MACKENZIE Investments

CONFIDENCE IN A CHANGING WORLD

Income Splitting

An excellent way to shift income between family members

Why Income splitting?

One of the easiest ways for families to reduce taxes is through properly structured income splitting. Income splitting can be an excellent way to shift income in a family from a member in the highest tax bracket to those who pay a lower rate of tax. The resulting effect is to increase family after-tax income. This will leave the family with more funds available for other financial planning goals.

The CRA's attribution rules

The federal government has put into place a number of rules to prevent income splitting in many situations. Known as the attribution rules, these rules prevent an individual from simply passing on a portion of their income or investments to another family member in a lower tax bracket to reduce overall family taxes. The attribution rules can be summarized as follows:

Income from property

Income from property includes interest, dividends, rents and royalties. Income from property in the Income Tax Act is distinguished from employment income, business income and capital gains. To be considered as income from a property source, a receipt must be earned from property in a passive manner without the commitment of time and labour by the taxpayer. *Income from property is also distinguished from capital gains, which arise from disposition of a property.*

Income (and losses) from property transferred or loaned to a spouse or minor

If an individual transfers or loans property to:

- His or her spouse or common-law partner, or a person who has since become the individual's spouse or common-law partner; or
- A family member who is under 18 years of age.

Any income or loss from the property is deemed to be the income or loss of the individual transferring the property, not of the spouse or minor. This means that the transferor still must declare the income and pay tax on it at his or her marginal tax rate. *Legal ownership of assets has no bearing on the attribution rules.*

Capital gains (and losses) realized on property transferred or loaned to a spouse or minor

Spouse

If an individual transfers or loans property to his or her spouse or common-law partner or a person who has since become the individual's spouse or common-law partner, any taxable capital gains realized on the disposition of that property is deemed to be a taxable capital gain of the transferor. An allowable capital loss arising on the disposition of property transferred or loaned to a spouse is also deemed to be an allowable capital loss of the transferor.

Minor

Capital gains and losses realized on property transferred or loaned to a minor do not attribute to the transferor. *This area is generally regarded as the most significant opportunity in the attribution rules and many income splitting strategies (discussed later) are based on this exception.*

Transfers and loans of property to corporations

The corporate attribution rules apply to transfers or loans of property to corporations (except Small Business Corporations discussed later). The attribution rules apply where one of the main purposes of the transfer or loan is to reduce the income of the transferor and to benefit a person who is the transferor's spouse or common law partner or a family member under 18 years of age. Under these circumstances the transferor is deemed to have received interest income on the outstanding amount of the loan or transferred property at the prescribed rates in effect during the year.

Transfers and loans of property to a trust

Where an individual has loaned or transferred property either directly or indirectly to a trust and one or more beneficiaries of the trust is a designated person of the individual (i.e. a spouse or related child under 18) the following attribution rules apply:

- All income from property (interest, dividends, rents and royalties) is attributed to the transferor in respect of that designated person but the amount attributed will not exceed the income actually allocated by the trust to that designated person in the year.
- The attribution of capital gains only applies in connection with a spouse or common-law partner of the transferor. The amount of the capital gain that is attributed for the year will not exceed that portion of the capital gain allocated by the trust to the spouse. *As with the attribution rules regarding the transfer of property directly to a minor family member, capital gains earned indirectly by that minor beneficiary through a trust do not attribute to the transferor.*

Loan guarantees

If an individual chooses to provide a guarantee for a loan to a spouse or related minor child who receives the loan only on the strength of the guarantee, the loan will be treated as if that individual had loaned the funds directly. Therefore, attribution rules will apply.

Reversionary trusts

If an individual transfers property to a trust for the benefit of a minor, capital gains realized on the sale of that property does not attribute to the transferor. However, if the person transferring the property to the trust is able to:

- Take that property back into his or her possession; or
- After the creation of the trust, determine who that property may pass to; or
- Control the disposition of that property, then all of the income or losses from the property **and** all of the capital gains and losses from the disposition of that property attributes to the transferor.

