PRIVATE WEALTH MANAGEMENT

Protecting your child's inheritance

When an estate or gift is left to a child, it can be subject to a family property claim if the child later separates or divorces. But, there are ways to protect the inheritance, which ensures your child is the sole beneficiary. Please note: the information in this article is relevant for Canadian provinces and territories other than Quebec. Remember to confer with an experienced family lawyer in your jurisdiction to understand the rules that apply to your specific situation.

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In this white paper, we will discuss various issues that you may want to consider when leaving an inheritance to your children. Here are three important points that we will address in more detail.

01 When a gift or inheritance is used to purchase a jointly-held asset, like a home, that asset will usually become shareable.

02 To protect an inheritance or gift to your child, emphasize to your child the importance of investing it in their sole name, and not in joint ownership with a spouse.

03 Additionally, ensure your will attempts to protect your child's inheritance to the fullest extent possible, such as a clause indicating the gift is meant to benefit only your child.

The best way to protect an inheritance or gift is for the child to invest it in his or her name alone, and not add their spouse as a joint owner.

FAMILY LAW LEGISLATION

Although the rules vary across Canada, in most jurisdictions inheritances and gifts may be exempt from a division of family property if the assets have been kept separate.[1] For example, once the gift or inheritance is used to purchase a jointly-held home or pay down a mortgage on a jointly-held vacation property, the asset will usually become shareable. If a parent knows in advance that the child's relationship is on shaky ground, they should try to have a private conversation with them about their concerns, and the things the child can do to protect any future inheritance they may receive. Even where there is no evidence that the relationship is on the verge of breaking down, the parent may simply tell the child that if at a future point their relationship starts to deteriorate, they need to understand that the best way to protect their inheritance is to keep it separate. For example, to the extent possible, the inheritance should not be used to:

- Purchase family assets, such as a home, vacation property or vehicle;
- Pay down debt related to family assets; or
- Make investments in joint names.

The best way to protect an inheritance or gift is for the child to invest it in his or her name alone, and not add their spouse as a joint owner. Although your child may not appreciate the importance of this information when they are young, it may take on a new significance by the time they receive the inheritance, by which point their relationship may not be as strong as they had originally hoped.

Of course, because the laws are different across the country, and because they can always change in the future, the best way to protect specific assets is for the spouses to enter into a form of domestic contract (sometimes referred to as a marriage contract or pre-nuptial agreement). However, some children (and/or their fiancés or spouses) may not be open to this suggestion. It is also important to keep in mind that even if there is a contract in place, if the parties do things that nullify the contract (e.g. add their spouse as a joint owner of an otherwise exempt asset) then the contract may be of limited use. If possible, your children should speak to a family lawyer licensed to practice in their jurisdiction to discuss the optimal method for protecting their assets.

ESTATE PLANNING

Aside from having a frank conversation with your children about the use of any inherited funds, are there things you can do as a parent to provide protection? One thing parents can do is to make sure that they have a will that attempts to protect their child's inheritance to the fullest extent possible. For example, in some jurisdictions it is recommended that parents include a clause in their will indicating that the gift is meant to benefit the child only, including any income and growth, and is not meant to be shareable. Although this type of clause is not effective in every jurisdiction, it should be included in your will no matter where you live, since it may be hard to predict which jurisdiction your child will be living in at the time of your death. Again, to the extent the child uses the inheritance (and/or the income and/or growth) to purchase family assets, this type of clause may be ineffective. But in scenarios where the child does choose to keep the inheritance invested separately, it may help to protect the future income and growth as well as the original amount inherited.

TESTAMENTARY TRUSTS

Another option is to draft your will such that the assets are left to a trust established for your child's benefit rather than to the child outright. A trust is a legal arrangement where a trustee holds legal title to the trust property for the benefit of the trust beneficiaries. The trustee has the power to deal with the assets and to distribute income and capital of the trust to beneficiaries in accordance with the terms of the trust.

The level of your child's control over the trust's assets will depend in large part on their age and the state of their relationship. For children under the age of about 30, most parents set up non-discretionary trusts, meaning that the trustees of the trust must follow specific instructions, usually transferring the capital to the children in stages (for example, one quarter of the capital at age 21, half at age 25, and the remainder at age 30). If the child is older, and there are concerns about the state of the child's marriage or their ability to manage large sums of money, then the parent may set out a different distribution scheme, or may make the trust discretionary, meaning that it is up to the trustee to decide when and how to distribute the capital. In many cases the trustee of the trust is the child, but where there are significant concerns about the child's ability to manage large sums, an independent trustee may be appointed instead. Speak to an estates lawyer or notary to ensure that your will is properly structured.

The income tax rules further provide that there will be a "deemed disposition" of the assets held in the trust every 21 years, meaning that any unrealized capital gains will be triggered on the 21st anniversary of the creation of the trust (i.e. the date of the parent's death). In order to avoid this deemed disposition, most trusts are drafted in a way that allows the assets to be transferred to the child before the 21st anniversary. If the child is a resident of Canada, the assets can generally "roll over" into the child's name personally, thereby deferring the triggering of the gains until such time as the child sells the assets or dies.

