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Wealth
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INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC WEALTH MANAGEMENT SERVICES



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Income splitting and the attribution rules

Understand the rules that may prevent you from income splitting

On July 18, 2017 the federal government released a consultation paper proposing a number of strategies which target private corporations with regards to income splitting, multiplication of the lifetime capital gains exemption, holding a passive investment portfolio inside a private corporation, and converting a private corporation's regular income to capital gains.

Generally, effective for 2018 and later taxation years, the government has proposed to limit income sprinkling to family members receiving "reasonable" compensation from a private corporation. The proposed measures extend the tax on split income rules (often known as "kiddie tax") to adults and limit the multiplication of claims to the lifetime capital gains exemption.

The government is also seeking input on possible measures to eliminate the tax advantage of investing undistributed earnings from an active business in a private corporation. If enacted, these measures may result in a disincentive for investing passively within a corporation.

The strategies discussed in this article may be affected by the proposed measures in the consultation paper and the accompanying proposed legislation. If you are an owner of a private corporation you should consider the potential impact of the proposed measures and discuss the implications with your qualified tax advisor.

If you are a high income earner and support family members with little or no income, you may be able to reduce the overall amount of income tax paid by your family by income splitting. Income splitting between family members is recognized as an acceptable tax planning method but the income attribution rules restrict the use of income splitting strategies. To determine whether you can benefit from family income splitting, it is important to understand how attribution works. This article discusses the various attribution rules as well as income splitting strategies that may help leave your family with more funds available for you to meet other financial planning goals.

This article outlines several strategies, not all of which will apply to your particular financial circumstances. The information in this article is not intended to provide legal or tax advice. To ensure that your own circumstances have been properly considered and that action is taken based on the latest information available, you should obtain professional advice from a qualified tax advisor before acting on any of the information in this article.

Income splitting

In Canada, each person reports the income that they earn personally. Each person then pays taxes based on a progressive tax system where, as their taxable income increases, their marginal tax rate increases. As such, there may be cases where a family consisting of high income earners and low income earners will pay more tax than a family with members who have equal incomes, even if the total household income is the same in both cases.

Income splitting is a strategy that takes advantage of the progressive tax system so that the family can retain more after-tax income. It involves moving income from a family member in a high tax bracket to one in a lower tax bracket. However, in order to achieve income splitting, it is important to understand the attribution rules that are designed to prevent family income splitting in certain circumstances.

Income attribution rules

In some cases, any investment income or loss and any capital gain or loss earned by a family member on property gifted or loaned by you, may need to be reported in your income tax return. The requirement to report the income in these circumstances is called income attribution. Whether income attribution applies depends on the type of income being earned as well as the relationship between the transferor and the recipient of the property.

For example, if you gift or loan (at low- or no-interest) property to your spouse, any income or loss (other than business income) as well as any capital gain or loss earned on that property or substituted property may be attributed back to you. Whereas, if you gift or loan (at low- or no-interest) property to your minor children, only the income or loss (other than business income) earned on that property or substituted

property may be attributed back to you. Any capital gain or loss earned on that property or substituted property will not be attributed back to you. For purposes of the attribution rules, a minor child includes a child, grandchild, niece or nephew under the age of 18.

If instead you gift assets to an adult child or other non-arm's length person, there is no attribution on any type of income. However, if you loan (at low- or no-interest) property to an adult family member or other non-arm's length person and one of the main reasons for the loan is to

reduce your taxable income, then any income or loss (other than business income) earned on that property or substituted property may be attributed back to you. Any capital gain or loss earned on that property or substituted property will not be attributed back to you.

A loan is considered a low-interest loan where the interest charged on the loan is less than the Canada Revenue Agency (CRA) prescribed rate.

The following table summarizes the income attribution rules.

Summary of Income Attribution Rules

Method of transferring property	Relationship to Transferor (i)		
	Spouse (includes common-law partner)	Non-arm's length minor (ii)	Adult child or other adult non-arm's length individuals (iii)
Property is gifted for no consideration (iv)	Income/loss (excluding business income) and capital gains/losses are attributable	Income/loss (excluding business income) is attributable; Capital gains/losses are not	No attribution of any type of income
Property is loaned at low- or no-interest rate	Same as above	Same as above	Income/loss is attributable; Capital gains/losses are not

(i) The transferor is the individual who is gifting or lending the property.
(ii) A non-arm's length minor is generally a child, grandchild, or a niece or nephew of the transferor who is under the age of 18 throughout the taxation year.
(iii) This includes an individual connected by blood relationship, marriage or common-law partnership or adoption such as a child, parent, brother, sister, brother-in-law, sister-in-law etc.
(iv) Gifts of property must be made with no restrictions as to its use or requirement of future repayment.

