cottage Insurance

Owning a cottage brings responsibilities for adequate property insurance and liability coverage. Life insurance is also appropriate if you intend to the cottage to be inherited without the inheritors needing to pay your capital gains tax.

Property Insurance for the Cottage

Insuring a cottage often poses greater risks for an insurer than insuring your home. This is because most cottages don't have the level of fire or police services that would be available at home. A cottage road that is not cleared in winter, so that your property might not even be accessible for emergency vehicles, magnifies this situation.

Features common to cottages can also be the source of insurance claims, such as a septic system that backs up, a wood-burning stove that overheats, or proximity to water that causes flooding. For these reasons, you'll pay more for your cottage premium based on its property value compared to your home. Plus, you may find it far more difficult to find an insurer for the cottage because there is a greater likelihood of a claim being made.

Other factors that enter the equation for cottage insurance are the amount of time you spend at the cottage and whether it is rented out. Long periods when the cottage isn't used is a concern to the insurer if, for instance, the water pipes could freeze without your knowledge.

You'll also want to provide insurance coverage for cottage contents, detached structures on the property such as a boathouse or shed, and watercraft. If you add a building, such as a sleeping cabin, make sure you update your policy to reflect such a change.

You may find you can list your cottage as a secondary or seasonal location on your home policy, or you may acquire a separate policy for the cottage alone. Be prepared for the cottage insurer to also want your home insurance business; insuring both properties is one way the insurance company spreads its risk in respect to the cottage.

To Reduce the Likelihood and Severity of a Claim

Make sure your cottage street address is easily visible from the end of your lane or local road. Ask yourself if the local volunteer fire department could easily find your property if they had to look for it, and could they find it at night? If you have a wood-burning fireplace or stove you may be required to have an annual WETT (Wood Energy Technology Transfer) inspection of the chimney; don't overlook this requirement. Have the septic tank pumped out regularly. If you have large trees close to structures, it is a good idea to have them inspected every year or two to see if the trees themselves or any large branches are likely to fall and damage a roof or add-ons, such as a deck. And, just like home, if vandalism may be a problem, consider installing an alarm system that you can monitor when you are elsewhere. Use the Snapshots handy *Cottage opening and closing checklist* to help with the maintenance of your cottage.

Liability Coverage at the Cottage

Slips, trips, and falls are far more likely to occur at cottages than at home. Surfaces tend to be uneven, debris may collect on paths or steps, lighting may be inadequate.

Liability insurance is essential to cover you from any claim arising from someone being hurt at your cottage, whether a guest or someone working on the property.

Life Insurance for the Cottage Owner

If the cottage is not your principal residence and you hope to keep it in the family, you may wish to acquire a life insurance policy to help pay future capital gains tax and pave the way for property transfer after your death. Any tax will be due when the property is transferred from your estate to an inheritor.

The higher the adjusted cost basis (ACB) of the property the lower the capital gain. This translates into less capital gains tax. There are many expenses that contribute to the ACB, such as the costs of acquiring the property, renovations, and improvements. Document these expenses with before-and-after photos, invoices and proof of payment and keep the paperwork with your will. Regular repair or maintenance costs do not count towards the ACB.

Amanda and I are both qualified CERTIFIED FINANCIAL PLANNER® professionals at your service to assist in all areas of comprehensive financial planning including financial goal discovery, cash flow/budget analysis, retirement income planning, tax savings, estate planning, insurance needs analysis, investment planning, education saving planning, special purpose or major purchase planning. I wish to thank you for your continued confidence and for the opportunity to serve you in all aspects of Financial Planning. As always, I will continue to keep in touch with you but if you have any questions or concerns, that you would like to discuss or review, please do not hesitate to contact either Amanda or I by email or by calling the office at 519-894-2661 or toll-free at 1-800-716-5538.

Have a great day!

Respectfully Yours,

Gary

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