The trust may provide a further benefit if the grandchildren are included as potential beneficiaries of each child's trust. If the grandchildren are low-income, then some of the income in the trust could be flowed through to them and taxed in their hands at lower rates. This would allow the family to pay less tax than if all the income were taxed in the hands of a higher-income parent or the trust. Also, if the child is disabled, further tax benefits may be available.

However, it is worth repeating that if the child receives property from the trust and then co-mingles it with the other family assets it would be very difficult to exclude such property from a potential future family property claim.

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COMMON-LAW RELATIONSHIPS

One increasingly common question that parents are asking is whether or not their child's assets will be shareable if they are in a common-law relationship. This is where the rules across the country start to diverge widely. Generally speaking, only common-law couples in Alberta, British Columbia, Manitoba, the Northwest Territories, Nunavut and Saskatchewan are treated the same as a married couple as far as the family property legislation is concerned, but the time period required for being considered a common-law couple varies even within those jurisdictions. Some jurisdictions allow couples to enter into a form of civil union (such as Alberta, Manitoba, Nova Scotia and Québec), and if certain conditions are met, then their assets would be shareable upon the dissolution of the civil union. However, even in jurisdictions where no such rules are in place, the courts have become more open to allowing a former common-law partner to make a claim against their former partner, particularly where the relationship is long term and they have formed a "family joint venture", usually by making joint decisions, such as raising children together, or where one partner moves to another jurisdiction for the sake of the other partner's career. Therefore, even if your child is living common-law in a jurisdiction where there are no specific rules dictating that their assets will become shareable at the time of separation, it is still advisable that you plan for the worst, and take steps to protect their inheritance.

GIFTS DURING YOUR LIFETIME

Some parents have sufficient wealth that they are able to give funds to their children during their lifetime, either for the purpose of buying a home or starting a business. If the amount of the gift is significant, then consideration should again be given to protecting the funds, particularly where the relationship is quite new. Some parents will give their children tens of thousands of dollars when their children first get married to buy a house, for example, only to be distressed to find out that these assets are shareable when the child separates from their spouse only a year or two later. If you want to protect the funds, consider structuring the transaction as a loan, not a gift. This would require the execution of a promissory note, and in a best case scenario, a loan agreement and security, usually in the form of a mortgage on the home (usually in second position after any bank mortgage). This can also help to alleviate situations where one child has received a significant gift during the parents' lifetimes, whereas another child or children may not have. In many cases the children are not expected to make payments against the loan during the parent's lifetime, but the amount of the loan can then be offset against the amount to be inherited by that child. For so long as the loan is in place, the parent will have a much stronger argument that those funds are to be repaid before any remaining equity in the home is to be divided between the spouses. It is very important for these types of arrangements to be properly documented and signed by all parties to minimize the possibility of someone denying the existence of the loan at a later date.

Some parents have advanced the funds on a verbal agreement or based on "home-made" loan documentation, only to have the loan disputed at a later date. If the child is not making regular payments of interest and/or principal, then it may also be necessary to "refresh" the loan from time to time, to ensure that it does not become statute-barred. If you want the funds to be treated as a loan, be sure to speak with a lawyer well in advance of entering into the transaction to make sure that everything is properly documented.

You should be aware that depending upon the amount of equity the child has in the home, it is possible that the bank will not agree to have the parents' mortgage registered against the property. It is also possible that the financial institution will require either the children or the parents to sign a document confirming that the funds being used to buy the home belong to the children and are not owed to the parents. If the children are not contributing a sufficient amount of equity, it may not be possible to characterize the parent's contribution as a loan.

"If you want to protect the funds, consider structuring the transaction as a loan, not a gift."

The rules regarding the division of family property can be complicated and vary by jurisdiction. To protect your child's inheritance, it's important to speak to a qualified professional. Contact your IG Consultant for more information.

If structuring the transaction as a loan isn't possible, then you should ask your child to request that their spouse acknowledge that the gift is an exempt asset in the event of marriage breakdown in a domestic contract.

If the gift is not being used to fund a joint family purpose, then it may be advisable to see a lawyer to have a declaration of gift prepared. In some jurisdictions it may be possible to have not only the original amount of the gift but also any increase in value protected from a future division of assets, if the proper declaration is in place. However, the child must ensure that the gifted assets are kept separate and not invested in joint names with their spouse.

As can be seen, the rules regarding the division of family property can be complicated. If you are concerned about protecting your child's property, be sure to speak to a qualified professional.

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Christine is Vice President, Tax & Estate Planning at IG Wealth Management, where she provides advice to high net worth clients on complex tax and estate planning issues. Christine is a member of the Canadian Tax Foundation, has her Certified Financial Planner designation and is a Registered Retirement Consultant and Trust & Estate Practitioner, certified by the Society of Trust & Estate Practitioners (STEP). She is also the recipient of the prestigious STEP Founder's Award. Christine is the author of Wealth Planning Strategies for Canadians, which is published annually by Thomson Carswell and is currently in its 14th edition. Christine has given lectures to numerous professional associations and is a regular media spokesperson for IG Private Wealth Management.

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