Dispositions on gifting or loaning property

Generally, you can gift or transfer property to your spouse at cost. If you transfer property that has appreciated in value to your spouse, you will have to report the capital gain when they eventually sell that property. If you transfer property in a loss position to your spouse, you may not be able to use the loss to reduce your capital gains because of the superficial loss rules. Your RBC advisor can provide you with articles that discuss the superficial loss rules. It is also important that gifts between spouses are properly documented.

If you gift or transfer property to any other family member, with the exception of your spouse, you will generally realize a disposition at fair market value resulting in a capital gain or capital loss on the date of the transfer. You will need to report this gain or loss on your tax return.

Income splitting with your spouse

Although the income attribution rules restrict the number of income splitting opportunities that are available to you, there are still several ways in which you can split income with family members. The following income splitting strategies may help you achieve tax-efficiency by equalizing your and your spouse's income.

Invest the earnings of the lower-income spouse

If your spouse works or has other sources of income but pays tax at a lower marginal tax rate than you do, consider the strategy where your spouse saves all their earnings in a separate account and you pay the living expenses for the household. This will allow your spouse to build an investment portfolio in their name. The income and capital gains earned in the account is taxable to them and not attributed back to you since the investment is funded with their own earnings.

Earn income on income

The income your spouse earns on funds that you gifted or loaned at low- or no-interest, will continue to attribute back to you. If your spouse reinvests the income on which you paid tax, the income or capital gains they earn will be taxed in their hands. This is known as "income on income." You should track the annual income carefully or maintain separate accounts for the original funds and the income earned. Over a number of years, this strategy can result in the lower-income spouse accumulating substantial capital for investment where the income will be taxed in their hands.

For example, Mrs. Smith gifts \$100,000 to Mr. Smith, the lower-income spouse, who invests the funds and earns 5% of interest income. Each year \$5,000 of income is taxed in Mrs. Smith's hands but the earnings become Mr. Smith's capital which he can reinvest. The future earnings on the \$5,000 would be taxable to Mr. Smith.

Use a prescribed rate loan

If you are the higher-income spouse and loan money to your lower-income spouse at an interest rate at least equal to the CRA's prescribed rate for these loans, you may be able to avoid income attribution. This means that all the income and capital gains your spouse earns by investing the borrowed funds will be taxed in your spouse's hands at their lower marginal tax rate. In return, your spouse pays you interest on the loan. You must include the interest your spouse pays you on the loan as part of your income when you file your income tax return. When the interest your spouse pays you is less than the income your spouse earns by investing the borrowed funds, this could result in significant tax savings.

In order for this strategy to work, you must have a formal written loan agreement and your spouse must make annual interest payments by

January 30th of the following year. If the interest payments are not made within these time limits, attribution will apply for the current year and all future years, even if the interest is paid after January 30th. As a result, this income splitting strategy will no longer work.

Gift or loan funds to your spouse to finance a business

If you gift or loan funds to your spouse to earn business income, that income will not attribute back to you. It will be taxed in your spouse's hands. If you have funds earning investment income and you are in a high tax bracket, this strategy may be an effective way to reduce your highly taxed investment income and provide capital to your spouse who is setting up a business or investing in one.

Pay your spouse a salary

If you are a business owner and have a spouse who is employed in the business, you can pay your spouse a salary for their work. The amount of salary you pay your spouse must be reasonable for the duties they perform. This is another way you may be able to put income into the hands of your lower-income spouse and have it taxed at their lower marginal tax rate. This will also enable your spouse to make contributions to the Canada Pension Plan (CPP)/ Quebec Pension Plan (QPP) and earn Registered Retirement Savings Plan (RRSP) contribution room to help increase their retirement savings.

Split eligible pension income with your spouse

If you receive eligible pension income and pay tax at a marginal tax rate that is higher than your spouse, you may want to allocate up to 50% of your eligible pension income to your spouse and have it taxed at their lower tax rate. Eligible pension income includes:

- Registered Retirement Income Fund (RRIF) income received by

The main advantage of a spousal RRSP is that it enables you and your spouse to income split by having RRSP income taxed in the lower-income spouse's hands when the funds are withdrawn.

the plan annuitant when they are age 65 or older. Note that the age of the recipient spouse is not relevant.

- Pension income from an employer plan received at any age by a plan member. Note that a plan member who is resident in Quebec must be 65 or older to split pension income for provincial income tax purposes.

