*August 2016*

# Income splitting strategies for Canadians

***Rock Lapalme, CPA, CA, TEP,*** *is a senior manager in the tax practice in the Sudbury office of Collins Barrow.*

The term "income splitting" refers to the transfer of taxable income from a higher-income family member to a lower-income family member to reduce the family's overall income tax payable. The advantages of income splitting are clear: lower-income earners pay tax at a rate of 20 to 26 per cent, whereas higher-income earners may pay 47 to 54 per cent, depending on the province or territory of residence.

With the Family Tax Cut, couples with minor children had finally experienced a taste – albeit a small one – of what it was like to split employment income between spouses. The Family Tax Cut was a tax credit that provided up to $2,000 in tax savings. However, the credit was repealed for 2016 and later years. Many families wonder why Canadians don't have the same opportunities to split income as our American friends who are permitted to file joint spousal returns to effectively split their income.

Though Canadian taxpayers may no longer effectively split employment income, practically speaking there are many other income-splitting tools available. A taxpayer might ask, "Can't I just give money to my spouse or children so that they can earn investment income and pay the tax?" The answer often is "no," since the Income Tax Act includes what are known as the attribution rules, which forbid that type of simple tax planning. Under those rules, income is "attributed back" to the person who made the gift or loan. Fortunately for taxpayers, there are many forms of income that are not caught by these attribution rules. The most common exceptions to the attribution rules are discussed below.

**Prescribed rate loans**

One popular strategy to split investment income between spouses is the prescribed rate loan, which sees the higher-income spouse making a loan to the lower-income spouse, who in turn invests the funds. The strategy succeeds when the rate of return earned by the lower-income spouse on those funds exceeds the interest paid to the higher-income spouse, thus generating a profit that is taxable at lower rates. Three requirements must be met:

1. The face value of the loan must be equal to the funds transferred (no gifts between spouses).
2. The interest must be charged at a rate equal to or greater than the prescribed rate (currently 1%).
3. The interest must actually be paid to the spouse (in cash, by cheque or by bank transfer) by January 30 of the following calendar year. If this deadline is missed, attribution will apply for the current calendar year and all future years.

As an example, assume that Jane (the higher-income spouse) lends $100,000 to John (the lower-income spouse), and charges him the one per cent prescribed rate of interest. John uses the funds to earn a six per cent annual return. The typical savings (in Ontario) can be illustrated as follows:

| | Jane | John | Total |
|---|---|---|---|
| Without a prescribed rate loan: | | | |
| Taxable income | $6,000 | - | $6,000 |
| Tax rate | 53.53% | 20.05% | |
| Income tax payable | $3,212 | - | $3,212 |
| Using a prescribed rate loan: | | | |
| Return on investments | - | $6,000 | $6,000 |
| Prescribed rate loan interest | $1,000 | ($1,000) | - |
| Taxable income | $1,000 | $5,000 | $6,000 |
| Tax rate | 53.53% | 20.05% | |
| Income tax payable | $535 | $1,003 | $1,538 |
| Annual savings ($3,212-$1,538) | $1,674 | | |

*August 2016*

# Income splitting strategies for Canadians

The rate of interest payable to the higher-income spouse is fixed at the time the loan is made and remains the same for the term of the loan. This strategy is popular now due to the historically low current prescribed rate of one per cent. But time is ticking! Rates have nowhere to go but up. Take care when implementing this strategy to ensure the rules are met and to avoid unexpected capital gains or limitations on capital losses that may result on the transfer by the higher-income spouse. These rules are complex; professional advice is necessary.

**Families**

Several strategies are available to families, depending on the circumstances:

- **Interest-free loans for business income**
  The attribution rules apply to income from property (e.g. investments, rental units) but not income from a business. Therefore, a gift or interest-free loan may be made to a spouse, child or other family member to carry on a business, and the income from that business is taxable in that person's hands.

- **Capital gains for minor children**
  The attribution rules do not apply to capital gains realized by children, including minor children. While interest, dividends or other income earned in a portfolio might still be attributed back to the parent, capital gains remain taxable to the child.

- **Loans or gifts to children who turn 18 in the year**
  The attribution rules generally do not apply to income earned on gifts or loans made to children in the year they turn 18. If a child was at least 17 years old on December 31, 2015, a gift or loan may be made to them at any time in 2016 and the attribution rules may not apply to income earned using those funds. Depending on the circumstances, it is possible that a lesser-known attribution rule found in subsection 56(4.1) of the Income Tax Act may apply to a loan made to a child age 18 or over. Make sure you obtain professional tax advice.

- **Income earned on Canada Child Benefit payments**
  If funds received through the Canada Child Benefit are deposited into an account solely in the child's name, most income earned on those funds will not be attributed to the parent.

- **Registered Education Savings Plans (RESPs)**
  An RESP is an attractive savings strategy for a child's post-secondary education. While there are no deductions for contributions, and there are contribution limits, the government provides matching grants of 20 per cent or more depending on a family's net income. The grants and the income earned within the RESP are taxable only when withdrawn and are taxed on the child's tax return. Assuming a 50 per cent tax rate for the parent, a five per cent annual compound rate of return, and a 20 per cent government grant, a $100 contribution to an RESP would grow to $289 after 18 years, and can likely be withdrawn tax-free if the child's income remains sufficiently low during school. Compare that $289 to just $156 if the original $100 contribution were instead invested in an unregistered account.

