The Great Divide: Income splitting strategies can lower your family’s taxes

Jamie Golombek
Managing Director, Tax & Estate Planning, CIBC Wealth Management

The proposed elimination of the Family Tax Cut credit for 2016, which provided a form of income splitting in 2014 and 2015, has sparked new interest in other ways to split income, some of which have been around for a long time and provide much more significant tax savings. With marginal tax rates for high-income earners now over 50% in more than half the provinces and historically low prescribed interest rates for income splitting loans, now is a great time to revisit some income splitting strategies, both old and new.

What is Income Splitting?

Income splitting is the transferring of income from a high-income family member to a lower-income family member to reduce the overall tax paid by the family. Since our tax system has graduated tax brackets, by having the income taxed in the lower-income earner’s hands, the overall tax paid by the family can be reduced.

The “attribution rules” in the Income Tax Act make this difficult by generally attributing any income and, in some cases, capital gains (losses) earned (realized) on money transferred or gifted to a family member back to the original transferor. However there are exceptions to the attribution rules that permit income splitting in a variety of situations.

Pension Splitting

One form of traditional income splitting is the ability to split up to half of your pension income with your spouse. Any pension income that qualifies for the $2,000 federal pension income credit also qualifies to be split. Specifically, this would include annuity-type payments from a Registered Pension Plan (RPP), regardless of age, and also includes Registered Retirement Income Fund (RRIF) or Life Income Fund (LIF) withdrawals upon reaching age 65.

If you are at least 65 years of age, you may want to consider converting a portion of your RRSP to a RRIF (if you do not already have a RRIF) so that you can benefit from pension splitting. Any withdrawals from your RRIF, whether minimum withdrawals or other amounts, would qualify for pension splitting. Note that RRSP withdrawals are not considered to be pension income.
To be able to split your pension income, you and your spouse must make a joint election on your income tax returns using Form T1032, “Joint Election to Split Pension Income”. You would claim a deduction on line 210 of your tax return for the “Elected Split-pension Amount,” which may be up to 50% of your pension income. This Elected Split-pension Amount would be added to income on line 116 of your spouse’s return. The election is made annually and is optional, so each year you can choose whether or not to split your pension. For each $10,000 of pension income that you split with your spouse, tax savings may be up to about $3,000 annually, depending on your province of residence and the spread between the tax rates of you and your spouse.

Splitting pension income may have benefits beyond the taxes that are saved by having part of your pension income taxed at your spouse’s lower tax rate, rather than your higher tax rate. Pension splitting also has the ability to affect credits and benefits that are solely based on one spouse’s net income. For example, in 2016 the federal age amount is worth about $1,070 but is phased out with income between about $35,900 and $83,400. Although the maximum total amount of Old Age Security (OAS) pension benefits is about $6,800 in 2016, these benefits are clawed back with net income between about $74,000 and $119,000. If pension splitting allows you to lower your net income, you may be able to preserve some (or all) of the benefits.

Since allocating pension income to a spouse merely reduces one spouse’s net income while simultaneously increasing the other’s net income, benefits and credits that are income-tested based on the combined income of both spouses will not be affected. Such credits include the GST/HST credit, the Canada Child Tax Benefit and related provincial or territorial benefits.

**Spousal RRSPs (RRIFs)**

If you think that, upon retirement, you will have a higher income or have accumulated more retirement assets than your spouse, it may be beneficial for you to contribute to a spousal RRSP. A spousal RRSP is an RRSP to which you make the contributions, but of which your spouse is the annuitant (owner) of the plan. It is often used to accomplish post-retirement income splitting since withdrawn funds are taxed in your spouse’s (the annuitant’s) hands instead of yours (the contributor’s). A spousal RRIF is the continuation of a spousal RRSP.

If your spouse is in a lower tax bracket than you in the year of withdrawal, there may be an absolute and permanent tax savings. For example, if upon retirement your spouse is in the lowest tax bracket and you are in the highest tax bracket, tax savings may range between about $2,200 to $3,400 for each $10,000 of RRSP or RRIF withdrawals, depending on the province.

If your spouse makes a withdrawal from a spousal RRSP (RRIF) and you made a contribution to an RRSP for your spouse in any of the previous three years, attribution will occur. You must include in your own income the amount of the withdrawal(s) from the spousal RRSP (RRIF) in the current year, or the amount of your contributions to spousal RRSPs in the past three years, whichever is less.

We saw earlier that pension splitting is permissible for RRIF income and that RRSP holders may convert a portion of their RRSPs to a RRIF to facilitate this. So are spousal RRSPs still relevant given the ability to income split RRIF income?