Splitting eligible pension income can potentially equalize both spouses' incomes and also enable both spouses to receive the \$2,000 federal pension income tax credit (they may also be entitled to a provincial pension income tax credit). In addition, because the pension income splitting rules provide an opportunity to reallocate income from one spouse to another and reduce the taxable income of the higher-income spouse, it can reduce or eliminate the possibility of OAS clawback.

For a more detailed discussion, please ask your RBC advisor for the articles, Pension Income Splitting and the Pension Income Tax Credit.

Contribute to a spousal RRSP

The main advantage of a spousal RRSP is that it enables you and your spouse to income split by having RRSP income taxed in the lower-income spouse's hands when the funds are withdrawn. However, since RRIF income can be split between spouses, there has been some discussion as to whether contributing to a spousal RRSP still makes sense. The following are some of the key reasons why, even with the pension income splitting measures, using a spousal RRSP may still be a useful strategy for you and your spouse:

- You and your spouse retire prior to age 65 and need to make withdrawals from your RRSP or RRIF to supplement your retirement income. In this case it may be beneficial to be able to draw on a spousal RRSP or RRIF

owned by the lower-income spouse to fund the shortfall. Since RRIF income cannot be split prior to age 65, withdrawals from the spousal RRSP or RRIF can be taxed at the lower-income spouse's rate.

- The lower-income spouse retires after age 65 but before the higher-income spouse who previously made contributions to the spousal RRSP. In this case the lower-income spouse may be able to withdraw funds from their spousal RRSP or RRIF in retirement and be taxed at their lower marginal tax rate.
- You and your spouse have retirement income taxed at different marginal tax rates and you want to split more than 50% of your income. A typical scenario is where one spouse has significant investment income while the other spouse does not. If the spouse with the investment income has unused RRSP contribution room, they could make spousal RRSP contributions so that the spouse who is not earning investment income can receive RRSP or RRIF income in retirement to equalize their incomes.
- The older spouse is still working after age 71 and wants to benefit from an RRSP deduction. If the older spouse has unused RRSP contribution room, they can make spousal RRSP contributions as long as the younger spouse is age 71 or younger. This will allow the working spouse to claim an RRSP deduction to reduce their taxable income while working and potentially have the future RRSP withdrawals taxed in their spouse's hands.

The withdrawals from a spousal RRSP or RRIF will not attribute to the higher-income spouse who made the RRSP contributions unless a spousal contribution was made in the year of withdrawal or the previous two calendar years. Also, please note that

The benefit of sharing CPP/QPP retirement benefits is that the lower-income spouse can receive a portion of the higher-income spouse's CPP/QPP and have that income taxed at their lower marginal tax rate without triggering the attribution rules.

minimum RRIF withdrawals from a spousal RRIF are not subject to the attribution rules. Ask your RBC advisor for the article on Spousal RRSPs for more information on this topic.

Share CPP/QPP

If you or your spouse receive CPP/QPP retirement benefits, you may have another opportunity to split income. CPP/QPP allow you to share your pensions with your spouse. You can apply to Service Canada or Retraite Quebec to share CPP or QPP respectively.

You cannot elect to split CPP/QPP on your tax return like eligible pension income. CPP/QPP sharing involves an actual transfer of the pension payments from one spouse to the other but, the overall benefits paid do not increase or decrease. The amount that can be shared is based on the period that you and your spouse lived together while accumulating retirement benefits.

The benefit of sharing CPP/QPP retirement benefits is that the lower-income spouse can receive a portion of the higher-income spouse's CPP/QPP and have that income taxed at their lower marginal tax rate without triggering the attribution rules.

Transfer capital losses to your spouse

If you have unrealized capital losses that you do not expect to be able to use personally and your spouse has taxable capital gains that would be subject to tax, you may be interested in transferring your unrealized capital losses to your spouse. Even if you can use the losses yourself, you may want to transfer your capital losses to your spouse if your spouse is in a higher marginal income tax bracket and has taxable capital gains that would otherwise be subject to tax at the higher marginal rate.

If you simply transfer your securities to your spouse, the income

attribution rules will prevent the loss from being realized in your spouse's hands and you will not achieve your goal. There is a strategy that involves using the superficial loss rules to transfer unrealized capital losses to your spouse. This strategy generally involves you selling your loss securities to your spouse at fair market value. It is important that your spouse pays fair market value consideration for the securities. Your spouse will need to hold onto the loss securities until the 30th day after the settlement date of sale in order to trigger the superficial loss. Triggering the superficial loss rules denies you from claiming the capital loss but allows the capital loss to be added to the adjusted cost base of the securities which now belongs to your spouse. To realize the capital loss, your spouse will need to dispose of the loss securities on the market. You will then need to file a tax election with your tax return to have the transfer to your spouse take place at fair market value.

