



TAX, RETIREMENT  
& ESTATE PLANNING  
SERVICES

## Income splitting

THE FACTS

An effective way to reduce the family tax bill is through the use of income splitting. Income splitting involves the transfer of income from a family member in a high tax bracket to one in a lower tax bracket. There are a number of rules, known as the “attribution rules”, that have been enacted to prevent the potential tax savings that may be realized from income splitting. However, if properly structured, income splitting strategies can save significant tax dollars and leave the family with more after-tax funds.

The following guide provides an overview of the attribution rules, details on what income splitting techniques are restricted by these rules, as well as some potential tax saving strategies that are permitted by the *Income Tax Act* (Canada), the ‘Act’<sup>1</sup>.

## THE ATTRIBUTION RULES

The attribution rules are intended to prevent a taxpayer and the taxpayer’s spouse<sup>2</sup> or a related minor<sup>3</sup> from splitting income from property so as to artificially reduce the total amount of tax payable on that income.

**Note:** legal ownership of an asset will have no bearing on the attribution rules.

### INCOME FROM PROPERTY

Income from property includes interest, foreign income, dividends, rents and royalties and is distinguished from employment income, business income and capital gains.

### PROPERTY TRANSFERRED OR LOANED TO A SPOUSE OR MINOR

The Act stipulates that where an individual has transferred or loaned property either directly or indirectly to:

1. The individual’s spouse, or a person who has since become the individual’s spouse; or
2. A related minor;

Any income from the property will be attributed back to the individual.

Any capital gain or loss on the disposition of the property by the spouse, but not by the related minor, will also be attributed back to the individual.

The Act also sets out more specific rules to restrict some of the following income splitting techniques and ensure that the general rules above cannot be avoided.

<sup>1</sup>This guide looks at income splitting strategies from an individual perspective and does not consider corporate situations. <sup>2</sup>All references to spouse in this guide also includes common-law partner as defined in the Act. <sup>3</sup>A related minor for the purposes of the attribution rules means a person who has not attained the age of 18 before the end of the year and who does not deal with the individual at arm’s length or is the niece or nephew of the individual.



### BACK TO BACK LOANS

If an individual has lent or transferred property to a third party which is then lent or transferred to a spouse or related minor, the attribution rules will apply to deem the property to have been lent directly by the individual to a spouse or related minor.

### LOAN GUARANTEES

If an individual guarantees the repayment of a loan for a spouse or related minor, the loan will be treated as if the individual had made the loan and the attribution rules will apply.

However, an exception to this rule occurs if the recipient of the loan (the spouse or related minor), paid a rate of interest equal to or higher than the Canada Revenue Agency's ("CRA's") prescribed rate or the commercial rate of interest in effect at the time the loan was made, and all interest payable is paid within 30 days after the end of the year.

### REPAYMENT OF AN EXISTING LOAN

If a loan, which is subject to the attribution rules, is repaid with a second loan from the same person, the attribution rules will apply to the second substituted loan as if it were the original loan.

### SUBSTITUTED PROPERTY

Where the attribution rules apply to income earned on property transferred or loaned, it will also apply to property that has been substituted.

### TRANSFERS AND LOANS TO A TRUST

Property lent or transferred to a trust for the benefit of a spouse or related minor is deemed to have been lent or transferred directly to the beneficiary and the attribution rules will apply.

All income will be attributed to the transferor, but the amount attributed will not exceed the income actually allocated by the trust to a spouse or related minor in that year.

Capital gains will be attributed only in connection with the spouse of the transferor, and the amount of the capital gain attributed will not exceed the portion of the capital gain allocated by the trust to the spouse in that year. Similar to the attribution rules surrounding the direct transfer to a related minor, capital gains earned through a trust for the benefit of the related minor are not attributed to the transferor.

### REVERSE ATTRIBUTION

The Act also prohibits the manipulation of the attribution rules to reduce taxes where this is one of the main reasons for the transfer or loan of property. This is known as "reverse attribution" and the attribution rules do not apply in such situations.

### REVERSIONARY TRUSTS

As previously discussed, where an individual transfers property to a trust for the benefit of a related minor, any capital gains realized on the sale of that property will not be attributed to the transferor.

However, where property is transferred to a trust under the terms of which it may revert to the transferor, or the proceeds may not be distributed without the transferor's consent, then all of the income or losses from the property and all of the capital gains and losses from the disposition of that property will be attributed to the transferor.

### TRANSFERS OF RIGHTS TO INCOME

The attribution rules will also apply where an individual simply directs payments of funds to go to another individual. For example, if a shareholder simply directs his dividend or bonus be paid to his spouse, the taxation on those funds would be attributed to him.

