Wealth Management

the Navigator

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC WEALTH MANAGEMENT SERVICES

Income splitting checklist

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

If you have a spouse who earns less income than you or children with little to no income, you may want to consider implementing an income splitting strategy. Income splitting shifts income that would otherwise be taxed in your hands at a high marginal tax rate to your lower-income spouse, children or other family members in order to take advantage of their lower marginal tax rates. The following article contains a checklist of some income splitting strategies you may wish to consider in order to reduce your family's overall income tax bill.

Any reference to spouse in this article also includes a common-law partner.

Income splitting strategies

The following is a checklist of some income splitting strategies you may wish to consider. Please note that this is not an exhaustive list:

Strategies involving a prescribed rate loan

- **Loan to your spouse:** This strategy involves you loaning funds to your spouse at the Canada Revenue Agency's (CRA) prescribed interest rate in effect at the time the loan is made. Your spouse will then invest the loaned funds for the purpose of generating investment income which may include interest, dividends and capital gains. This investment income will be taxable to your spouse at their lower marginal tax rate, which effectively reduces your family's overall tax bill. Your spouse must pay you annual interest on the loan by January 30th of the following year (and by January 30th of every subsequent year the loan is in place). If the interest payment is late by even one day, the attribution rules will apply for that particular year, and all subsequent years. This prescribed rate loan strategy may also function between yourself and an adult child. For more information, please ask your RBC advisor for the article on the spousal loan strategy.

- **Loan to a family trust:** This strategy involves you loaning funds to a family trust for the benefit of your family members at the CRA's prescribed interest rate in effect at the time the loan is made. The trustee will then invest the loaned funds for the purpose of generating investment income which may include interest, dividends and capital gains. To the extent that

the investment income can be allocated to your family members by the trustee, that income will be taxable to your family members at their lower marginal tax rate, which effectively reduces your family's overall tax bill. The trustee must pay you annual interest on the loan by January 30th of the following year (and by January 30th of every subsequent year that the loan is in place) from the trust. For more information, please ask your RBC advisor for the article on using a family trust for a prescribed rate loan.

Strategies involving a gift

- Gift funds to an adult child and have your child invest the funds in their own non-registered account. All investment income can be taxed in your adult child's hands at their lower marginal tax rate. There will be no attribution of interest, dividends or capital gains back to you.

- Gift (or loan) funds to an adult child to purchase a principal residence. When your adult child eventually sells the home, they may be able to use their principal residence exemption to eliminate the taxes on any capital gain. Beware that this strategy may expose the value of the home to your child's marital or creditor claims.

- Gift funds to a trust for a minor child. There will be attribution of interest and dividends back to you but capital gains can be taxed in your minor child's hands at their lower marginal tax rate.

Strategies involving paying expenses or tax obligations

- If you pay for all of the family's expenses, your lower-income spouse can invest their own income. This way, the investment income earned can be taxed at your spouse's lower marginal tax rate.

- If you pay your spouse's quarterly tax installments or their final tax liability (in April of the following taxation year), your lower-income spouse can invest their own income. The investment income earned can be taxed at your spouse's lower marginal tax rate.

Strategies involving non-registered funds

- **Earn income-on-income:** If you gift or loan (at low or no interest) property to your lower-income spouse, any income earned or capital gains realized on that property is attributed back to you for tax purposes. However, if this income is reinvested by your spouse, the income earned on that reinvested amount (i.e. the income on income) is not attributed back you and can be taxed in your spouse's hands at their lower marginal tax rate.

- **Transfer capital losses from your spouse to you:** If your spouse has unrealized capital losses that they are unable to use personally and you have taxable capital gains that would be subject to tax, your spouse may be a able to transfer their unrealized capital losses to you. Even if your spouse can use the losses themselves, they may want to transfer the capital losses to you; this may be the case if you're in a higher marginal tax bracket and have taxable capital gains that would otherwise be subject to tax at a higher marginal rate. The strategy involves your spouse selling the loss securities to you for fair market value (FMV). You then trigger the superficial loss rules by holding the securities for at least 30 days before selling them on the market. It's important to ensure the transaction is appropriately reflected as occurring at FMV on your spouse's tax return. For more information on this strategy, please ask your RBC advisor for the article on transferring capital losses to your spouse.

- **Transfer future growth of a security to your spouse:** If you own a security that you anticipate may appreciate in value, consider transferring it to your spouse so that any future capital gain will be taxed at your spouse's lower marginal tax rate. You can transfer the future growth either by:

  - Transferring the security in-kind to your spouse and having your spouse pay you FMV consideration using their own funds; or

  - Selling the security on the open market and having your spouse purchase the same security with their own funds; or

  - Lending cash to your spouse to fund their purchase of the same security.

  If your spouse purchases the security for FMV with their own funds, it will not trigger the attribution rules, and any future capital gain will be taxable in your spouse's hands. It's important to ensure the transaction is appropriately reflected as occurring at FMV on your tax return. For more information on this strategy, please ask your RBC advisor for the article on transferring future growth of a security to your spouse.

