



# Sharing the Wealth— Family Income Splitting



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CHARTERED PROFESSIONAL ACCOUNTANTS

## SHARING THE WEALTH—FAMILY INCOME SPLITTING

[Please note that any reference to the term “spouse” in this article includes a reference to the term “common-law partner”.]

Simply stated, income splitting among family members results in less tax being paid on the same overall family income – a result most Canadians and Canadian families would readily welcome. Income splitting works because the Canadian tax system is an example of a “progressive” tax system in which the tax rate imposed on individual taxpayers rises as taxable income increases.

Take, for example, a taxpayer who has \$50,000 in taxable income in 2016. Assume that the tax rate on the first \$25,000 in income is 10% and the second \$25,000 of income is taxed at 20%. The taxpayer’s total tax payable for the year would be as follows:

$$\$25,000 \times 10\% = \mathbf{\$2,500}$$

$$\$25,000 \times 20\% = \mathbf{\$5,000}$$

$$\text{Total tax payable for the year} = \mathbf{\$7,500}$$



Now assume that the taxpayer was able to split that income equally with his or her spouse, each spouse then having \$25,000 of taxable income for the year. The total tax payable for the family for the year would then be as follows:

$$\text{Spouse 1} — \$25,000 \times 10\% = \mathbf{\$2,500}$$

$$\text{Spouse 2} — \$25,000 \times 10\% = \mathbf{\$2,500}$$

$$\text{Total tax payable for the year} = \mathbf{\$5,000}$$

As a result of income splitting, the tax payable on the same amount of income has been reduced by \$2,500, or one-third of the tax that would have been payable had the income been taxed solely in the hands of one spouse. And since, in any progressive tax system, tax rates rise as income increases, the benefits of income splitting become more pronounced at higher income levels.

Given the tax savings to be achieved, and the resulting loss of revenue to our tax system, it's not surprising that rules have been put in place to prevent, or at least to penalize, such tax saving maneuvers. Those rules are known collectively as the “attribution rules”. In general terms, the attribution rules work by providing that income earned on property transferred to a spouse or minor child of a taxpayer is “attributed” back to the transferor and taxed in his or her hands. However, while the attribution rules are broad in scope and application, they are not airtight, and some opportunities for income splitting within the family unit remain available.

### The general rules—what's not allowed

#### No joint return or filing married

There is a relatively common misconception among Canadian taxpayers that it's possible for a husband and wife to file a single tax return – usually referred to as a “joint return” or “filing married”. There is, in fact, no such concept in the Canadian tax system (the U.S. system makes more allowances in this area, which probably accounts for the misconception). In Canada, each taxpayer files an individual return accounting for and paying tax on his or her own income. While it is possible for spouses to transfer certain credits between them, and a degree of pension income splitting is allowed, there is no such thing as a joint return or “filing married” in Canadian tax.

#### The “kiddie tax”

For many years, a common income-splitting strategy involved the payment of dividends from an incorporated family business to lower-income family members, typically a spouse and children of the business owner. Because of the favourable tax treatment afforded dividends paid by small Canadian-controlled private corporations, it was possible to receive a fairly significant amount of dividend income with very little tax payable.

Unfortunately, such arrangements are no longer tax-effective. In 1999, the federal government announced the creation of an “income-splitting tax” (more popularly known as the “kiddie tax”) to forestall such arrangements. In general, the kiddie tax works by taxing specified types of income (including the dividend income outlined above, as well as certain partnership or trust income) at the current top marginal rate, thereby nullifying any tax benefit which would otherwise arise.

#### Attribution between spouses

The sections of the *Income Tax Act* which provide for the attribution of income back to a transferor of property are straightforward. Those rules provide

simply that where property (the definition of which includes money) is loaned or transferred, directly or indirectly by a taxpayer to his or her spouse, any income from that property or any capital gain which arises on the sale of the property is taxed as though it was received by the transferor spouse.

