The great divide: Income splitting strategies can lower your family's taxes

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There are a number of ways to split income, some of which have been around for a long time and may provide significant tax savings. With marginal tax rates for high-income earners now over 50% in more than half the provinces and territories and relatively 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 or common-law partner. 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.[1] Income from the Canada Pension Plan and Quebec Pension Plan cannot be split in the same way, although there may be options to share your CPP retirement pension[2] or Quebec retirement pension[3] with your spouse or partner.

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 or partner must make a joint election on your income tax returns using Form *T1032 – Joint Election to Split Pension Income*. On line 21000 of your tax return, you would claim a deduction for 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 11600 of your spouse's or partner'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 or partner, tax savings may be up

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1 In Quebec, the pension recipient must be at least 65 years of age for any type of pension income to be split for Quebec provincial tax purposes.

2 For additional information see canada.ca/en/services/benefits/publicpensions/cpp/share-cpp.html

3 For additional information see rrq.gouv.qc.ca/en/retraite/retraite_a_deux/impact_fiscal/Pages/division_rr.aspx

to about $3,000 annually, depending on your province or territory, and the spread between the tax rates of you and your spouse or partner.

Splitting pension income may have benefits beyond the taxes that are saved by having part of your pension income taxed at your spouse’s or partner’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 or partner’s net income. For example, in 2020 the federal age amount is worth about $1,150 but is phased out with income between about $38,500 and $89,400. Although the maximum total amount of Old Age Security (OAS) pension benefits is about $7,300 in 2020, these benefits are reduced with net income between about $79,000 to $128,000. 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 or partner merely reduces one spouse's or partner’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 or partners will not be affected. Such credits include the GST / HST credit, the Canada Child Tax Benefit and related provincial or territorial benefits.

Spousal or partner RRSPs (RRIFs)

If you think that, upon retirement, you will have a higher income or have accumulated more retirement assets than your spouse or partner, it may be beneficial for you to contribute to a spousal or partner RRSP. A spousal or partner RRSP is an RRSP to which you make the contributions, but of which your spouse or partner 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 or partner’s (the annuitant’s) hands instead of yours (the contributor’s). A spousal or partner RRIF is the continuation of a spousal or partner RRSP.

If your spouse or partner 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 or partner is in the lowest tax bracket and you are in the highest tax bracket, tax savings may be up to about $3,000 for each $10,000 of RRSP or RRIF withdrawals, depending on the province or territory.

If your spouse or partner makes a withdrawal from a spousal or partner RRSP (RRIF) and you made a contribution to an RRSP for your spouse or partner in any of the previous three years, attribution will occur.[4] You must include in your own income the amount of the withdrawal(s) from the spousal or partner RRSP (RRIF)[5] in the current year, or the amount of your contributions to spousal or partner 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 or partner RRSPs still relevant given the ability to income split RRIF income?

The pension splitting rules have not, in fact, heralded the demise of spousal or partner RRSPs. First of all, spousal or partner RRSPs allow you to split more than 50% of your pension income. With a spousal or partner RRSP, you could theoretically split up to 100% of your RRSP income with your lower-income spouse or partner.

Secondly, primarily due to the definition of pension income, as described earlier, if an individual is under age 65, eligible pension income typically only includes annuity payments from an RPP and will not generally include amounts paid from an RRSP or RRIF.[6] So anyone who wants to income split before age 65 and does not have an RPP should still consider the use of spousal or partner RRSP contributions, which would allow the ultimate withdrawals to be taxed in a lower-income spouse’s or partner’s hands without having to wait until age 65.

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4 Certain exceptions apply. For example, there will be no attribution if you and your spouse or partner were living separate and apart because of the breakdown of your relationship at the time of the withdrawal.

5 There is no attribution of the RRIF minimum amount.

6 In Quebec, pension splitting is only available starting at age 65 for all types of income.

Higher income earner pays all expenses

Another very simple, yet highly effective, strategy is to have the higher-income earning spouse or partner pay all the household expenses and the lower-income earner do all the non-registered investing. A low-income earner has less income available that could potentially be invested than their higher-earning spouse or partner. 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

Amount	Marlee	Kevin	Total
After tax income	$70,000	$30,000	$100,000
Household expenses	(30,000)	(30,000)	(60,000)
Available to invest	**$40,000**	**$0**	**$40,000**

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 or partner) 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 or partner

Amount	Marlee	Kevin	Total
After tax income	$70,000	$30,000	$100,000
Household expenses	(60,000)	(0)	(60,000)
Available to invest	**$10,000**	**$30,000**	**$40,000**

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 or partner obtained funds for investment. Having each spouse or partner keep separate bank and investment accounts, rather than having joint accounts, helps to leave a solid paper trail. The couple needs to balance the benefits of joint accounts such as access, control and survivorship rights, with any benefits of tax-saving.

