



Income splitting opportunities and the income attribution rules

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Income splitting is the ability to utilize the lower tax rates of family members to decrease the overall tax burden of the family. Various income attribution rules in the Income Tax Act (“the Act”) restrict income splitting for tax purposes by attributing it back to the higher income individual. While these rules limit the opportunities for income splitting, there are still a number of strategies available. This article outlines the various income splitting strategies and identifies the attribution rules currently in effect.

Income attribution rules

General rules

Attribution between spouses¹

The Act provides that where an individual has transferred or loaned property for the benefit of the individual’s spouse, any income or loss from the property and any capital gain or loss on the disposition of the property will be attributed back to the transferor.² This means that even though the spouse is now receiving the income, the transferor pays the tax on this income at their marginal tax rate.

Attribution with respect to minor children

Income or loss on property transferred or loaned to a related minor child, niece, or nephew is attributed back to the transferor if the transferee is under 18 at the end of the year. Attribution does not apply to capital gains or losses.

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¹ For the remainder of this article spouse will also include common-law partner.

² For the remainder of this article any reference to transferred or loaned property will include either directly or indirectly and will include the use of a trust or other means.



Attribution on loans to other family members

Attribution will also apply to loans to other family members if one of the main reasons for the loan was to achieve income splitting and reduce taxes and the loan does not bear interest at a commercial rate or the Canada Revenue Agency's (CRA) prescribed rate in effect at the time the loan was entered into.

Loans for non-investment purposes, such as the down payment on a home, are not covered by this attribution rule because no income is earned on these loaned funds.

Exceptions to attribution

Attribution does not apply in the following circumstances:

- Income on property transferred to adult children
- Capital gains to adult and minor children
- Where the transferor is a non-resident
- Where spouses divorce.

Note: If spouses separate because of a relationship breakdown, attribution of income and loss on property no longer applies; however, attribution of capital gains and losses will continue to apply unless a joint election is made.

- On the death of the transferor or lender

Specific anti-avoidance rules

In addition to the general attribution rules, there are a number of more specific rules to ensure that the general rules cannot be circumvented. They include the following:

Transfers to a trust

Indirect transfers to a trust for the benefit of a spouse or related minor child will result in the attribution rules being applied exactly as if the transfers had been made directly to the spouse or minor child.

“Tax on Split Income” (TOSI) rules

Previously, the TOSI rules generally resulted in taxable dividends on shares of private companies paid to certain minors being subject to tax at the highest marginal tax rate. Income subject to this tax could not be reduced by any tax deductions or tax credits, other than the dividend tax credit and foreign tax credit. This was commonly referred to as the “kiddie tax.”

Changes to TOSI rules in 2018 now expand the scope of these rules to all Canadian residents in receipt of private corporation income and have resulted in significant limits on the ability to use dividend income splitting strategies. There are certain exclusions from the TOSI rules, depending on the age of the individual in receipt of private corporation income. The expanded TOSI rules are extremely complex and are outside the scope of this article. Professional tax advice is necessary in order to manage the complexities of these rules and to determine whether there are still viable income splitting strategies for individuals with interests in private corporations.

Income-splitting opportunities

Pension income splitting

Canadian residents who receive income that qualifies for the existing Pension Income Tax Credit can allocate to their Canadian-resident spouse up to one-half of that income regardless of the age of the spouse receiving the income allocation.

For individuals aged 65 years and over, eligible pension income includes prescribed annuity payments, lifetime annuity payments under either a registered pension plan, a registered retirement savings plan or a deferred profit sharing plan as well as payments out of or under a registered retirement income fund.

For individuals under 65 years of age, eligible pension income includes lifetime annuity payments under a registered pension plan and certain other payments received as a result of the death of the individual's spouse or common-law partner.

For income tax purposes, the amount allocated will be deducted in computing the income of the transferor (the person who actually received the pension income) and included in computing the income of the transferee (the person to whom the pension income is allocated).

The pension income splitting allocation is made on an annual basis where both spouses agree to the allocation in their tax returns for the year.

Reinvestment of “attributed” income

Reinvested income that has been earned on income subject to attribution is not attributed back to the transferor or lender because it is no longer income from the transferred property. It can therefore be advantageous to transfer property to a spouse or minor and allow the income attribution to occur on the income from the original investment. This second-generation income (or “income on income”) is taxed in the hands of the recipient. Generally, it is recommended that the second-generation income (and all future accumulation of this income) be maintained separately from the original capital so that attributed income and non-attributed income are accounted for separately.

Salary to spouse or child

Where you carry on a practice, you may be able to income split by paying a reasonable salary to a spouse and/or child. You must however ensure that the salary is reasonable in relation to these services.