Short-term spousal RRSP contributions

Specific attribution rules exist to prevent the use of spousal RRSPs as short-term income splitting vehicles. If a spousal RRSP withdrawal is made in a given calendar year and there have been contributions to a spousal RRSP within the current calendar year or the previous two calendar years, the withdrawal will be attributed to the contributing spouse. The income attributed is capped at the sum of the contributions made within the last 3 calendar years (current year, plus two previous). The same attribution rules apply when the spousal RRSP is converted to a spousal RRIF and the payment is greater than the minimum amount. The difference between the minimum payment and the actual payment from the spousal RRIF would be attributed to the contributing spouse. The minimum payment from the Spousal RRIF is not subject to the attribution rules, regardless of the contributions made to the spousal RRSP in the current calendar year or previous years.

Tax on split income (kiddie tax)

A special federal tax at the rate of 33%, rather than normal graduated rates, is levied on certain types of passive income (referred to as split income) received by an individual under the age of 18. Split income includes taxable dividends, capital gains and shareholder benefits from private corporations received directly or through a trust. This rule does not catch dividends received from a public corporation or dividends received from a mutual fund corporation.

The split income tax provisions do not apply to capital gains that result from the sale of public corporation or mutual fund corporation shares. Furthermore this rule does not affect employment income.

Back-to-back transfers and loans

A loan or transfer made by an individual to a third person who then loans or transfers it to that individual's spouse or related minor child in a back-to-back arrangement, is deemed to be a loan or transfer by the individual.

Interest-free or low-interest loans

If one of the main reasons for making the loan was to reduce or avoid tax by causing income from the property to be shifted to a lower-income person, all of the income from the property attributes to the transferor. This attribution rule is primarily designed to catch income splitting arrangements involving low-interest or no-interest loans to adult children. Attribution, however, does not apply to capital gains (or losses) realized from the disposition of the property by adult children.

Transfer of rights to income

A taxpayer cannot avoid taxation on an amount of money by simply directing that the payment of that lump sum of money go to another individual. For example, a shareholder of a corporation who directs that his or her annual dividend or bonus be paid to his or her spouse will be caught by the attribution rules.

Pension Income Splitting

Individuals who are 65 years of age or older can allocate for tax purposes up to a maximum of 50% of their eligible pension income received from a lifetime annuity (purchased with registered, non-registered, superannuation pension, registered pension plan, or deferred profit sharing plan funds), registered pension plan, registered retirement income fund, life income fund or deferred profit sharing plan income. The individual continues to receive the entire amount of income but can allocate up to 50% of the amount to a spouse or common-law partner, who will include this amount on his or her annual tax return. The receiving spouse or common-law partner is not required to be 65 years of age or older to receive an allocation, and the amount allocated can be changed each year for the benefit of the couple.

For individuals not resident in Quebec and under 65, eligible pension income can include a registered pension plan. Income from a deferred profit sharing plan or annuity (registered and non-registered) received as a result of the death of a spouse are also sources of eligible pension income. Individuals can also allocate up to 50% of annual income received from these sources to a spouse. RRIF or LIF income however cannot be split while the annuitant is under age 65, unless the individual is receiving the RRIF or LIF income due to the death of his or her spouse or common-law partner.

Income splitting strategies

While the CRA's attribution rules eliminate most opportunities for income splitting there are a variety of income splitting strategies allowed. The following is a list of various strategies that are not prevented by the attribution rules:

Prescribed rate loans/transfers for fair market value

The attribution rules do not apply where property is transferred to a spouse, common-law partner or minor and the transferor receives consideration for the property that is at least equal to the fair market value of the property transferred.

Prescribed rate loans

In the case of a loan to a formal trust, spouse or minor, the attribution rules do not apply as long as interest is charged on the loan at a rate equal to or higher than CRA's prescribed rate at that time. It is also critical that the amount of interest payable on that loan be paid no later than 30 days after the end of the calendar year. If a payment deadline is missed in any year, the attribution rules will apply for that year and all subsequent years. Interest charged on the loan is income that must be reported by the lender.