Spousal or partner loan

The attribution rules discussed above will not apply if, rather than making a gift, you lend funds to your spouse or partner at the prescribed interest rate that is in effect at the time the loan was originated and your spouse or partner pays interest annually by January 30 of the following year. Spousal or partner loans have been used by savvy couples for many years and the prescribed interest rate is currently at a historical low of 1% until at least March 31, 2021.[7]

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).

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7 Quarterly prescribed interest rates are available online at canada.ca/en/revenue-agency/services/tax/prescribed-interest-rates.html.

If you establish the loan at the current 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. If you previously entered into a loan with your family member when the prescribed rate was 2% (or higher), with some proper planning, you may be able to use the lower 1% prescribed rate that is currently in effect. Additional information is available in the report Prescribed rate loans: The one per cent solution.[8]

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[9] interest on the spousal or partner loan, can then be taxed in the lower-income spouse's or partner's hands.

Example: Spousal or partner 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 when the prescribed interest rate is 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 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. Jack, in turn, would report $5,000 of interest income that he received from Dianne on his tax return.

The net tax savings to the couple would be having $15,000 of 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 B.C. and Ontario) annually, depending on the province or territory.

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 or partner 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) 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.

Loans to adult children

Young adults may find it difficult to buy their first home and sometimes turn to the "bank of mom and dad" for financing. If you are thinking about giving funds to your kids to help them out, the attribution rules won't be a concern, since they don't apply when you gift funds to relatives who are 18 years or older.

If you would rather lend funds to an adult child, perhaps to protect those funds via a secured mortgage in case of a marriage or relationship breakdown of the child later in life, there is no need to charge interest on the loan. Since your child is then using the loaned funds to buy a home there will generally be no income generated from their home, so there will be no attribution of income back to mom or dad. And if your child claims the

8 The report "Prescribed rate loans: The one per cent solution" is available online at cibc.com/content/dam/personal_banking/advice_centre/tax-savings/prescribed-rate-loans-en.pdf.

9 Since the loan was taken out for the purpose of earning investment income, the interest paid on the loan is tax deductible.

principal residence exemption to exclude the capital gain from income upon eventual sale of the home, there will be no attribution of the capital gain either.

If your child does plan to earn income from the home, perhaps by renting it out, then you will need to charge interest at the prescribed rate (or higher) to avoid being taxed on rental (or other) income from the home that would be attributed back to you. Although making a prescribed rate loan would prevent attribution, you would still pay tax on the interest income that you earn from lending funds to your child.

Finally, be aware that, in some cases, renting a home may prevent your child from claiming the principal residence exemption.[10] If that's the case, when your child later sells the home, the capital gain may be attributed back to you.

Put your family members to work

If you own a business, hiring your spouse or partner 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 personal 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 or territory, 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 members as shareholders

If you operate a business through a private corporation, you may think of adding family members as shareholders in order to split dividend income from the corporation with them; however, before proceeding with this strategy, beware of some rules that could hinder your ability to do this.

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[10] Additional information is available in the report titled "So… You Wanna be a Landlord", which is available online at cibc.com/content/dam/personal_banking/advice_centre/tax-savings/landlords-en.pdf.

The "kiddie tax" (formally known as the Tax on Split Income or "TOSI") has been in existence for many years and imposes a tax at the highest marginal rate on any Canadian dividends received, either directly or through a family trust, by someone under the age of 18 from a related private corporation, including a corporation that is controlled by the child's parent. In fact, not only does it tax these dividends at the highest rate regardless of the amount of other income that the child may have, but also it does not allow the basic personal tax credit to be used to shelter this dividend income.

The TOSI rules were expanded in 2018 and may also eliminate the income splitting advantage for adults. These rules apply where an adult, either directly or through a trust, receives dividend or interest income from a private corporation, or realizes a capital gain on shares of a private corporation, and a related individual is either actively engaged in the business of the corporation or holds a significant amount of equity (with at least 10% of the value) in the corporation.

While the TOSI rules contain a number of exceptions, they are complex and more information is available in our report The CCPC Tax Rules[11]. For instance, depending on the shareholder's involvement in the business, or percentage ownership of the corporation, an exception may be available.

Another exception from the TOSI rules permits income splitting between shareholders and their spouses or partners in retirement. When the shareholder who was involved in the business is at least 65 years old then income received by that person's spouse or partner generally won't be subject to TOSI. This is consistent with the current pension income splitting rules for RRIF income after age 65 that were discussed in the section titled "Pension Splitting."

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 the couple's overall taxes, and may want to convert some RRSPs to RRIFs to take advantage of this opportunity. Spousal or partner RRSPs can also be an effective method of income splitting in retirement.

When the higher-income spouse or partner 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 or asking your tax and legal advisors if it may be beneficial to include family members as shareholders of your corporation. The result could be thousands of dollars of annual tax savings.

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11 The report titled "The CCPC Tax Rules" is available online at cibc.com/content/dam/small_business/day_to_day_banking/advice_centre/pdfs/business_reports/private-corporation-tax-changes-en.pdf.