The pension splitting rules have not, in fact, heralded the demise of spousal RRSPs. First of all, spousal RRSPs allow you to split more than 50% of your pension income. With a spousal RRSP, you could theoretically split up to 100% of your RRSP income with your lower-income spouse.
Secondly, primarily due to the definition of pension income, as described earlier, if an individual is under 65, eligible pension income typically only includes annuity payments from an RPP and will not generally include amounts paid from an RRSP or RRIF. So anyone who wants to income split before age 65 and does not have an RPP should still consider the use of spousal RRSP contributions, which would allow the ultimate withdrawals to be taxed in a lower-income spouse’s hands without having to wait until age 65.

Higher Income Earner Pays All Expenses

Another very simple, yet highly effective, strategy is to have the higher-income earning spouse pay all the household expenses and the lower-income earner do all the non-registered investing. Low-income earners have less income available that could potentially be invested than their higher-earning spouses. This problem is compounded when the couple shares in the payment of their household expenses.

For example, suppose Marlee and Kevin have annual after-tax incomes of $70,000 and $30,000, respectively. They have combined household expenses of $60,000 annually.

Figure 1 shows that if the $60,000 of household expenses were divided equally so that Marlee and Kevin each paid $30,000, Marlee would have $40,000 to invest while Kevin would have $0. Given that Kevin pays tax at a lower marginal tax rate than Marlee, it would be helpful to have investment income earned in Kevin’s hands rather than Marlee’s.

Figure 1
Household expenses are divided equally

<table>
<thead>
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<th></th>
<th>Marlee</th>
<th>Kevin</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>After-tax income</td>
<td>$70,000</td>
<td>$30,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>Household expenses</td>
<td>(30,000)</td>
<td>(30,000)</td>
<td>(60,000)</td>
</tr>
<tr>
<td>Available to invest</td>
<td>$40,000</td>
<td></td>
<td>$40,000</td>
</tr>
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Note that there is no tax reason why the couple’s expenses must be paid equally by Marlee and Kevin. In fact, Marlee (the higher-income spouse) could pay 100% of the household expenses so that Kevin could invest all of his after-tax income, as shown in Figure 2.

Figure 2
Household expenses are paid by the high income spouse

<table>
<thead>
<tr>
<th></th>
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<td>$30,000</td>
<td>$40,000</td>
</tr>
</tbody>
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Since this strategy is purely a cash-flow exercise, there is no impact on your income tax return and no reporting is necessary. It’s important, however, to keep good records of income and expenses, in case you ever have to prove to the Canada Revenue Agency (CRA) how the lower-income spouse obtained funds for investment. Having each spouse keep separate bank and investment accounts, rather than having joint accounts, helps to leave a solid paper trail.

Spousal Loan

The attribution rules discussed above will not apply if, rather than making a gift, you lend funds to your spouse at the prescribed interest rate that is in effect at the time the loan was originated and your spouse pays interest annually by January 30 of the following year. Spousal loans have been used by savvy couples for many years but they are exceptionally attractive now since the prescribed interest rate is currently at a historical low of 1% (which is the lowest rate possible) until at least June 30, 2016.

The prescribed interest rates are set by the CRA quarterly and are tied directly to the yield on Government of Canada 90-day Treasury Bills, albeit with a lag. The calculation is based on a formula, which takes the simple average of three-month Treasury Bills for the first month of the preceding quarter, rounded up to the next highest whole
percentage point (if not already a whole number). If you establish the loan at the current 1% rate, you can use that rate for the duration of the loan, which could be unlimited if there is no fixed term and it is simply a demand loan.

The loan should be supported by a properly drafted loan agreement and interest on the loan must be paid within thirty days of the end of the calendar year (i.e. by January 30), starting the year after the loan is made. The investment returns, net of the tax-deductible interest on the spousal loan, can then be taxed in the lower-income spouse’s hands.

Example: Spousal loan income splitting

Here’s how the income splitting strategy works, using an example of Jack, who is in the highest tax bracket, and Dianne, who is in the lowest bracket. Jack loans Dianne $500,000 at the current prescribed interest rate of 1%, secured by a written promissory note. Dianne invests the money and earns ordinary income at a rate of 4%, so she reports $20,000 on Schedule 4 of her tax return. Each year, she takes $5,000 of the $20,000 income she receives to pay the 1% interest on the loan and claims an interest expense deduction of $5,000 on Schedule 4. Jack, in turn, would report $5,000 of interest income on Schedule 4 of his tax return.

The net tax savings to the couple would be having income, net of the interest expense, taxed in Dianne’s hands at the lowest rate instead of in Jack’s hands at the highest rate. The tax savings would range from about $3,300 (in Saskatchewan) to $5,000 (in Ontario) annually, depending on the province.