Fair market transfers

If an individual transfers property to a spouse, or common-law partner, the attribution rules will not apply where cash or property of equal fair market value is taken back as consideration. This exception to the attribution rules can be exploited where the high-income spouse has transferable income-earning assets and the low income spouse has assets that do not produce income. For example jewelry, art, a cottage and an interest in a principal residence could be used as consideration in a fair market transfer. Since the transfer of assets will be done at fair market value, the tax liability of the capital gains that are realized will need to be accounted for when determining the benefit of this strategy.

For inter-spousal fair market value transfers of this nature, the transferor must elect in his or her tax return not to have the provisions of the tax deferred spousal rollover apply.

Capital gains on property transferred to a minor

One of the most significant opportunities in the attribution rules applies to capital gains and minor children. Capital gains (and losses) realized on the disposition of property by a minor does not attribute to the transferor. It is therefore advantageous to invest in assets that generate capital gains as opposed to income producing assets. In-trust for accounts are commonly used for income splitting purposes with minor children. They are typically referred to as informal trusts due to their lack of a written trust deed. However particular attention must be paid to the reversionary trust rules (described earlier), which state that capital gains as well as income may be attributed to the transferor if certain conditions are not met.

Second generation income

Where income earned by the transferee is re-invested in income-producing properties, the transferee will earn income on income, also referred to as second generation income. The attribution rules do not apply to this second generation income. In order to keep track of the second generation income, the most practical approach is to set up two accounts. The transferred property is invested in the first account. All interest and dividends earned on the transferred asset can be transferred to the second account.

This exception to the attribution rules on second generation income applies only to income from property, not gains from the disposition of property.

Canada Pension Plan benefits

Spouses, married or common-law, can 'share' their CPP benefits to achieve an effective income splitting technique. Spouses can share their CPP credits that have been built up during the time that they have lived together. To benefit, spouses or common-law partners need to apply to Service Canada. CPP Pension Sharing is not the same as pension income splitting discussed earlier.

Transfer capital losses to your spouse

If one spouse has unrealized capital losses and no capital gains to apply these losses against they can transfer these losses to their spouse which can be applied against their capital gains, reducing the tax payable on those gains.

To transfer losses to a spouse the securities must be sold by the spouse that currently owns them. Then their spouse must repurchase those same securities in the open market within 30 days of the sale. While the purchase of the securities will be at the current market price, the adjusted cost base (ACB) will be equal to the ACB of the spouse who sold the securities. Then after 30 days, the securities can be sold by the second spouse and the loss can be applied against their taxable capital gains.

Loans to earn business income

The attribution rules do not apply where funds are loaned from a high-income spouse to a low-income spouse for the purpose of financing a business and/or earning business income, as opposed to income from property.

Small business corporations

The corporate attribution rules do not apply to the issuance of shares of a small business corporation to family members. Generally, small business corporation dividends paid on shares owned by a spouse and/or children are not attributed back to the primary owner of the corporation. However, attention must be paid to tax on split income discussed earlier. This special tax is aimed at minor children and not spouses. Once a child attains the age of 18, tax on split income no longer applies.

Paying a salary to a spouse and/or children

Spouses/common-law partners and/or children can be employed in a business and paid a salary for their efforts. It is important that the salary paid be commensurate with the compensation paid to non-arms length individuals with similar job roles. Otherwise the CRA could impose a penalty on both the corporation and the employee.

Gifting

The attribution rules do not apply to outright gifts of property to adult family members (other than a spouse). However, gifts in-kind to adult, non-spouse family members are subject to a deemed disposition. Any capital gains that arise as a result of the deemed disposition are taxable to the giftor.

Other income splitting techniques

The following summarizes some additional income splitting techniques that require no further explanation:

- Contributions to a registered education savings plan (RESP) to achieve income splitting with children attending university.
- Contributions to a spousal RRSP to allow a couple to split tax deferred pension income in retirement.
- The high-income earner pays the family's living expenses thus increasing the lower income spouse's investment base.
- The Canada Child Benefit (CCB) payments can be invested in the child's name without attribution.

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