### **Attribution between parents and minor children**

A second general rule provides for the attribution of income back to parents. This rule states that where property is loaned or transferred to a minor child (ie. one under the age of 18 at the end of the year), any income arising from that property is attributed back to the parent (or grandparent) who loaned or transferred the property. Note that, unlike transfers or loans between spouses, there is no attribution of capital gains on property transferred or loaned to minor children.

### **What's still possible?**

While the general rules outlined above may seem all-encompassing, and they do generally catch most strategies designed to defeat them, there are still some income-splitting strategies which may be effected within the parameters of the attribution rules. Some of the more available strategies are outlined below.



### **TFSA's**

Starting in 2009, individuals 18 years of age and older receive \$5,000 of TFSA contribution room each calendar year. This was increased to \$5,500 for 2013 and 2014, \$10,000 for 2015, and returned to \$5,500 after 2015. There is no deduction for contributions to a TFSA, but neither is there any income inclusion when funds are withdrawn, and while contributions remain in the TFSA, interest, gains, etc. accumulate tax-free.

There is no restriction on a higher-income taxpayer funding a TFSA for his or her spouse (or adult children). If an individual transfers property to a spouse or common-law partner, the attribution rules generally treat any income earned on that property as income of the individual. However, an exception to the attribution rules allows individuals to take advantage of the TFSA contribution room available to them using funds provided by their spouse or common-law partner: the attribution rules will not apply to income earned in a TFSA that is derived from such contributions.

### **Loans to spouse or children**

The general rules do catch loans made to spouses or children, but an exception is provided where interest is charged on such loans at at least the prescribed rate of interest set by the Canada Revenue Agency (CRA). Where, as is currently the case, such prescribed interest rates are relatively low, it can make sense to make such a loan, as in the following scenario.

One spouse, whose earnings put him or her in the top tax bracket, loans \$20,000 to the other, non-working spouse, who then invests the funds. The prescribed rate for such loans for the first quarter of 2016 is 1% (or \$200 per year on a \$20,000 loan), making that the minimum rate payable. If the non-working spouse pays interest at that rate to the other spouse, but earns 2% (or \$400) on the investment, a tax savings is achieved. While the transferor spouse will pay tax on the 1% interest received, the 2% investment income will be taxed, at a lower rate, in the hands of the recipient, lower-earning spouse. If that recipient spouse has no other income, it's possible for the investment income to be received essentially tax-free.

It's important to remember that, in order to escape the application of the attribution rules, the recipient spouse must actually make that interest payment to the transferor spouse, on or before January 30, 2011.

### **Investment of funds by lower-income spouse**

The two-income family is more the rule than the exception and, in virtually all cases, there is a disparity between the income levels of each spouse. Where that disparity is enough to put the two spouses into different tax brackets (i.e. one spouse earns over about \$45,000 and one earns less than \$45,000, or one earns less than about \$89,000 and one earns over that level), a tax savings can be achieved by using all or part of the earnings of the lower-income spouse for investments. Any investment income earned will therefore be taxed in the hands of that lower-earning spouse, and a permanent tax savings will be achieved.



## Employment of spouse or children

An increasing number of Canadians are self-employed, and such self-employment creates the possibility of employing one's spouse or children in the family business. Any salary paid to the spouse or child will be deductible by the self-employed spouse, and the income received will be taxed in the hands of the lower-income spouse or child, at a lower tax rate.

A few caveats are necessary. Where a business owner employs other family members, the CRA will look to see that the remuneration paid is reasonable in the circumstances (i.e., what would be paid to a non-related person for the same work), and that the family member employed is both capable of doing the work (i.e., you can't pay your 5-year old for doing the books) and has actually done the work. Many spouses work full-time for a family business, and teenagers can put in part-time hours on the weekend and during school vacations. As long as the caveats listed above are observed and the business owner complies with all of the usual obligations which accrue to an employer, the employment of family members in a family-owned business is a legitimate tax saving strategy.