## WHEN THE ATTRIBUTION RULES DON'T APPLY

While the tax rules prevent income splitting in many situations as previously discussed, there are some instances where the attribution rules do not apply.

### MARRIAGE BREAKDOWN

Attribution of income between spouses does not apply to the period during which the transferor is living separate and apart from their spouse because of a breakdown of their marriage. This principle also applies with respect to capital gains or losses. However, the spouses must jointly complete an election stating such and file it with the transferor's tax return.

### NON-RESIDENTS

The attribution rules will not apply if the transferor or lender is a non-resident or becomes a non-resident, however, they may incur tax consequences in their country of residence.

### DEATH

The attribution rules will also cease to apply on the death of the transferor or lender.

### CAPITAL GAINS OF RELATED MINORS

Attribution rules do not apply to capital gains earned on property transferred or loaned to related minors. Consequently, it may be tax-effective to invest the transferred or loaned property in assets that generate predominantly capital gains, such as shares in growth companies, and allow the gains to be taxed in the

related minor's hands. Any dividends or interest would still be attributed back to the transferor or lender, however.

Since mutual fund corporations can only distribute ordinary dividends or capital gains dividends, one strategy with funds transferred or loaned to a related minor is to invest in corporate class mutual funds that do not distribute ordinary dividends. This way all of the return would be either capital gains or return of capital and would not be attributed back to the transferor or lender. For more information see Tax Managed Strategy #21 Ideal Candidates for Mutual Fund Corporations (MK2529).

### TRANSFERS TO CHILDREN OVER THE AGE OF 17

The attribution rules apply to related minors, which requires that the beneficiary be under the age of 18 at the end of the year. Therefore, transfers or loans of property to children older than 17 will not be subject to the attribution rules provided that the general anti-avoidance rule ("GAAR") or subsection 56(4.1)<sup>4</sup> of the Act do not apply.

To be safe, one requires a bona fide purpose for the transaction such as the funding of education or financing the purchase of a house or car. Any tax benefit should be secondary to the main purpose of the transfer or loan.

<sup>4</sup>56(4.1) is an attribution rule of more limited application than those applicable to the individual's spouse or related minor. It applies only to loans (not transfers) to adult taxpayers, and only where income-splitting is one of the main reasons for the loan.



### INCOME ON INCOME (“SECONDARY INCOME”)

As pointed out earlier, income from property transferred or loaned to a spouse or related minor is attributed back to the transferor or lender. However, if this income (the “attributed income”) is reinvested it will earn additional income (“secondary income”), which is taxed in the hands of the recipient and not attributed back to the transferor or lender.

For example, take the situation of a spouse who transfers \$100,000 to her husband which he invests and earns \$5,000, a five per cent return. The \$5,000 income would be attributed back to the wife, however, if he were to reinvest the \$5,000 of attributed income and it earned \$250 of secondary income, this income would not be subject to the attribution rules and instead would be taxed in his hands. For administrative ease, it is recommended that the attributed income be invested in a separate account from the transferred or loaned property.

### BUSINESS INCOME

The attribution rules apply to income earned from property, but not from business income. Therefore, one can transfer or loan property to a spouse or related minor for the purpose of earning business income without having the attribution rules apply.

### INTEREST BEARING LOANS

Loans made to a spouse or related minor which charge interest at a rate equal to or greater than the lesser of CRA's prescribed rate or the commercial rate of interest in effect at the time the loan was made are not subject to the attribution rules.

However, any interest payable must be paid within 30 days after the end of the year. If the above interest payment deadline is ever missed, that year's income and all future years' income will be attributed back to the lender. For more information, see Tax Managed Strategy #6 Lower the Family Tax Bill – Income Splitting Using Loans (MK1355).

### TRANSFERS AT FAIR MARKET VALUE (FMV)

The attribution rules do not apply if the individual transfers property at FMV (and reports any resulting gains) and receives back cash or property of equal FMV as consideration. If the property is given to a spouse, the spouse would have to elect out of the automatic rollover provisions.

**Note:** if a loan is part of the consideration, it must charge interest and have payments made as outlined above.



## OTHER INCOME SPLITTING STRATEGIES

### CHILD TAX BENEFITS

Child tax benefits may be invested in the child's name and the income earned will be taxed in the child's hands without any attribution to the parents.

### CANADA PENSION PLAN ("CPP") BENEFITS

Spouses who are at least 60 years old can choose to share the CPP benefits earned while living together and will only be taxed on the amount he or she actually receives, thereby providing an effective income splitting technique.

