Selling property at a fair market value will adjust the cost base and help avoid the issue of double taxation on property sold to your children.
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# Avoid pitfalls when transferring assets to kids

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When I sat down with James, he shared with me his story. As part of his estate planning, he's been wanting to transfer ownership of his cottage and a rental property to his son and daughter respectively. So, a few months ago he did just that. In addition, he's been concerned about creditors and wanted to remove those assets from his hands to protect those assets. So, he sold the cottage to his son for $1, and the rental property to his daughter for the same price. James and I had a long conversation about what this meant for him, and what he might have done differently.

**The problems**

James has a few issues to be concerned about here. First, if you give or sell an asset to anyone but your spouse (or common-law partner), you'll be deemed to have sold the asset for fair market value, even if you set the selling price at much less, as James had done. So, James will pay tax as though he sold both the cottage and rental property at their fair market values.

The result? James will pay some tax. Now, he's able to use his principal residence exemption to shelter the tax on the cottage (you'll need to visit a tax pro to determine whether you can do the same; a cottage can often qualify for this exemption). As for rental properties, you won't generally be able to designate one as your principal residence, and James will face some tax in his case.

The second issue for James is that he owed tax to the Canada Revenue Agency at the time he transferred these properties to his kids. Section 160 of our tax law could cause his kids to be liable for the tax he owes to the agency. This section can apply any time you owe money to the taxman, then transfer assets to another person without receiving fair market value in return. In this case, the kids could be on the hook for James's taxes up to the value of the properties they received, less whatever they paid for the properties (just $1). His kids have no idea that the taxman might chase them for that tax bill.

Next, there's a double-tax problem here. Let's take the rental property as an example in James's case. James will pay tax on the capital gain on the rental property, which is basically fair market value, or $500,000. That's the first layer of tax. Next, his daughter now owns the rental property, which has a value of $500,000, but her adjusted cost base is just $1 (the actual amount she paid for the property). So, if his daughter sells that property for its value of $500,000, she'll face tax on a capital gain of $499,999. That is, she'll face tax on basically the same value that James was already taxed on. This is a double-tax problem.

Finally, James may not have protected his assets as he thought. If he made the transfer to his kids at a time when he owed money to creditors or when such a liability was foreseeable, certain legislation in his province – the Fraudulent Conveyances Act in some jurisdictions – may prevent that transfer and allow creditors to attack those assets. Wow. There's a lot for James to think about.

**The lessons**

James might have done things a little differently. First, he could have sold the properties to each of his children for fair market value. If he didn't want his kids to face the burden of paying him cash, he could have taken back a mortgage on each property and simply not required payment. The mortgage could have been set up such that no amount would be due immediately to him. This would have allowed him to defer the tax on the capital gain on the properties (for a period as long as five years).

Selling at fair market value would also have provided the kids with an adjusted cost base in each of the properties equal to fair market value, so the double-tax problem would not have existed.

Further, James could have revised his will so that any amounts owing to him at the time of his death could be forgiven, effectively making the transfer to the kids at no cash cost to the kids.

As for creditors, he'd arguably avoid the Section 160 problem with the tax agency if the kids did purchase the properties for fair market value, even if they didn't pay the cash today. His problem with other creditors may still exist and he'd need to speak to his lawyer about that issue.

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