

Tax Management – Income Splitting

What is income splitting?

Income splitting refers to strategies which allow families to lower their overall tax liability. Variations in income levels can often occur between spouses/common-law partners (“partners”) and with their children. Income splitting saves taxes by shifting income from the hands of a family member in a higher tax bracket to the hands of a second family member in a lower tax bracket; the shifted income is taxed at a lower rate, or not at all, if the second family member's income is low enough.

How does income splitting work?

Income splitting is achieved in different ways. Pension income splitting can be realized by the higher-income spouse choosing to allocate, up to 50%, of his/her eligible pension income to be taxed in the hands of the lower-income spouse. This is done by completing specific Canada Revenue Agency (CRA) joint election forms which must be attached annually when filing your tax returns. Similarly, either spouse/partner can apply to Service Canada for Canada Pension Plan (CPP) pension sharing if you applied for or are already receiving a CPP retirement pension. Note that pension splitting will affect personal tax credits and benefits that are calculated using one taxpayer's net income, such as age amount, spouse/partner amount and the repayment of Old Age Security (OAS) benefits.

For families not yet in retirement, income splitting may occur more simply by having the higher-income earning spouse or partner pay for everyday non-deductible household expenses which may allow the lower-income earning spouse to invest. Future income generated from these investments will be taxed in the lower-income earner's hands, which will presumably be at a lower tax rate.

Other Income Splitting opportunities:

- 1. Spousal Retirement Savings Plans (RSPs)*
- 2. Prescribed rate loans where interest is paid on time*
- 3. Registered Education Savings Plans (RESPs)/Registered Disability Savings Plans (RDSPs)*
- 4. Paying a reasonable salary from a family business to spouse/partner and/or children for actual services rendered*
- 5. investing Child Tax benefit and Universal Child Care Benefit payments in the name of your children*
- 6. Electing to transfer taxable Canadian dividends to a spouse/partner*
- 7. Transferring property to children for a capital gains*

What about the attribution rules?

It would not be prudent to discuss income splitting opportunities without discussing the attribution rules that exist within Canada's income tax laws. The attribution rules are tax measures designed to prevent abuse from an income tax perspective. The rules attribute income of a transferee or borrower back to the transferor or lender of property so as to prevent income splitting. The attribution rules may apply whenever property is transferred to a family member, or where a loan is made to a family member with little or no interest tied to the loan.

The most common situations where attribution rules apply include:

- Where you transfer or loan property to your spouse or partner other than for fair market value consideration. In this situation, any income or capital gains from the transferred property may be attributed to you.
- Where you give property (transfers and loans) to a minor (i.e., a son, daughter, niece or nephew under 18 or some other minor child with whom you do not deal at arm's length). The income from the funds may be attributed to you, however there is no attribution of capital gains on property transferred to one's children.

It is important to note that if income that is subject to the attribution rules is subsequently reinvested by the recipient, it may earn a secondary stream of income. This "second generation income" is not attributed back to the transferor (or lender) since it is normally not viewed as income from the original property transferred. It will be taxed in the transferee's or borrower's hands.

There are also special attribution rules related to spousal RSPs. This rule is designed to prevent a high-income spouse from contributing to a spousal plan and having the funds almost immediately withdrawn and taxed to the lower income earning spouse. If contributions to any spousal plan are withdrawn in the calendar year during which a contribution was made or in the next 2 calendar years, they are attributed back to the contributor and the withdrawal is treated as income on their personal tax return. If the withdrawal is made more than three calendar years after the contribution, income splitting can be achieved as there will be no attribution.



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