Use your kids to your tax advantage!

by Jamie Golombek

While parents often bemoan the cost of raising kids, don’t forget that there are various child-related tax benefits, credits or deductions that you can use to reduce your personal income tax. In addition, filing tax returns for minors, as well as income splitting with kids, can go a long way to reducing the overall tax burden of the family.

A. BENEFITS

Universal Child Care Benefit (line 117)
The Universal Child Care Benefit (UCCB) was introduced in 2006 and is "designed to assist Canadian families, as they seek to balance work and family life, by supporting their child care choices through direct financial support."

If you’ve been receiving the Canada Child Tax Benefit, then you should automatically be receiving the UCCB as well which is equal to $100 per month for each child under the age of six. Higher-income Canadian families, who are not eligible to receive the Child Tax Benefit, must apply for the UCCB. The application form can be downloaded from the Canada Revenue Agency’s (CRA’s) website. Note that unlike the Canada Child Tax Benefit, the UCCB is not income-tested.

That being said, the UCCB is considered to be taxable income and must be reported by the lower-income spouse or partner, regardless of which spouse or partner actually receives the payments. The UCCB is excluded from income when calculating your entitlement to the Child Tax Benefit and the GST/HST credit.

B. TAX DEDUCTIONS

Child care deduction (line 214)
The "child care expense" deduction is designed to provide some tax relief for parents who incur child care expenses to enable them to work outside the home, run a business or pursue an education.

The general rules for child care expenses permit you to deduct up to $7,000 annually for each child who was 6 or under in 2010 and up to $4,000 per year for each child between the ages of 7 to 15. If the child is eligible for the disability tax credit, you can claim up to $10,000 of child care fees. Generally speaking, any child care expenses must be claimed by the lower-income parent.

The Income Tax Act defines child care expenses broadly to include payments not only to such child care providers, as babysitters, nannies, nursery schools and daycare facilities, but also to day camps or summer residential camps (discussed below).

In order to claim child care expenses, including eligible camp fees, you need to complete Form T778, Child Care Expenses Deduction with your tax return. Although the CRA does not require you to submit your receipts with your return, keep them in case the CRA asks to review them at a later date.
Summer camps

One of the terms used by the CRA, in discussing the types of day camps that may qualify for the child care deduction, is “day sports school” and, according to the CRA, “is intended to cover those day camps providing a sufficient degree of child care services.”

Many summer camps include elements of child care, which are tax deductible, as well as sports education and training, which are generally not tax deductible.

Rather than having to prorate the camp fees into eligible and ineligible portions, which would be nearly impossible to do, the CRA has set out a list of factors that help determine whether a particular sports program involves a sufficient degree of child care to qualify as a deductible child care expense.

Factors to consider include: age of the participating children, instructors’ qualifications, time devoted to the program, duration of the program, training and educational facilities used and the extent to which progress is measured.

For example, the CRA’s general position is that since day camps for young children are generally for a limited period (a week or two) and provide a sufficient degree of child care, such fees are usually fully eligible for the child care deduction.

On the other hand, older children who participate in a sports program for lengthier periods of time, taught by instructors with physical education degrees, where their progress is regularly monitored and “sophisticated training methods and facilities are used,” may be more properly classified as “education and training” as opposed to child care, and therefore are generally not tax deductible.

For overnight camp, in addition to the normal child care limits discussed above, there are further caps on the amount of camp fees that can be claimed as child care expenses: $175 a week for each child age six or under, $100 a week for each child age seven to 15, and $250 a week for each child who is eligible for the disability tax credit.

C. TAX CREDITS

Tuition, education and textbook amounts transferred from a child (Line 324)

Under the tax rules, students who don’t need to use all their tuition, education and textbook tax credits to reduce their tax payable to zero can transfer up to $5,000 to a spouse, partner, parent or grandparent, regardless of whether he or she contributed financially towards the student’s education.

With both federal and provincial credits available, a $5,000 transfer could be worth over $1,250 (25%) to a parent, depending on the parent’s province of residence.

Of course, students do have the option of saving their unused credits to apply to their own taxes payable in a future year rather than transferring them to a parent, so this is something worth discussing with your children at tax time, especially if you’ve been providing them with financial support.

Children’s fitness amount (Line 365)

This federal non-refundable credit is applicable for up to $500 in eligible fees paid for the enrolment of a child under 16 in an “eligible program of physical activity.” The credit is worth 15% of the amount spent, up to the $500 maximum creditable per child, for a maximum benefit of $75 per child.