Loan to a Family Trust

Kids can be expensive and fees for private school, sports, music lessons, and other extracurricular activities can add up to tens of thousands of dollars per year. The spousal loan strategy can be expanded to help fund expenses for your children if you make a prescribed rate loan to a family trust.

If you simply lend your kids money to invest and don’t charge interest on that loan, any income or dividends earned on those funds is attributed back to you and taxed in your hands, at your marginal tax rate.

On the other hand, as long as you charge interest on the loan at the prescribed interest rate, and interest is paid within 30 days of year end, any income earned above that rate can be taxed in the child’s hands. If the child has minimal or no income, the tax payable on any excess return earned above the prescribed rate charged on the loan can be substantially reduced or eliminated. This is particularly true for children in post-secondary school, due to the various credits (personal, tuition, education, textbook) that a student may claim.

Frequently it is not desirable or feasible to lend funds directly to children, particularly when they are minors. The solution is to lend the funds to a family trust with your minor children as beneficiaries where payments can be made to them or to their benefit. The trustee then invests the funds and pays the net investment income, after the interest on the loan, to the kids either directly or for their benefit by paying certain expenses. If the kids have zero or little other income, this investment income can be received perhaps entirely tax-free.

Put Your Family Members to Work

If you own a business, hiring your spouse or children to work for you can be a great way to income split. But if you do, be sure you follow the rules. Otherwise, you may find the salary expense is denied as a valid tax deduction.

You should ensure the amount paid is reasonable in relation to the work that is performed. You’ll also want to keep good records, such as copies of timecards, cancelled cheques or electronic fund
transfers, to prove to the CRA that a working relationship truly exists and that compensation was paid.

The salaries would be deducted by the business, either on your T1 income tax return if you are a sole proprietor, or on a corporate tax return if your business is structured as a corporation.

Make sure you also make appropriate payroll deductions for any salaries that you pay and properly remit amounts to the CRA (Revenu Québec) in a timely manner. These amounts may include Canada (Quebec) Pension Plan contributions, Employment Insurance premiums, income taxes and, depending on the province, provincial health care payroll taxes. You would need to issue T4 (Relevé 1) slips to the family member employees to report the salaries and payroll deductions, and the reported amounts would be included in the personal tax returns of each family member.

**Family Tax Cut Credit (2014 / 2015)**

The Family Tax Cut credit became available for the first time for the 2014 taxation year but is proposed to be eliminated after 2015. The credit provides a version of income splitting that allows you to notionally transfer up to $50,000 of income to your lower-income spouse, provided you have a child who was under 18 at the end of the year. To claim the credit, you must complete Schedule 1-A, “Family Tax Cut”. The credit may be claimed by either you or your spouse.

In essence, Schedule 1-A involves calculating federal taxes with and without the notional income split. Although there are only three basic steps in the calculation, they can be quite complex. Using tax preparation software can help you prepare the new schedule and calculate the credit more easily.

Since the credit is capped at $2,000, presumably to limit the governmental cost of the program, I like to refer to this credit as “fake” income splitting. If there was real income splitting with no cap to the credit, the true 2015 federal tax savings of moving $50,000 of income from a top federal tax rate spouse at the 29 per cent marginal rate to a bottom tax rate spouse at the 15 per cent / 22 per cent marginal rates would be almost $6,600.

Also, since this is “fake” income splitting, net income for you and your spouse does not actually change. As a result, any benefits and tax credits based on net income, such as the GST/HST credit, Canada Child Tax Benefit, the age amount, and the spouse or common-law partner amount, will not be affected.

There are a few odd conditions to be able to claim the credit. You cannot have been imprisoned for more than 90 days in the year and neither you nor your spouse can have declared bankruptcy in the year. Finally, if you split your pension income, you can’t also claim the Family Tax Cut credit.

**Conclusion**

When your marginal tax rate differs significantly from those of your family members, it’s worth considering some income splitting strategies. Retirees may be able to use pension income splitting to reduce their overall tax burden, and may want to convert some RRSPs to RRIFs to take advantage of this opportunity. Spousal RRSPs can also be an effective method of income splitting in retirement. Couples with kids under 18 may be able to realize tax savings from the Family Tax Cut credit, although this measure is likely to be eliminated after 2015.

When the higher-income spouse holds or is expected to accumulate significant non-registered investments, consider having the higher-income earner pay all the household expenses or make a prescribed rate loan to family members, possibly with a family trust. And finally, when you own a business, consider employing family members. The result could be thousands of dollars of annual tax savings.
Disclaimer:
As with all planning strategies, you should seek the advice of a qualified tax advisor.

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