THE GLOBE AND MAIL

Reduce the sting of taxes when making gifts

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SPECIAL TO THE GLOBE AND MAIL
OCTOBER 27, 2017

It's not even November yet, and my wife, Carolyn, is putting pressure on me to start my Christmas shopping. It doesn't help that my annual tradition includes waiting until Dec. 23 to start asking the kids what they'd like. I like to give gifts, but I'm not very good at it. I tend to buy things that I'd like for myself – such as the men's golf clubs I bought Carolyn last year. I borrow them all the time.

This week, a reader e-mailed me to share that he's thinking of making a meaningful gift to his kids this Christmas. He wants to give them the cottage. Now, whether it's the cottage or another asset, be aware that you could trigger a tax hit. How so? When you

gift an asset, you're generally deemed to have sold it at fair market value (unless gifting to a spouse), which can create a tax bill if the asset has appreciated in value.

There's some help available. Rather than paying the tax all in one year, it's possible to pay it over a period as long as five years, leaving some of those tax dollars in your hands longer. This can be done using the "capital gains reserve" in our tax law.

The story

Jack Spratt owns a cottage and wants to give the property to his two adult children. The cottage is worth $600,000 today. Jack's cost of the property, including some renovations over the years, is $250,000. If Jack simply gives the cottage to the kids today, he'll trigger the $350,000 capital gain, which could cost him $93,625 in taxes (in Ontario) in the year he makes the gift.

"What if I sell the cottage to the kids for $1? Will that reduce my taxes?" Jack asked. Unfortunately, selling at below fair market value is the worst thing he could do from a tax perspective. Suppose he did sell to the kids for $1. In this case, he'd still be deemed to have sold the cottage for fair market value, so the $93,625 tax bill would still arise. But the kids would have an adjusted cost base in the property of just $1 in this example. So, if the kids sold the cottage later for its value of $600,000, they would have a $599,999 capital gain that could become taxable. But since Jack will have already paid tax on his $350,000 capital gain, there's a double-tax problem here.

Here's a better idea: Jack can sell the cottage to the kids for its fair market value of $600,000. The kids can pay for this by way of promissory notes (or a mortgage) that become due upon demand in the future. That is, Jack won't have a right to collect his sale proceeds in the year of the sale. In fact, Jack never intends to demand payment on the notes, and he'll simply forgive the notes at the time of his death. This way, the kids will not have to pay any cash to him.

When you sell an asset and realize a capital gain, but don't have a right to collect all your sale proceeds in the year of the sale, you can defer the tax on part of the capital gain until you do have a right to collect.

The caveat is that you must report at least one-fifth of the capital gain in the year of the sale, and in each of the subsequent four years.

The result? Jack can pay his $93,625 tax bill over a five-year period (or at least $18,725 a year).

The nuances

There are a few other points to keep in mind:

- The capital gain can be spread over a period as long as 10 years if the property being transferred is a farming or fishing property, or the shares of a qualified small-business corporation.
- The reserve is not available to non-residents, or where you subsequently become a non-resident after the asset transfer.
- If you choose to claim less than the maximum reserve available in one year, you can't play catch up and claim a larger reserve in a later year; you must pay tax on at least one-fifth of the capital gain every year until the full amount of tax due has been paid.
- You can't claim a reserve if you sell the asset to a corporation that you directly or indirectly control, a partnership of which you're a majority interest partner, or in certain other cases where you sell to "affiliated" taxpayers (your kids are not "affiliated" with you under our tax law).
- You can't claim a reserve on a capital gain arising in the year of your death.

Speak to a tax pro to ensure you're doing it right, before you transfer the asset.

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