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WEALTH DISTRIBUTION

A worry for the wealthy: keeping cash from children's ex-spouses

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You've made your money and raised your kids. Now you want to share the wealth with your family – perhaps give your adult children a down payment for a house, or help fund a business venture.

But what could happen to this money if your children's marriages or live-in relationships fall apart?

This question often plagues high-net-worth Canadians as they sit down to write that big cheque or update their will. With hundreds of thousands or even millions of dollars on the line, many worry that money intended for their offspring will fall into the hands of ex-spouses and stepchildren.

"We deal with this every day," says David Altro, managing partner at Altro Levy LLP, a law firm with offices in Canada and the United States that specializes in tax and estate planning, immigration and real estate services to wealthy individuals. "Our clients want to know how to transfer their wealth to the next generation while protecting the assets they've worked so hard to accumulate."

A common scenario among the wealthy sees mom and dad handing over a million dollars or so toward a new house for their married child, only for the couple to split up in a few years, says Mr. Altro. His advice: Put a lien on the property and have both the child and spouse sign a promissory note saying they'll give the money back some time in the future.

"If all goes well and they stay married, the promissory note doesn't get enforced – what we do in the parents' will is say they forgive the loan," says Mr. Altro. "But if the marriage dissolves, the money goes back to the parents."

One thing to keep in mind with this approach, however, is if the home buyers need a mortgage to top up the parents' gift, having a lien on their house will make it hard to qualify for one, says Mr. Altro.

Krista Kerr, chief executive officer at Kerr Financial Group, with offices in Toronto and Montreal, offers two other options for giving adult children money for a home: Register a mortgage toward the property in the amount of the parents' gift to their child, or ask the child and the in-law to sign a loan agreement.

"If you're registering the gift as a mortgage, know that this might restrict your child and their spouse's ability to borrow," says Ms. Kerr. "If you're going with a loan agreement, make sure it is signed by both parties, because if it isn't and the marriage ends, the ex-spouse could take the position that he or she didn't think it was a loan."

Giving for a child's home isn't the only situation wealthy parents need to handle carefully. Ms. Kerr says distributing large sums of money to married or cohabiting kids should also be done in a way that protects against future claims from an ex-partner.

"If you had a pattern every year of doing a $100,000 distribution to your child, and that $100,000 is important to the recipient in terms of providing for his or her family, then an ex could bring a claim against this money," she says.

To prevent a "dependency" claim on large money gifts, parents can stagger distributions so the money isn't viewed as a regular part of the child's family income, says Ms. Kerr. Even better, use a discretionary trust to distribute the funds; this sets up the child as a beneficiary but keeps parents in control of the money.

It's also important for married children to have separate bank and investment accounts for big money gifts from their parents, says Doug Carroll, practice lead for tax, estate and financial planning at Meridian Credit Union.

"Under the Family Law Act in Ontario, these funds are treated like an inheritance and exempted from the calculation process of what divorcing couples brought into the marriage and what ends up getting accredited to each spouse," says Mr. Carroll. "When they intermix these funds with other funds in the marriage, it's not trackable any more."

He notes that family and marital laws in Canada differ across the provinces and territories. For example, Nova Scotia and Saskatchewan lump gifts and inheritances into marital property to be distributed after divorce, while other provinces do not. Some provinces also do not apply their marital property laws or family acts to live-in couples.

Wealthy parents should be aware that while inheritances are excluded from marital assets in most provinces, the same protection may not apply to income from the investing of these funds, says Mr. Carroll. This is why it's a good idea for parents to add a clause to their will that says investment income from their child's inheritance should also be excluded from postseparation equalization calculations.

Mr. Carroll says some parents who want to pass on their home to a child choose to go about this by making the child a joint owner of the property. But if the child is married and decides to move into the home with the spouse and kids, that could turn the property into a matrimonial home.

"If a married child dies while living in his wealthy mother's house and there's joint ownership, the child's portion of the house does not go back to the mom – it's severed because it's a matrimonial home and the child's interest in that property goes to his estate, which likely names his wife as primary beneficiary," says Mr. Carroll.

Ms. Kerr says high-net-worth individuals should talk to their adult kids about prenuptial agreements with their prospective spouses. While this may ruffle a few feathers, having this discussion before the engagement ring is bought and the caterers brought in can save a lot of grief in the future, and keep the family's money in the family.

"A prenuptial agreement shouldn't be seen as punitive but rather as a way of protecting the assets your children bring into their marriage," says Ms. Kerr. "Have a meeting with your child and their future spouse so you can explain that you want to be fair, and ensure that the spouse-to-be has their own counsel, too."

Ms. Kerr says high-net-worth families should sit down every one or two years to look at the risks to their wealth – including marital discord – and talk about strategies to address these risks.

"Too often the focus is primarily on taxes," she says. "But they really should make sure they're looking at the big picture and have a long-term plan for protecting their wealth, which includes keeping it in the family."