Loans and sales at fair market value

Where you make a loan to a spouse or child and interest is charged on the loan at a rate at least equal to the CRA’s prescribed interest rate at the time the loan is entered into, the attribution rules will not apply. The interest must be paid within 30 days after the end of the year for the attribution rules not to apply.

Also, where you sell property at fair market value to a spouse or minor child and receive cash or property of equal fair market value as consideration, the attribution rules will not apply. If the property is sold to a spouse, the spouse would have to elect out of a tax provision that automatically rolls over the property at its tax cost.

Loans to earn income from your practice

If a loan is made to earn income from your practice (as opposed to income from property) attribution will not apply.

Capital accumulation

Where the high-income earner pays all of the family’s daily living expenses and the lower-income family members accumulate capital for purposes of investing, a tax savings will result due to family members utilizing their lower marginal tax rates. Payments of taxes on behalf of other family members

also fall into this category. These payments will not attract attribution since they are not invested and therefore there is no income to attribute.

Spousal RRSPs

Contributions made to a spousal RRSP are deductible by the contributing spouse and when the plan is withdrawn in retirement it will be taxed in the hands of the beneficiary spouse with no attribution of income back to the contributing spouse.

Spouses who are each receiving their CPP benefits can choose to share their benefits for possible tax savings.

Attribution will however apply to the contributing spouse if the beneficiary spouse withdraws funds from the spousal RRSP within three years of a contribution being made to the spousal RRSP. That said, this will not apply if the spousal RRSP is converted to a RRIF and minimum required annual payments are made, even if the conversion has occurred within the preceding three years.

Canada Pension Plan (CPP) benefits

Spouses who are each receiving their CPP benefits can share their benefits if they choose. If one spouse is in a lower tax bracket, this can be an effective income splitting technique.

“In Trust For” accounts

If a donor contributes to an in-trust account for a minor beneficiary and the account is designed to provide primarily capital gains (e.g., by investing in an equity mutual fund), the resulting taxes, if any, may be paid by the child, assuming the account is set up properly. Any income from property earned (i.e., interest, dividends) in that account would still be attributed back to the donor.

If the in-trust account is set up improperly, it is possible that both capital gains as well as income may be attributed back to the donor. For additional information please see our education article on this topic.

Registered Education Savings Plans (RESPs)

RESPs provide an opportunity to save for post-secondary education with tax-deferred growth on investments as well as the advantage of additional contributions to the plan in the form of government grants and bonds. Each beneficiary of an RESP has a lifetime contribution limit of \$50,000 and a lifetime Canada Education Savings Grant (CESG) of \$7,200. The annual grant or bond is based on the annual contribution amount and family income.

While the contributions are not tax-deductible, the contributor may withdraw these contributions at any time on a tax-free basis. In addition, all income, growth and CESGs are tax deferred while in the plan. When this money is distributed in the form of educational assistance payments to a beneficiary attending a qualifying program, it will be taxed as regular income in the beneficiary's hands. The tax payable by the beneficiary may be little to none, especially after taking tuition tax credits into account.

Registered Disability Savings Plans (RDSP)

For individuals who qualify for the Disability Tax Credit, RDSPs provide families with a vehicle to save funds on a tax deferred basis while also benefitting from government grants and bonds. The lifetime contribution limit is \$200,000. The Canada Disability Savings Grant has a lifetime limit of \$70,000 and is based on the amount of the annual contribution to the plan and family income. Canada Disability Savings Bonds do not require annual contributions from the


family and are based solely on family income. Grants and bonds can be paid into the RDSP until the beneficiary's 49th birthday.

Beneficiaries must begin annual withdrawals from the plan at the age of 60. Grants, bonds and investment income from the plan will be taxed in the beneficiary's hands when received. This provides a valid income splitting opportunity for parents who contribute to the plan.

Canada Child Benefit (CCB)

The CCB, introduced in 2016, is a monthly non-taxable amount to help eligible families with the cost of raising children under 18. The CCB accumulated directly in segregated bank accounts for the benefit of minor children are considered the funds of the children rather than of the parents; therefore, investment income earned on these funds can avoid attribution. To achieve this, it is important to ensure that the investment income can be traced to the CCB.

Conclusion

Managing your wealth effectively requires a full understanding all of the income splitting opportunities available to you. Capitalizing on the income splitting strategies identified above as well as avoiding the pitfalls of the attribution rules will help you save taxes and enhance your family's wealth. For questions about your specific tax situation please consult your Investment Advisor and a professional tax advisor. 

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