Income Splitting Opportunities

Our last article made it seem that there are no income splitting opportunities left. The good news is, – there are! Sensible tax planning can indeed make it possible to divert income to spouses and children. In this article (a follow up to "Income Attribution Rules") we will outline some of these opportunities.

Why Income Split?

The purpose behind income splitting is simple. It is designed to shift income from an individual in a high tax bracket to an individual in a lower tax bracket. The result of this is to reduce the total amount of tax dollars paid because this income would attract a lower tax rate in the hands of the lower income earner. (See Big Picture article "Average and Marginal Tax Rates.")

The Opportunities:

<u>Income Splitting between Spouses</u>

Income on Income

The attribution rules tax income earned on money transferred to a spouse back to the transferring spouse. This income, however, is then the capital of the spouse receiving it for reinvestment purposes. The income earned on this reinvested capital (income on income) is not attributed back but is instead taxed in the hands of the transferee spouse. Note, however, the income on the original capital transferred will continue to be taxed each year in the hands of the transferring spouse. Over time this strategy is a very effective method of transferring capital from a spouse in a high tax bracket to a spouse in a lower tax bracket.

With this type of arrangement it is important to maintain two accounts so that attributed and non-attributed income are easily separated.

Pay Your Spouse (or Children) a Salary

If you own a business, you can pay your spouse or children a salary for work they perform. Remember however, that the salary must be "reasonable." This means that you are paying them the same amount as you would pay someone else for work of equal value.

Invest One Spouse's Excess Income and Pay Their Taxes

If both spouse work, and there is excess income that is being invested, this income should be invested in the hands of the lower income spouse. This would mean that the spouse in the higher tax bracket should pay all the household expenses. In addition, payments of taxes on behalf of the lower income spouse will provide more money for them to invest. These tax payments will not attract income attribution because they are not invested.

Loan or Transfer Made to Earn Business Income

If a loan is made to your spouse to earn business income (as opposed to earn investment income) attribution will not apply.

Loaning Money

If you make a loan to your spouse (or child), which they in turn use for investment purposes, the attribution rules will apply. However, if interest is charged on this loan at a rate at least equal to the Canada Customs and Revenue Agency's prescribed interest rate at the time, the attribution rules will not apply. The interest must be paid each year, or within 30 days after the end of the year. If this deadline for this interest to be paid is missed, then that year's income and all future years income will be attributed back to you.

While it may seem that a loan may not achieve the desired income splitting, it may make sense if an excess yield or capital gain can be earned. This avoids the attribution rules and at the same time puts a high yield asset in the hands of a lower taxed individual.

Transferring Property

Transfers of assets between spouses are done at adjusted cost base unless you elect the transfer to occur at fair market value. If you transfer at the adjusted cost base, when the property is sold, any capital gain resulting from the sale is attributed back to the original spouse. However, the attribution rules can be avoided by receiving cash or property of equal fair market value as consideration at the time of transfer. For example, you can give your spouse non-income producing property such as jewelry as consideration for income producing assets.

Spousal RRSP

This is one of the most obvious methods of splitting future income. Although there are no immediate additional tax savings, (the contributing spouse still takes the same deduction) a tax saving on the future income will be realized because, if done correctly, the total future family income will be more equally received by both spouses.

Remember that the attribution rules will cause income to be taxed in your hands if your spouse withdraws money from the spousal RRSP and you have made a contribution in that calendar year or the two previous calendar years.

Canada Pension Plan Benefits

When you apply to start receiving your Canada Pension Plan benefits, you can elect to split them with your spouse. As long as one spouse is in a higher tax bracket this strategy makes sense as the resulting amount of tax the family will pay is decreased.

Income Splitting with Minor Children

Capital Gains and Children (under 18)

Unlike interest or dividends, attribution does not apply to **capital gains** realized on a disposition of property by a child. This can make it advantageous to loan or transfer money to a minor child to invest in assets that would tend to generate capital gains over time.
Note: Refer to above comments re "Loans for Value."

Child Tax Benefit

The child tax benefits (received by some families) can be invested in the child's name without any attribution of income back to the parents.

Registered Education Savings Plan (RESP)

Contributions up to $4,000 per year (to a maximum of $42,000 over 21 years) may be made to an RESP to save for someone's higher education. In addition, if certain conditions are met, the beneficiary may qualify to receive the Canada Education Savings Grant (CESG) of 20% of the RESP contribution to a maximum of $400 per year. Contributions to an RESP are not tax deductible, however all the income earned remains tax deferred while in the plan. When the money is distributed in the form of educational assistance payments, it will be taxed as regular income in the beneficiary's hands, not the contributor's.

Conclusion

The attribution rules are very complex and before you initiate any income-splitting strategies you should seek professional advice. In particular where minors are involved this may be even more important because provincial laws vary with respect to the ability of minors to enter into a contract. This being said, with proper advice some of these strategies can result in a lower tax bill for your family.

Note: The above article is for information purposes only and should not be construed as offering tax advice. Individuals should consult with their personal tax advisors before taking any action based upon the information in this article.