- **Registered Disability Savings Plans (RDSPs)**
  An RDSP is a plan created for the benefit of a family member under age 60 who is eligible for the disability tax credit. As with an RESP, contributions are not tax-deductible and there are contribution limits, however, income and

*August 2016*

# Income splitting strategies for Canadians

government grants (up to 300 per cent of the contribution, depending on family income) grow tax-free in the plan until they are withdrawn by or for the benefit of the person with the disability. At that time, the funds are taxed on the disabled person's tax return, likely at a lower rate than would apply to the person who contributed the funds.

- **Spousal Registered Retirement Savings Plans (RRSPs)**
  Contributions by a high-income earner give rise to a tax deduction at their high tax rate while subsequent withdrawals by that person's spouse are taxed on the spouse's return. But watch out for the "three-year attribution rule": if the spouse withdraws funds from the spousal RRSP, to the extent that any contributions were made in the year of the withdrawal (even after the day the withdrawal occurs) or in either of the two previous calendar years, the withdrawal will be attributed to the contributing spouse and taxed at that spouse's higher rate.

- **Graduated Rate Estates (GREs)**
  Beneficiaries of a family member's estate may be able to reduce the family's overall tax payable by designating the estate as a GRE. The estate will then have its own set of graduated tax rates for up to 36 months after the date of death. Income earned on the investments of a deceased person may attract less tax in the GRE than in the beneficiaries' hands. The rules regarding GREs can be complex; speak to your Collins Barrow advisor for guidance.

**Retirees**

- **Pension income splitting**
  A spouse may split up to 50 per cent of eligible pension income with a lower-income spouse by completing CRA form T1032. The most common types of eligible pension income include annual benefits paid from a registered pension plan and payments from RRSPs and RRIFs if the pensioner reaches age 65 or older during the year.

- **CPP sharing**
  Spouses may split their Canada Pension Plan payments if they file Form ISP1002 with Service Canada. For example, if one spouse would otherwise collect $10,000 of CPP each year and the other spouse only $2,000 (a total of $12,000 for the couple), they would instead each receive $6,000. If they split the CPP payments, the couple's overall tax payable may be reduced in many circumstances. This is not simply a notional income splitting like the pension splitting discussed above; the actual cheques written by the government provide exactly half of the total CPP to each spouse. This process is required in addition to pension income splitting, as CPP is not a form of eligible pension income.

**Business owners**

- **Salaries paid to family members**
  Business owners may pay salaries to their spouses and children for work they perform for the business, with the related income taxed at the lower graduated tax rates of those spouses or children. Such business owners should beware, however, that payments to family members are often an area of focus during CRA audits. In addition, the CRA may conduct interviews and request documentation, such as time cards, as proof that family members actually performed the services for which they were paid. If the CRA is not satisfied that family members actually performed the work, it may deny the expense to the business. Further, the amount of the expense must be reasonable in the circumstances, or it may be denied. Do not pay your 8-year-old $100 an hour to sweep floors!

*August 2016*

# Income splitting strategies for Canadians

- **Loans from private corporations to family members**
  If a business is incorporated, any loan made to a family member is included in the family member's income in the year received unless it can be shown that it was repaid to the corporation within two year-ends. Corporate owner-managers can consider making loans to children age 18 or over who are pursuing post-secondary education. While such loans may be taxable income to the child, the funds would likely be taxed at a lower rate than the owner-manager's rate on a dividend that would otherwise be required to fund the child's post-secondary education. The loan might even be tax free if the child's income remains below the basic personal exemption. In the (somewhat unlikely) event that the child repays the loan to the corporation, the child would receive a deduction. If this repayment occurs in a year after the child graduates and earns a higher level of income, the deduction might even give rise to a large tax refund despite the fact that the initial loan might have been taxed at a low rate or may not have been taxed at all.

- **Discretionary shares held by children**
  A common tax planning technique in an owner-managed private company setting is to issue discretionary – or "dividend sprinkling" – shares to family members. Owner-managers should consider issuing these shares to spouses and children to pay dividends to them and make use of their tax brackets, particularly if they plan to help children pay for post-secondary education. There are a few traps to consider. Children must be turning 18 years of age in the year they receive a dividend, otherwise the "kiddie tax" may apply to tax the children at the highest marginal rate. In addition, discretionary shares should only be issued after an "estate freeze," and professional advice is critical with this strategy.

- **Family trusts**
  Although anyone may set up a family trust, these flexible tax-planning tools are most often used by owner-managers of private companies for the same reasons as discretionary shares, along with the ability to potentially claim multiple capital gains exemptions upon the sale of a business. Family trusts can be complicated from a tax perspective; professional advice is important.

These are just some of the most common strategies available to Canadians to split income with family members. Often, the difficulty lies in knowing which strategies would work best for you. Your Collins Barrow advisor can help.

***Rock Lapalme, CPA, CA, TEP**, is a senior manager in the tax practice in the Sudbury office of Collins Barrow.*