## Children turning 17

As outlined above, investment income arising from transfers of property to minor (i.e. under 18 at the end of the year) children is attributed back to the transferor. However, such attribution ceases in the year the child turns 18. Consequently, where funds are transferred to a child by a parent in the year the child turns 17 and invested for a period of one year or longer (for example, in a guaranteed investment certificate), the interest paid when the GIC matures will be taxed in the hands of the now adult child, and no attribution will result.

## Other income splitting opportunities

In some cases, our tax laws, or administrative policies of the CRA expressly permit income splitting within a family unit, particularly between older spouses. Some of those permitted strategies are outlined below.

## Pension income splitting

In the fall of 2006, the Department of Finance announced that older Canadians would be able, beginning with the 2007 taxation year, to "split" certain types of pension income with a spouse, thereby lowering the couple's overall tax liability.

While most seniors who have spouses or common-law partners are able to benefit from the pension income splitting provisions, not all income qualifies as "eligible income" for pension income splitting

purposes. In general terms, the income which qualifies is private pension or annuity income – that is, income arising from a registered pension plan (RPP), a registered retirement savings plan (RRSP) or a registered retirement income fund (RRIF) or a deferred profit sharing plan (DPSP). What doesn't qualify is income from government sponsored pension or income plans like the Canada Pension Plan or Old Age Security.

More specifically, the type of income which may be split between spouses or common-law partners depends on the age of the taxpayer receiving the income. For taxpayers who are over the age of 65, eligible pension income which may be split includes income or payments from an RPP, RRSP, RRIF, or DPSP. For those under the age of 65, the list of eligible pension income is more restrictive, and is limited to pension payments from an RPP and, in some cases, payments received following the death of a spouse or common-law partner.

The benefits of pension income splitting can be seen from the following example:

*Taxpayer A, age 74, has taxable income for 2016 of \$100,000. That income includes \$50,000 in payments from Taxpayer A's registered retirement income fund and \$40,000 in payments from an employer-sponsored pension plan. Without any income-splitting, Taxpayer A would pay federal tax for 2016 as follows:*

$$\$45,000 \times 15\% = \$6,750$$

$$\$45,000 (\$90,000 - \$45,000) \times 20.5\% = \$9,225$$

$$\$10,000 (\$100,000 - \$90,000) \times 26\% = \$2,600$$

$$\text{Total federal tax payable for the year} = \$18,575$$

*Taxpayer A is able to allocate or "split" up to half of his or her eligible pension income of \$90,000 with a spouse. If that spouse had no other income for the year, the combined 2016 tax bill for the couple would look about like this:*

*Taxpayer A – income of \$55,000*

$$\$45,000 \times 15\% = \$6,750$$

$$\$10,000 \times 20.5\% = \$2,050$$

$$\text{Total tax} = \$8,800$$

*Taxpayer B – income of \$45,000*

$$\$45,000 \times 15\% = \$6,750$$

The combined federal tax bill for the couple for 2016 totals \$15,550 – a tax savings of \$3,025 over the year before, on the same amount of income.

While the ability to split pension income will obviously create significant continuing tax benefits, not all seniors will be able to take advantage of the new opportunity. Most obviously, seniors who

do not have a spouse or common-law partner will have no eligible person with whom pension income can be split. Taxpayers whose income is limited to government retirement benefits – Canada Pension Plan, Old Age Security, or Guaranteed Income Supplement payments – will not be able to split such income, as government benefits are not included in the definition of “eligible pension income”. Less obviously, senior couples each of whom enjoys an income over about \$200,000 cannot create any significant tax benefit through pension splitting, as each is already taxed at the top marginal rate. At the other end of the financial spectrum, senior couples each of whom has an income of less than about \$45,000 are similarly unable to create a real tax benefit by income splitting, as each is already taxed at the lowest marginal tax rate. Those couples who stand to gain the most from pension income splitting are those with a significant disparity in income between spouses, especially where the bulk of the larger income arises from pension income eligible for splitting.

