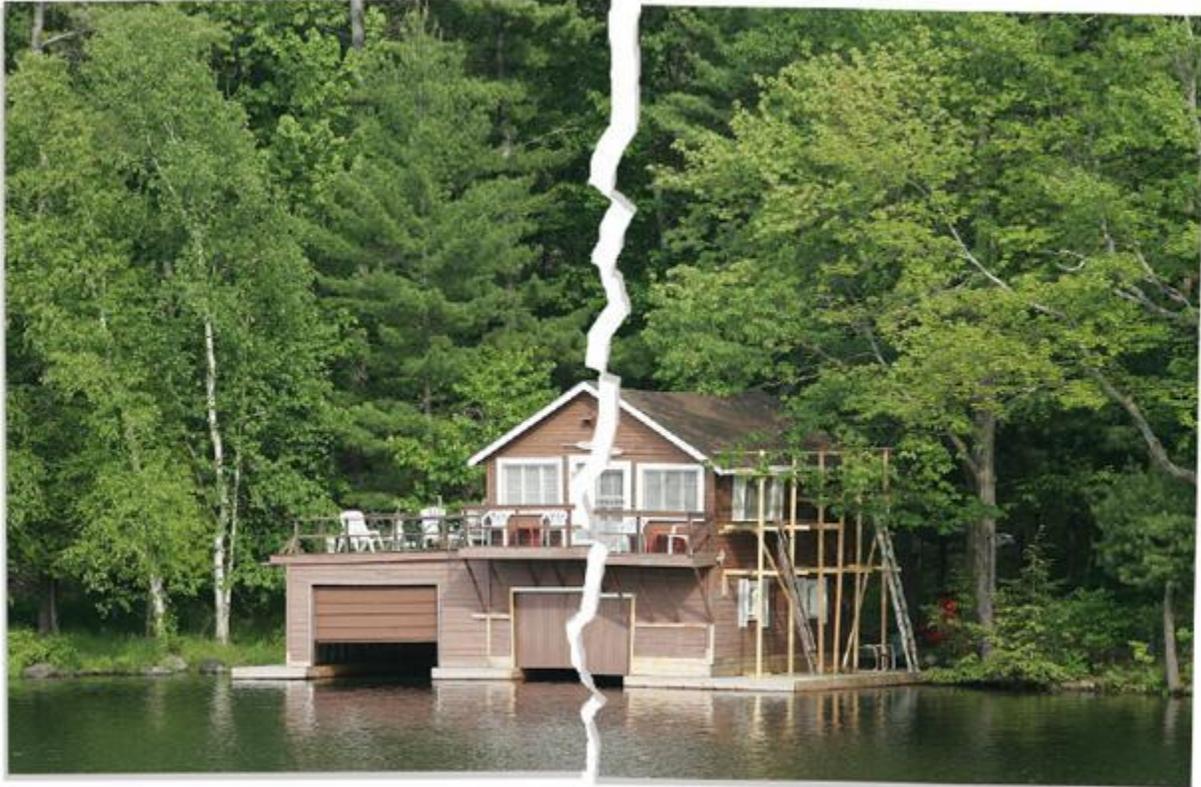


When cottage succession turns toxic



James Pasternak, Financial Post · Jun. 21, 2009 | **Last Updated: Jun. 21, 2009 12:01 PM ET**

When John McCarthy drafted his will, he left everything to his son and daughter, including a cottage-vacation property in Arizona. Mr. McCarthy imagined his children would have dinners together, swim in the pool, play cards and laugh as the grandchildren shared their funny stories.

When settling the estate, son Tyler and daughter Claire — now both married — agreed to carve up cottage usage based on the months of the year.

Dad's plans didn't quite work out.

At their first visit, Judy, Tyler's wife, noticed various deficiencies that annoyed her, including cracked tiles, a broken screen door and stains on the carpet. But when Tyler approached Claire and her husband about sharing the costs of the repairs, they refused.

Things got worse when Tyler and Judy returned for their second visit. Claire and her husband left the place looking like a hurricane hit: rotting food in the fridge, crumbs on the floor, beds unmade and dirty dishes in the sink. The mess was the result of a teenagers' party. Judy wanted her niece banned from the condo.

By the fourth stay, Judy was so furious about the mess that she threw many of Claire's family's belongings into a dumpster. Tyler has been acting as a referee between the sisters-in-law.

The case of the McCarthys (not their real name) and the complex financial and emotional quagmire known in estate-management circles as cottage or property succession is not new, nor is it rare.

“What it all boiled down to was that dad didn't pay attention to the personalities of his kids — people think that when you leave an asset equally to your kids, what are they going to fight about?” says Les Kotzer of Thornhill, Ont.-based law firm Fish & Associates and co-author of *Where There's an Inheritance ... Stories From Inside the World of Two Wills Lawyers*. “The fact is, there is a lot to fight about even when you leave something like a cottage or condo equally.”

And this is particularly difficult when the asset has a sentimental attachment.

