

# The TaxLetter®

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Your Guide to Tax-Saving Strategies

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## TAXSTRATEGY

### *Giving a Gift*

# It's Not Easy

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It's officially holiday-season time, and we are all consumed by giving. And when it comes to what gifts to give your loved ones, we tend to be overly generous. However, be prepared for not only hugs and kisses from your family; it's possible that you may also be giving yourself a gift in the form of a tax bill.

Unlike the U.S., Canada does not have a gift tax on gifts of money or property to your family members (see discussion below). However, there are a variety of other tax rules that can be triggered by a gift between family members. Obviously these rules would not apply to your typical gift such as a sweater or an iPhone. But what if you wanted to make a grand gesture, and gift the cottage

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property to your kids? Or gift a large amount of cash to your family so they can invest on their own? That's when it gets tricky. Subject to certain exceptions, the tax rules have two main purposes: (1) to ensure that the CRA gets their fair share of the tax on any accrued gain; and (2) to prevent "abusive" income splitting transactions among related persons.

**Inadequate Consideration:** Where you transfer property to a family member (i.e., any non-arm's length person) for consideration less than fair market value, your "deemed proceeds" will be adjusted upward to the fair market value of the transferred property. This may not mean much if the fair market value of the property is not more than the cost of the property to you (i.e. if you gift a used car to your kids, chances are that the current value of the car is lower than what you paid for it). However if the property has increased in

value since you acquired it, this will mean that you will have a capital gains tax hit to you on the gift equal to the increase in value. The silver lining (however thin) is that if you transfer the property by way of gift to your loved one, the cost of the property to them will also be adjusted upward so that the tax hit is only to you, the giftor.

**Transfers of Property to a Spouse:** Another rule to lighten your load relates to gifts to a spouse. There is an exception to the rules discussed above for gifts to a spouse. In the usual case, and subject to the comments below, a transfer of a property to a spouse will automatically occur on a tax-free rollover basis, unless you elect otherwise (i.e. you are deemed to have transferred the property at your cost to your spouse). Note: this also applies to any property that is transferred to a former spouse as a result of a settlement upon marriage breakdown. However, this spousal rollover only applies where both spouses are Canadian residents at the time of the transfer. But the net effect is that you, as the giftor, do not get hit with a deemed capital gain, and your spouse inherits your original cost amount.

**Attribution on a Transfer to a Spouse or Minor Child:** Despite the lax rules relating to gifts to spouses, the ubiquitous attribution rules will still sneak up on you in respect of gifts of

property to your spouse or a minor child that creates income. Specifically, any future income from the gifted property will be included in your income even though you no longer own it. The attribution rules will also jump into play in the case of a loan or incurred indebtedness on a transfer of property, unless the prescribed rate of interest is charged and paid for each year the loan is outstanding (currently 2 per cent). And if you think that the attribution rules have exhausted their reach, think again: any capital gain realized on a sale or other disposition by your spouse will also be attributable to you. Happily, though, this rule relating to capital gains does not apply to your minor kids. Which means that you should be able to legitimately capital-gains split with your kids.

So what's the point of gifting to your kids or spouse if you're not going to get any tax benefits (other than love and gratitude from them)? A couple of planning points include:

- There is no attribution where the property is received from a non-resident (i.e., this is of use if your kids have grandparents that might live in Florida or elsewhere).

- Gift investments with low current yield but high capital gain potential to your kids. Even though the income may be attributed to you, the capital gain will be taxed to your kids and subject to their tax rates.

- "Child tax benefits" accumulated directly in segregated bank accounts for the benefit of your kids are considered funds of the child rather than the parent.

#### **Transfers to Adult Children:**

Transfers to adult children (18 years of age or older) can be made without the attribution rules kicking in, such that the income will be taxable to your kids. (But beware of the rule regarding inadequate consideration.)

**Principal Residence:** You can transfer your home by gift, and if the home was properly designated as your principal residence for each year you owned it, the transfer will be exempt from tax. (If your home was only a principal residence for some years and not others, the portion of the exempt gain is accordingly pro-rated.) To qualify as a principal residence, you (or your spouse or child) have to have ordinarily inhabited it – and there is only one principal residence exemption per family. However, a transfer of a second home, (i.e. a non-principal residence) can be made to your adult and/or married child and qualify as a principal residence for the child. Although you will be liable for any accrued gain up to the time of the transfer of this second home to your adult child, assuming the home remained your adult child's principal residence on a go-forward basis, any further gain would be exempt since the adult child can claim his or her own principal residence.

One perk about gifting your principal residence to a family member is that, in Ontario, land transfer tax will not be triggered since this tax is based on the consideration paid by the person receiving the property. When documenting the transfer with the registry office, you should note that the consideration is "nil", as it is a "gift for

natural love and affection" – this way, your family member receiving the gift won't have to cough up cash to the Ontario governments on that transfer. And for those of us living in Toronto, this is a double gift since you will also avoid the additional municipal land-transfer tax (and which, added to the provincial tax, results in double the land-transfer tax for us unlucky ones within the GTA). NOTE: if the gifted property has a mortgage on it, such that the adult children receiving the property as a gift assume the remaining balance of the mortgage, there will be land-transfer tax (at both the Ontario and Toronto levels) on the amount of the mortgage being assumed.

**Joint liability:** Beware, however, of section 160, which is designed to prevent you from avoiding tax by transferring property to your family members. You will be jointly and severally liable with your family for any pre-existing tax that you were liable to pay, not only for the year of the gift, but also any preceding year. Although this liability is limited to the extent that the fair market value of the gift exceeds the value of the consideration (usually nothing where a gift is involved), there is no limit on the interest on such tax amount for which either party would be liable.

Gift Tax? The gift-tax rules were repealed back in 1971 as part of the major tax reforms of that year. The rationale behind this change was that since any accrued gains on capital assets would be taxable at death, the combination of this tax with the gift tax would result in a huge tax hit upon death. However,

the United States has not been so kind, and continues to tax gifts by any individual (the tax is on the giftor). However, so long as you are not gifting property that is located in the U.S., don't worry about gifts to family members south of the border. The U.S. gift tax will generally

not apply to gifts of intangible property by a non-U.S. citizen or gifts of tangible personal property and real property by a non-U.S. citizen if the property is not located in the U.S. If, however, you are a U.S. citizen, even if you are resident in Canada for tax purposes, the

U.S. gift tax rules will still apply to you, so make sure that you consider the U.S. rules before making any substantial gift. Note: there are certain annual exemptions in the U.S. for gift tax, as well as a lifetime exemption. Speak to your U.S. tax advisor. 