An eligible program of physical activity is defined by the CRA as “an ongoing, supervised program, suitable for children, in which substantially all of the activities undertaken include a significant amount of physical activity that contribute to cardio-respiratory endurance, plus one or more of: muscular strength, muscular endurance, flexibility and balance.”

Normally, programs are only eligible for the tax credit if they are at least eight weeks long with a minimum of one session per week. Children’s camps, however, can also qualify if they are at least five consecutive days, provided half the program time is devoted to physical activity.

Since summer camp fees may qualify for both the children’s fitness amount and the child care deduction (discussed above), it’s generally advisable for a parent who is in a higher federal tax bracket than 15% to claim the child care deduction first since it will be worth more than the non-refundable fitness credit which is set at 15%.

On the other hand, if the family is already taking advantage of the full annual deductible child care expense limits, as discussed above, then claiming the fitness credit will provide some additional relief.

Child amount (Line 367)

This non-refundable credit is based on an amount of $2,101 per child under the age of 18 at the end of 2010, multiplied by 15%. This translates into a tax credit of about $315 per child under the age of 18.
D. FILING A TAX RETURN FOR THE KIDS

There are a number of situations in which you are required to file a tax return, the main one being if you have to pay tax. Since most children earn less than the basic personal amount, which was $10,382 in 2010, they don’t owe tax. Nonetheless, it still may be worthwhile for the kids to file.

One reason is to report income the child may have earned from casual, part-time or summer employment. Though it’s likely no tax would be payable on such income due to the basic personal credit, reporting such “earned income” will generate RRSP contribution room, equal to 18% of the amount earned, which can be carried forward indefinitely by the child and claimed in a later year, when his or her income is higher.

The introduction of the tax-free savings account (TFSA) makes this strategy even more palatable. Often, young people starting their first jobs, and in the lowest tax bracket, are discouraged from making RRSP contributions until they get into a higher tax bracket where the deduction is worth more.

Instead of contributing to an RRSP, a young person (age 18 and over) can save excess funds in a TFSA for a number of years. RRSP contribution room grows while they earn and report employment income.

When the individual, perhaps now in their late 20s or 30s, enters into a higher tax bracket in which RRSPs make more sense, they could simply withdraw the TFSA funds on a tax-free basis and contribute them to the RRSP taking advantage of the accumulated RRSP room. They would claim an RRSP deduction at the new, higher bracket.

The icing on the cake is that the TFSA withdrawal will re-establish their TFSA contribution room for that amount in the following calendar year. The TFSA room can also be carried forward and used in any future year to make a contribution.

It also makes sense to file a tax return for a child when you’ve been investing on the child’s behalf and want to demonstrate a track record of tax compliance with the CRA (see below under heading “Income Splitting.”)

By reporting any income and/or gains earned by the child annually on the child’s tax return, even though they may not be taxable due to the basic personal credit, you are demonstrating to the CRA that such income and/or gains do indeed belong to the child and should not be attributed and taxed in the parents’ hands.

E. INCOME SPLITTING WITH MINOR CHILDREN

“In-trust” accounts can be used by parents or grandparents to save on behalf of their children (or grandchildren) and accomplish income splitting. Generally speaking, the attribution rules attempt to prevent income splitting among family members by attributing investment income earned by a child back to the contributing (grand)parent. While both interest and dividend income are subject to attribution when funds are invested on behalf of a minor, there is an exception for capital gains.

By investing in equities directly (or indirectly through equity mutual funds) for children, if only capital gains are generated, those gains will be taxed in the hands of the child or grandchild without worrying about the attribution rules.

If income splitting of interest or dividends is desired, then parents may wish to consider a prescribed rate loan strategy using a family trust. In this scenario, funds are loaned by a parent to a family trust at the CRA prescribed interest rate. Any investment income earned by investing the loan proceeds inside the trust, in excess of the prescribed rate payable on the loan, can be paid to the minor children without running afoul of the attribution rules discussed above, provided the interest is actually paid before January 30th of the following year.

While the prescribed rate can vary quarterly based on the 90-day Government of Canada Treasury Bill rate, the tax rules specify that to avoid the attribution rules, you need only use the prescribed interest rate at the time the loan was originally extended.

With the current prescribed rate at an all-time historic low of 1% until at least June 30, 2011, now is an ideal time to consider this income splitting strategy.

In summary, there are definitely tax advantages for those who have children. Given that raising children can be costly, parents should ensure they capture all the various tax benefits, credits and deductions entitled to them.

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