It is recommended that you consult with your tax advisor prior to implementing this strategy to determine if you could benefit from it. Note that the financial benefit of implementing this strategy may be partially reduced by any professional fees incurred.

Income splitting with your children

The following income splitting strategies may help you achieve tax-efficiency by equalizing your and your children's income. You may want to consider these strategies if you would like to provide support for your children and reduce your family's overall tax burden.

Gift to adult children

Since the attribution rules do not apply to outright gifts of property to adult children, consider gifting them funds which they can invest. Any income earned or capital gains



If you are a business owner and employ your children in your business, consider paying them a salary for their work.

realized on the investments will be taxed in your child's hands at their lower marginal tax rate. If you gift an asset in-kind, you will realize a disposition at fair market value resulting in a capital gain or capital loss on the date of the transfer. You will need to report this gain or loss on your tax return.

Invest in growth stocks

If you gift or loan (at low- or no-interest) funds to a minor child, any capital gains realized on those funds will be taxed in the child's hands. As a result, you may be able to avoid attribution by investing the gifted or loaned funds in growth-oriented securities. As always, the investment merits of the securities should be considered first before looking at the tax benefit.

Earn income on income

The income your minor child earns on funds that you gifted or loaned at low- or no-interest, will continue to attribute back to you. If your child reinvests the income on which you paid tax, the income they earn will be taxed in their hands. This is known as "income on income." You should track the annual income carefully or maintain separate accounts for the original funds and the income earned. Over a number of years, this strategy can result in the child accumulating substantial capital for investment where the income will be taxed in their hands.

Pay your child a salary

If you are a business owner and employ your children in your business, consider paying them a salary for their work. The salary you pay your children must be reasonable for the duties they perform. If they invest the salary they receive, the investment income they earn on those funds will not attribute back to you. Further, this can help the child create RRSP contribution room. If your child is age 18 or older, paying them a salary will also enable them

to make contributions to CPP/QPP and help increase their eventual retirement savings.

Use a family trust

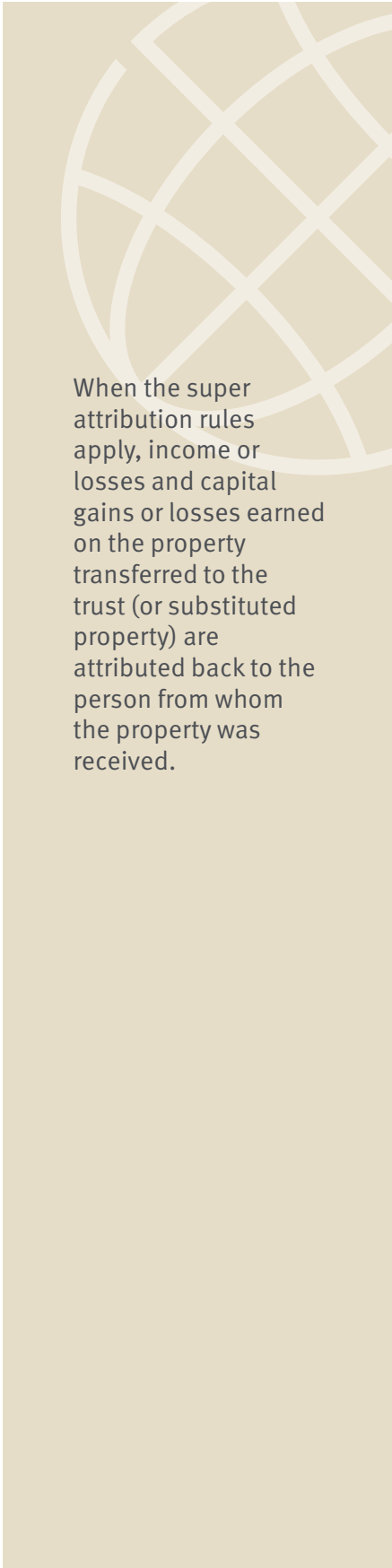
Because minors generally do not have the capacity to contract, they may not be able to open an account and invest funds on their own. In this case, you may want to use a family trust, where the trustee can invest the funds on the minor child's behalf. You may also want to use a family trust to maintain control over the property that you intend to benefit your children. If the trust is properly structured, the income from the trust can be taxed in your child's hands, as the beneficiary of the trust. However, it is important to understand that the attribution rules apply to income that is earned and allocated through a trust in the same manner as a gift or loan that is made directly to a child. In addition, you will need to avoid the super attribution rules, which are discussed further in this article.