- **Buy a non-income producing asset from your spouse:** If your lower-income spouse has a non-income-producing asset such as a family car, a piece of artwork or jewelry, consider buying it from them for FMV. Your

If you gift or loan (at low or no interest) property to your lower-income spouse, any income earned or capital gains realized on that property is attributed back to you for tax purposes.

spouse can then invest the sale proceeds and the income earned on the sale proceeds will be taxable in their hands at their lower marginal tax rate. For more information on this strategy, please ask your RBC advisor for the article on buying non-income-producing assets from your spouse.

Strategies involving registered funds

- **TFSA:** You can gift money to your spouse or adult child to contribute to their own TFSA. Any income earned or capital gains generated within the TFSA will not attribute back to you. This strategy can help your spouse or adult child earn tax-free investment income and save for retirement or other goals.

- **RRSP:** You can contribute to a spousal RRSP for the future benefit of your spouse. The withdrawals from the spousal RRSP will be taxable to your spouse (provided you did not make a contribution in the year of withdrawal or in the two previous tax years).

- **RESP:** You can contribute to an RESP to save for your child's post-secondary education. The maximum contribution you can make to an RESP is $50,000 for each beneficiary. The federal government will also contribute to the plan by providing grants and bonds, in certain circumstances. Not only is all of the income earned in the plan tax-deferred, but all of the income as well as the government incentives, can be taxable to your child at their lower marginal tax rate when they withdraw the funds for their education.

- **RDSP:** You can contribute to an RDSP for a family member with a disability. The maximum contribution you can make to an RDSP is $200,000. The federal government will also contribute to the plan by providing grants and bonds, in certain circumstances. Not only is all of the income earned in the plan tax-deferred, but all of the income, as well as the government incentives, can be taxable to the plan beneficiary at their lower marginal tax rate when they withdraw the funds.

Strategies involving pensions

- **Pension income splitting:** If you receive eligible pension income, such as an employer pension or payments from a RRIF or LIF when you are age 65 or over, consider allocating up to 50% of it to your spouse. By splitting your pension income, the income can be taxed in your spouse's hands at their lower marginal tax rate and you may also avoid the Old Age Security (OAS) clawback or the reduction of other income-tested government benefits. To split the qualifying pension income, you and your spouse have to make a joint election when you file your tax returns.

You can gift money to your spouse or adult child to contribute to their own TFSA. Any income earned or capital gains generated within the TFSA will not attribute back to you.

- **CPP/QPP sharing:** If you receive a higher CPP/QPP retirement pension than your spouse, consider sharing your pension. To qualify for CPP/QPP pension sharing, certain conditions must be met, including that both you and your spouse must be 60 years of age or over. By electing to share your pension, a portion of your retirement income may be shared with your lower-income spouse and taxed in their hands. The pension sharing process combines both your and your spouse's pension entitlements that have accumulated during the time you've lived together and reallocates 50% of the combined entitlements to each spouse.

Strategies for business owners

- If you gift or loan funds to your spouse and they use the funds 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're 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.

- Whether or not your business is incorporated, your business can pay reasonable salaries to your family members for the services they provide. This strategy allows you to take advantage of your family members' lower marginal tax rates while generating RRSP contribution room for them at the same time.

- If your business is incorporated, you may be able to pay dividends to family members who are shareholders of the corporation, but you have to be aware of the tax on split income ("TOSI") rules which limit splitting certain types of income with family members. Taking these rules into account, you may want to consider the following:

  - If you have lower-income adult family members who are actively involved in the business, you may consider paying them dividends if they are shareholders of the corporation either directly or indirectly (say, through a family trust). This would take advantage of their lower marginal tax rates.

  - If your business is not a professional corporation or one that primarily provides services, you may be able to pay dividends to lower-income family members

who are 25 years of age or over. Your family members would need to own more than 10% of the votes and value of the corporation directly in order for you to effectively split income with them.

For more information, please ask your RBC advisor for the article on income splitting using a private corporation.

- You can implement an estate freeze of your business in order to restructure the ownership of your corporation and transfer future growth to other family members. An estate freeze limits the value of your assets and transfers the tax liability of the future growth onto your next generation. If you eventually sell the business and the shares qualify as small business corporation shares, you may be able to claim the lifetime capital gains exemption (LCGE) and save a significant amount of tax. In addition, you may also be able to multiply the LCGE among family member shareholders of all ages if the business is sold to an arm's length party. It's important to note that there may be negative tax implications if the shareholders are minors (under age 18) and the business is sold to a non-arm's length party.

Conclusion

If you are looking for strategies to reduce your family's overall income taxes, speak to your RBC advisor and a qualified tax advisor to learn more about which strategies may be most appropriate for you and your family.

This article may contain strategies, not all of which will apply to your particular financial circumstances. The information in this article is not intended to provide legal, tax or insurance 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, legal and/or insurance advisor before acting on any of the information in this article.

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