### PENSION CREDIT SPLITTING

If you have a spouse who is in a lower tax bracket, you and your spouse will be able to elect to have up to 50 per cent of eligible income transferred to the lower income spouse. Eligible income is defined as income eligible for the pension income credit. For more information see Tax Managed Strategy #15 Opportunities for Pension Income Splitting (MK2070).

### SPOUSAL RRSPS

An effective income splitting strategy, particularly where there is a large disparity in the projected pension incomes between spouses, involves having the higher income earning spouse contribute to a spousal RRSP and obtain a tax deduction while having the recipient spouse taxed on any withdrawals.

There is one important caveat however; income will be attributed back to the contributing spouse if the beneficiary spouse withdraws funds from any spousal RRSP within 3 years of any contribution being made to any spousal RRSP. The amount of the income attribution will be equal to the lesser of: the amount contributed to any spousal RRSP in the current and prior 2 years; and the amount withdrawn by the annuitant.

However, a planning opportunity does arise on qualifying withdrawals under the Home Buyer's Plan (HBP) where the annuitant's plan is a spousal RRSP. If the annuitant of the spousal plan does not repay the HBP, the income inclusion will be to the annuitant and not the contributor. Where the lower earning spouse is the annuitant, they may prefer to have an income inclusion at a lower tax rate and have the higher earning contributor spouse use funds to make ordinary deductible contributions against their higher income.

**Note:** for a spousal contributor's RRSP contributions in the 89-day period just before an HBP withdrawal to be fully deductible, the value of the spousal RRSP after the withdrawal must be at least equal to those contributions.

If an individual is making contributions regularly, another strategy would be to wait until he or she has three years' worth of RRSP room and then make the full contribution all at once and deduct it over the next three years. At the end of the three-year income attribution period, the individual's spouse



could make a withdrawal without attribution being applied. The following year, the individual could make another lump-sum deposit that maximizes all of his or her unused RRSP room. Because the attribution rules are applied based on when the contribution was made, not deducted, this provides the client with a decision window every three years – to withdraw or to contribute. The only downside to this strategy is the lost investment gains because of the delayed contributions.

#### FAMILY BUDGETING

One of the most effective income splitting techniques is to have the higher income earner pay for all family expenses (i.e. household and personal expenses, including personal taxes) and have the lower income earner invest their income. This allows the family's investment income to be earned in the hands of the lower income earner and consequently taxed at a lower marginal tax rate.

#### TAX-FREE SAVINGS ACCOUNT (TFSA)

Since income attribution does not apply on funds transferred, the recipient spouse could make a TFSA contribution thereby increasing the amount of combined investments that grow on a tax-free basis.

#### SALARY TO SPOUSE OR RELATED MINOR

If an individual carries on a business, either personally or through a corporation, some income splitting may be achieved by paying a salary to a spouse or related minor. However, it is required that services are genuinely being provided and the salary must be reasonable in relation to the services provided. A spouse or related minor could also be a director for a corporation and receive reasonable director's fees.

#### GIFTING

The attribution rules will not apply where gifts of property have been made to adult family members other than a spouse. Gifts should be made where there are minimal capital gains realized on the transfer, but where there is potential for future income and/or capital gains.

#### REGISTERED EDUCATION SAVINGS PLAN (RESP)

As attribution does not apply to income earned within an RESP, income splitting may be achieved with children pursuing post-secondary education. When the funds are eventually withdrawn, the returns are taxed in the hands of the child.

Another income splitting opportunity arises for adults holding an RESP. Where the RESP has spouses as joint subscribers of the plan, the Accumulated Income Payments<sup>5</sup> from the RESP could be transferred to the lower income earning spouse's RRSP, provided there is sufficient contribution room. Future withdrawals could then be taxed at a lower tax rate. For more information see Tax Managed Strategy #9 RESP's – No Longer Just for Kids (MK1688).

#### REGISTERED DISABILITY SAVINGS PLAN (RDSP)

Attribution does not apply to income earned in an RDSP. Income splitting can be achieved when payments are made from the plan and the returns are taxed in the hands of the disabled beneficiary.

As well, on the death of a parent, funds in an RRSP or RRIF can be transferred, on a tax-deferred basis, directly to an RDSP in which their financially dependent disabled child or grandchild is a beneficiary.

<sup>5</sup>An Accumulated Income Payment (AIP) represents the investment earnings in the RESP and not the original contributions, grants or bonds and generally speaking may only be paid if the RESP beneficiary isn't enrolled in a qualifying institution, is over age 21 and the plan has been open for more than 10 years; or the RESP beneficiary is deceased.

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