If the beneficiary of the trust is a minor child, you will have to loan funds to the trust in and the trust must pay you interest at least at CRA's prescribed rate in order to avoid the income attribution rules. The income can then be taxed in the beneficiary's hands if the income is paid or made payable to them.

If the beneficiary of the trust is an adult child, you can gift or loan funds at an interest rate that is at least the CRA's prescribed rate. The income can then be taxed in the beneficiary's hands if the income is paid or made payable to them.

Contribute to a Registered Education Savings Plan (RESP)

If you make a contribution to an RESP to save for your child's education, you can achieve income splitting when your child later attends post-secondary school. To the extent that the withdrawals are taxable, they will be taxed in the hands of your



When the super attribution rules apply, income or losses and capital gains or losses earned on the property transferred to the trust (or substituted property) are attributed back to the person from whom the property was received.

child when your child is enrolled in a qualifying educational program.

Reversionary trust rules (super attribution)

The reversionary trust rules are attribution rules that we refer to as the “super attribution” rules. These rules may apply if a Canadian resident trust holds property on condition that the property:

- may revert back to the person from whom the property was received; or
- the person from whom the property was received has the power to determine who receives the property, or substituted property, after the creation of the trust; or
- during the lifetime of the person from whom the property was received, the trust property cannot be disposed of without their consent.

Examples of when the first condition may exist is where the settlor is also a capital beneficiary of the trust or if the trust is a revocable trust. One example of when the second and third conditions may exist is where the settlor is the sole trustee of the trust.

When the super attribution rules apply, income or losses and capital gains or losses earned on the property transferred to the trust (or substituted property) are attributed back to the person from whom the property was received. In addition, trust capital cannot be rolled-out to beneficiaries at cost. However, if the person from whom the property was received or their spouse is a capital beneficiary of the trust and the terms of the trust allow it, the trust property can be rolled-out at cost to either of these two individuals.

Generally, the super attribution rules do not apply to any additional property that is loaned to the trust as long as the loan is outside the terms of the trust.

Corporate attribution

If you own a corporation and would like to direct income earned in the corporation to a family member, you should be aware of the corporate attribution rules. Corporate attribution generally applies when an individual transfers or lends property to a corporation and one of the main purposes of the transfer or loan is to benefit a spouse or a related minor child (which includes a grandchild, niece or nephew) who owns 10% or more of any class of shares of the corporation. If corporate attribution applies, the individual who transferred or loaned the property to the corporation is deemed to have received interest income in the year equal to the CRA prescribed rate of interest for the period on the outstanding amount of the transferred property or loan. This annual deemed interest benefit is reduced by the following:

- Any actual interest received in the year by the individual in respect of the transfer or loan;
- Grossed-up taxable dividends received by the individual in the year on shares that were received from the corporation as consideration for the transfer; and
- Income subject to kiddie tax (discussed below) reported by the related minor child.

Corporate attribution does not apply to a Canadian-controlled private corporation if all or substantially all (generally means 90% or more) of the fair market value of its assets are used in an active business carried on primarily in Canada. Therefore, corporate attribution is a concern only if your corporation holds passive investment assets exceeding 10% of the fair market value of its total assets.

There are more sophisticated ways of structuring a corporation that avoid the application of the corporate

Please contact us for more information about the topics discussed in this article.

attribution rules with respect to a spouse or minor children. However, these structures are beyond the scope of this article. In any case, as this area of taxation is quite complex, it is strongly recommended that you discuss these issues with a qualified tax advisor prior to implementing any strategies involving a corporation.

Tax on split income (kiddie tax)

Another rule that restricts the ability to split income with minor children is tax on split income (also known as kiddie tax). Kiddie tax is not an attribution rule, however, it does affect income splitting. Kiddie tax is designed to discourage business owners from income splitting with non-arm's length minors. Under this rule, a minor child who receives certain dividend payments from a Canadian corporation whose stock is not listed on a designated stock exchange (e.g. a privately held company) is taxed on the grossed-up value of the dividend received at the highest personal marginal tax

rate. The parent is also jointly and severally liable with the child for the taxes payable on the split income. In addition, the rules disallow the minor from claiming personal tax credits other than the dividend tax credit.

If kiddie tax applies to the income received by the minor, the income attribution rules will not apply on the income.

Conclusion

Income splitting can be a great way for you to reduce your family's overall tax burden. However, it is important to avoid the application of the many attribution rules in order to successfully income split. Therefore, it is important to discuss income splitting strategies with your professional tax advisor before implementing them. This will ensure that you take your personal circumstances into consideration and help maximize the effectiveness of the tax planning strategies you choose.



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