“Dealing with a cottage property as part of one's estate plan is probably one of the most difficult and challenging tasks,” says Toronto estate lawyer and mediator Howard Black, a partner with Minden Gross LLP. “Similar to the distribution of personal effects, which can create a great deal of resentment and potential disputes, the cottage property is associated with deep emotional connections.”

Despite the lion's den that is cottage succession, other than an outright sale there are a number of strategies to reduce the likelihood of battles over usage, ownership and tax liabilities.

Experts in the estate-planning business encourage families to sit down and have a frank discussion about the cottage and other assets. For example, these fireside chats can identify which family members are not interested in owning or inheriting the family cottage. Not dealing with this early can lead to a deep family split. This occurred with the Robinson family (not their real name) of Montreal who had a cottage in New England. Three of the six children wanted to keep the cottage while the others wanted it sold. With no succession plan in place, a multi-year struggle ensued with dueling appraisals, nasty lawyers' letters and various court appearances.

One option for settling such disputes is for the owner of the cottage to carry a life insurance policy that can be used to “buy out” family members who are not interested in cottage life.

The most efficient way to accumulate the required funds to buy out the so-called “absent child” is to purchase a permanent life insurance policy,” says Bruce Gilboord, a Toronto-based Sun Life retirement income specialist and registered health underwriter.

And the sooner the policy is purchased, the better. Mr. Gilboord says it is essential to lock into a life insurance product at a younger age before medical conditions affect eligibility. “Many life insurance applicants are rejected these days through regular medical testing. Wisdom, foresight and authentic estate planning should see future generations enjoying the family cottage,” he says.

A more business-like approach to ensuring peaceful future use of the cottage is the drafting of a formal agreement covering almost every possible aspect of usage, expenses and ownership. Those tasks that dad and mom used to assign are now on paper. These might include management of a fund for repairs, dealing with the local municipality, arranging snow removal and bringing the boat up at the end of the season. Having an “annual meeting” is also prudent.

Passing the cottage on to family members is also at risk if provisions are not made for potential capital gains taxes.

One avenue for tax savings is for parents to transfer the property to their children during the parents’ lifetime. An earlier transfer will also reduce the necessity for an estate to cover any potential tax liability. The immediate downside, however, would be that parents might have to pay tax on capital gains made up to the time of the transfer.

Larry Berdugo, a chartered financial consultant at Toronto-based Wealthmore Financial Strategies Inc. (www.wealthmore.ca) suggests that cottage owners who feel their property will appreciate more rapidly than their city residence should consider designating the cottage their principal residence.

While Canada Revenue Agency (CRA) will see that as a deemed disposition for tax purposes producing a potential tax liability, any growth in value after the date of designation occurs on a tax-sheltered basis.

According to Mr. Berdugo, another tax-deferment option is to roll the cottage into a family trust. A trust “freezes” the value of the cottage for 21 years. At the end of that time, it is evaluated and the capital gains are paid to CRA. The property can then be “rolled back” into the protection of the trust for another 21 years.

As an added measure, according to Mr. Gilboord, a life insurance policy payable to the family trust can be used to settle any future tax issues that might emerge after the 21-year period.

Planning can take place even before a cottage is purchased. For example, cottage succession strategies can be simplified through the purchase of a fractional ownership property. In fractional ownership, owners purchase one or more shares of a single-family detached cottage, with each share translating into about five weeks of use per year. Ideally, one share would be purchased for each child in the family.

There’s little to fight about. There are no estate taxes as the shares are already in the sons’ or daughters’ names and everyone is a partial owner in a separate unit. All the decorating, cleaning and maintenance decisions are handled by a management company. Owners can’t even paint without management permission.

“That’s very much our view that family cottages should stay in the family. So we have a pretty easy answer for it,” says John Puffer, president of Toronto-based fractional ownership developer Chandler Point Corp. Best of all, if one descendent wants out, they can sell their share and not affect the ownership of other family members.

The problem of cottage succession can get particularly messy when sons and daughters who inherited a vacation home separate or divorce.

“There are ways to exempt a cottage from claims of a child’s ex-spouse. However, they have to be written either into the agreement transferring the cottage to the children during the father’s lifetime or into his will if it is to be transferred after death,” says Toronto-based financial planner Michael Cherney, of Michael Cherney Associates (www.michaelcherneyassociates.com).

The Federation of Ontario Cottagers’ Associations suggests the children of cottage owners have their spouses sign a prenuptial agreement that excludes their cottage as a shared asset.

As for the McCarthy’s, they discovered after the fact that the complexities of extended family combined with the absence of a plan can cast a dark shadow over past good times. Mr. Kotzer remembers Tyler McCarthy talking about dreading the day when he was gone and his wife and sister would be left to work things out.

“This is a very innocent asset, which everyone enjoyed. But it became a flashpoint for a fight when it belonged to the children. Seeing the dad or mom as referee — once that referee is gone, all bets are off,” Mr. Kotzer says.