Is it Wise to Make Gifts to Adult Children?

Parents often want to give their adult children their wealth during the parents' own lifetime, rather than have the children wait for an inheritance. The decision to give to children must be made carefully after considering all the consequences and potential unforeseen events. Below are answers to the most frequently asked questions about gifts to adult children.

Will the Gift be Taxable?

In Canada there is no gift tax. However, where a gift consists of capital property with an unrealized gain, and where the transfer is NOT between spouses, the transfer is deemed to occur at fair market value (the only exception is the spousal rollover).

This means that capital gains tax will be payable even if the property is sold (or transferred) to the child for less than fair market value. That is, a sale or transfer at less than fair market value to the child will be deemed to have occurred at fair market value, and tax will be payable by the transferor (the parent), on the gain. There is an important caveat to the planning described here, involving a gift of property to an adult child **at less than fair market value**: Since there is a one-sided "adjustment" to deem the parent (vendor) to have received fair market value proceeds and therefore tax paid on the entire gain while the child is deemed to have acquired the property **at the less than fair market value amount**, the child's cost base will remain at that lower level, and when the child disposes of the property, the child will AGAIN pay tax on the gain previously taxed in the hands of the parent, resulting in double taxation on a portion of the gain.

Where the property being transferred is your principal residence, and assuming that you have actually resided in that home during all the years you have owned it, the capital gains exemption would apply and there would be nil tax payable, with respect to the gain in value accrued in that property. This exemption of capital gain would take place in any event, including with respect to the proceeds of an actual sale of your home during your lifetime or, with respect to a deemed disposition of your home occurring upon your death. When considering succession planning, given the availability of the principal residence exemption and depending on your particular circumstances, if you sell your home during your lifetime and give your child the cash proceeds, you could save your estate the probate tax which otherwise would be imposed on your estate after your death, with respect to the fair market value of your home.

What About Marriage Breakdown?

Each province in Canada has different rules that offer varying degrees of protection for property received by gift or inheritance during marriage. A consideration would be how the child intends to maintain the ownership of the gifted funds going forward. If the gift is comingled in his/her community property it may lose its potential protection of gifted property. This protection may be available in the context of a property claim on marriage breakdown, or with respect to a claim against the estate of a deceased spouse. However, the statutory protection may not be sufficient because there are many exceptions and they are strictly interpreted. In addition, children may move from one province to another, making it uncertain what the applicable law will be in the future. Transferring the gifted property to a Trust of which the children are both income and capital beneficiaries is sometimes recommended. In addition to offering some protection from spousal claims, it can also prevent the child from voluntarily transferring the property to the spouse. It is important that the Trust you create is a discretionary Trust and that your child, if he or she is one of the Trustees, does not have veto power over Trust property. It is also recommended that you are not a controlling Trustee of the Trust.

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Gifting to adult children by way of an inter-vivos Trust provides the children with benefits from the property while allowing you to maintain at least some control of the property. In addition, the Trust may protect the property from creditors and others making claims against your children. Professional advice is essential if the Trust route is chosen to ensure that it provides the appropriate protection for your circumstances and avoids certain tax traps.

Alternate Strategies

You may decide to register a mortgage against a home which you have purchased for your child as one way to protect your assets. If the gift you are contemplating is not real estate but rather, cash, you may want to consider simply creating a debt where you are the creditor and your child and his or her spouse, jointly, are the debtors, in an amount equal to the value of the gift. This can be achieved by way of a personal loan agreement with an accompanying non-interest bearing demand promissory note. Properly structured, such an agreement would be an enforceable contract which you may use to demand repayment to protect the assets, in the event of marriage breakdown between your child and his or her spouse. Alternatively and depending on the nature of the property, a Deed of Gift may be used to protect the property in the event of a marriage breakdown between the child and his or her spouse.

Think and Think Again

Gifting to children can have unintended legal and tax consequences. Consider some of the non-tax related factors:

- Loss of control over the funds or property once they are gifted;
- Loss of access to the property or funds in the event of deterioration of your health or financial situation;
- Exposure of the funds or property to the children's creditors, spouses or heirs
- Effect on the children's work ethic or lifestyle;
- Potential undue influence on you by the children to make the gift;
- Effect on the distribution of your estate to others, including other children.

Consider some of the tax-related consequences:

- To avoid the application of attribution of income rules, the child must have attained the age of majority;
- Parents and children involved in the gifting and receiving should be Canadian residents, and not U.S. citizens;
- The property should not be U.S. property;
- The transferred property must be transferred beneficially outright (or if sold for consideration, the consideration must be for not less than fair market value) and not by way of a non-interest or low interest bearing loan, to avoid attribution rules.

You should seek independent legal advice if you want to make large gifts to your adult children. A safe philosophy for gifting to children is never give away anything that you may need or want back. Remember, once the gift is made, there is no reversing it.

Your BMO financial professional can assist you in locating an estate planning specialist.

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