For income tax purposes, the amount to be split (limited to one-half of eligible pension income) will be deducted in computing the income of the transferor (the person who actually received the income) and included in computing the income of the transferee (the person to whom the pension income is allocated). Since the allocation of income will affect the tax liability of both transferor and transferee, both parties must agree to the allocation in their tax return for the year. Finally, any allocation made is effective only for

There’s an additional benefit arising from the splitting of pension income in the ability to minimize or eliminate any clawback of Old Age Security Benefits. Most Canadians are eligible to receive such benefits, which can amount to about \$571 per month, once they reach the age of 65. However, taxpayers who have net income of more than \$73,756 (with the amount indexed annually) have their benefits reduced or “clawed back”. The clawback rate is 15% of net income over the threshold amount of \$73,756. Taxpayers having income of more than about \$119,436 receive no benefits at all.

Take the situation of the couple described above as an example. One spouse in that couple has an income of \$90,000 and the other an income of \$0. At those income levels, the lower income spouse would have full OAS entitlement, but the spouse with the higher income would lose almost half of OAS benefits. Once pension income is split, as shown in the example above, both spouses would have income below \$73,756 and consequently both would enjoy full OAS entitlement, amounting to about \$13,700 for the year. Absent pension income splitting, the couple’s total OAS entitlement for year would have been just over \$11,260.

### Credit transfers between spouses

In the calculation of tax payable on the annual return, taxpayers can claim a number of non-refundable tax credits, at both the federal and provincial levels. As the name implies, such credits do not generate a refund of tax, but rather reduce tax which would otherwise be payable. And, in some instances, some of those credits can be transferred from one spouse to the other, in order to create a better bottom-line tax result for the family unit as a whole.

Generally, the credits which may be transferred between spouses include the age amount, the pension income amount, the disability amount and tuition, education or textbook amounts. Where one spouse is entitled to claim some or all of these credits, but has already reduced his or her tax payable for the year to zero (perhaps as a result of the application of other, non-transferable credits like the basic personal credit), then some or all of the available age amount, pension income amount, disability amount or tuition, education or textbook amounts can be transferred to a spouse and claimed by him or her on the return for the year. It should be noted that in some cases (notably the tuition, education and textbook amounts) there are certain restrictions on transfer which must be observed.

A similar result can be effected by the pooling of certain expenses eligible for a non-refundable

the designated year, meaning that the allocation can be maintained or changed from year to year, in order to create the most favourable tax result possible.



credit on the annual tax return. Medical expenses incurred and charitable donations made by either spouse can be aggregated and claimed on the return filed by either spouse. (Obviously, each expense can only be claimed once.) In the case of medical expenses, it's most beneficial for the lower-income spouse to claim the credit, assuming that he or she has tax payable for the year. The unique structure of the medical expense claim ensures that, where the claim is made by a lower-income spouse, a greater percentage of medical expenses incurred will be claimable. With respect to charitable donation claims, the credit amount will be the same no matter who claims it. However, in provinces where a high-income surtax is levied, it's likely better for the higher-income spouse to make the claim, in order to help reduce tax payable to below the surtax threshold.

### Credit transfers between parents and children

The rules outlined above with respect to the transfer of tuition, education and textbook credit amounts between spouses also apply to such transfers between parents and children. Students don't generally have a lot of income and consequently don't usually have much in the way of a tax bill for the year. Tuition, education and textbook credits which the student doesn't need to eliminate tax liability for the year can be transferred to a parent or grandparent whose tax liability for the year is likely much greater, regardless of who actually paid the bills. As is the case with spouse-to-spouse transfers, there are some restrictions on amounts which may be transferred, especially where the student is married, and those must be observed.

### Splitting of Canada Pension Plan benefits

Canadians who work, either as employees or in self-employment, during their working years accumulate contribution-based credits under the Canada Pension Plan. Those contributions entitle the taxpayer to receive a pension during retirement (usually after age 65, although benefits can be received as early as age 62), based on the accumulated contributions. The amount of pension benefits to which a taxpayer will be entitled depends in part on the number of years during which contributions were made and the level of contributions made. Even where both spouses are employed outside the home, it's common for one spouse to be entitled to a larger CPP pension in retirement. The difference in pension amounts can mean a significant difference in tax payable for the year, especially where the taxpayer has additional retirement income from other sources.

The Canada Pension Plan rules allow for what is called "pension sharing" between spouses (including common-law spouses) where both spouses are at least 60 years of age. Essentially, the CPP entitlement of both spouses (or just one spouse if only one is entitled to receive CPP) which was earned during the marriage is totaled, and that total is divided by 2, with each spouse then receiving half. There is no change in total CPP entitlement, but each half is taxed in the hands of the spouse who receives it, regardless of the original entitlement.

Take, for example, a couple where only one spouse worked outside the home since the marriage. That spouse is entitled to \$850. per month (\$10,200 per year) in CPP retirement pension and, in addition, receives a payment of \$3,500 per month from an employer-sponsored pension plan, giving him or her a total income of \$52,200 per year. Spouse 1 will pay federal tax as follows:

#### Spouse 1

*First \$45,000 of taxable income* × 15% = **\$6,750**  
*Remaining \$7,200 of taxable income* × 20.5% = **\$1,476**  
*Total federal tax liability* = **\$8,226**

However, if the total CPP entitlement of \$10,200 per year was shared equally between the spouses (i.e. \$5,100 each), the total federal tax picture looks more like this:

#### Spouse 1

*\$47,100 of taxable income (\$52,200 - \$5,100)*  
*\$45,000* × 15% = **\$6,750**  
*\$2,100* × 20.5% = **\$431**  
*Total federal tax payable* = **\$7,181**

#### Spouse 2

*\$5,100 of taxable income* × 15% = **\$765**  
*Total combined federal tax liability* = **\$7,946**

The total federal tax bill payable on the same amount of income has been reduced by about \$280 simply by splitting one spouse's CPP entitlement between the two spouses.

The tax savings which can be achieved by splitting of CPP benefits can in fact exceed those presented in this example. Where one spouse has no other source of income in retirement, he or she can receive up to about \$11,474 (in 2016) in income without tax liability, because of the basic personal amount claimable by all Canadian tax-filers. Consequently, it will always be beneficial to split Canada Pension income where one spouse in a couple has income below the level of the basic personal exemption or no income at all.

## Investment of Canada child tax benefit payments

“Child Tax Benefits” accumulated directly in segregated bank accounts for the benefit of minor children are considered funds of the child rather than the parent. Accordingly, the interest on these funds is not attributed. This rule continues a policy which also applies to payments made prior to 1993 under the predecessor family allowance program. The same rule should apply to the new Canada Child Benefit to be paid from July 2016. So long as the funds can be traced to the child tax benefit or family allowance payments, they can be invested in a lucrative investment without attribution. A formal trust is not necessary for the amounts in question; usually, a joint bank account for parent and child will suffice. Full Child Tax Benefits for one child set aside in this way and invested at a 5% return compounded monthly would amount to \$30,303 by the time the child reaches 18, of which \$11,472 would be interest on which no tax has been required (unless the child has another substantial income). It is not necessary to save the entire amount received, but you should be careful to set aside the amount to be saved in a separate account for the

child(ren), and to be able to trace all amounts in that account to Child Tax Benefit cheques. Strictly speaking, this rule does not extend to parallel provincial programs, such as the B.C. family bonus, but so far the CRA has been willing to apply the same policy of non-attribution to provincial as well as federal benefits.

## Conclusion

At one time, there were a number of avenues by which income splitting within the family unit could be achieved fairly easily within the parameters of the income tax rules. However, the implementation of first the attribution rules and, later, the kiddie tax closed off many of those possibilities. Notwithstanding, while income splitting has become more difficult in recent years, some opportunities remain and new ones, particularly in the area of pension splitting between older couples, have become available. Whether the federal government will move to make income splitting within the family unit available on a wider scale remains a matter for speculation, but most Canadian families can benefit from at least some of the currently available income-splitting strategies.

