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Income Splitting

With Canada's high personal tax rates, there's a great desire among many Canadians to find ways to save on taxes. However, over the past several years, the government has slowly eliminated many of the techniques previously used to minimize tax. Fewer tax shelters and deductions are available and more rules have been introduced to curtail tax planning.

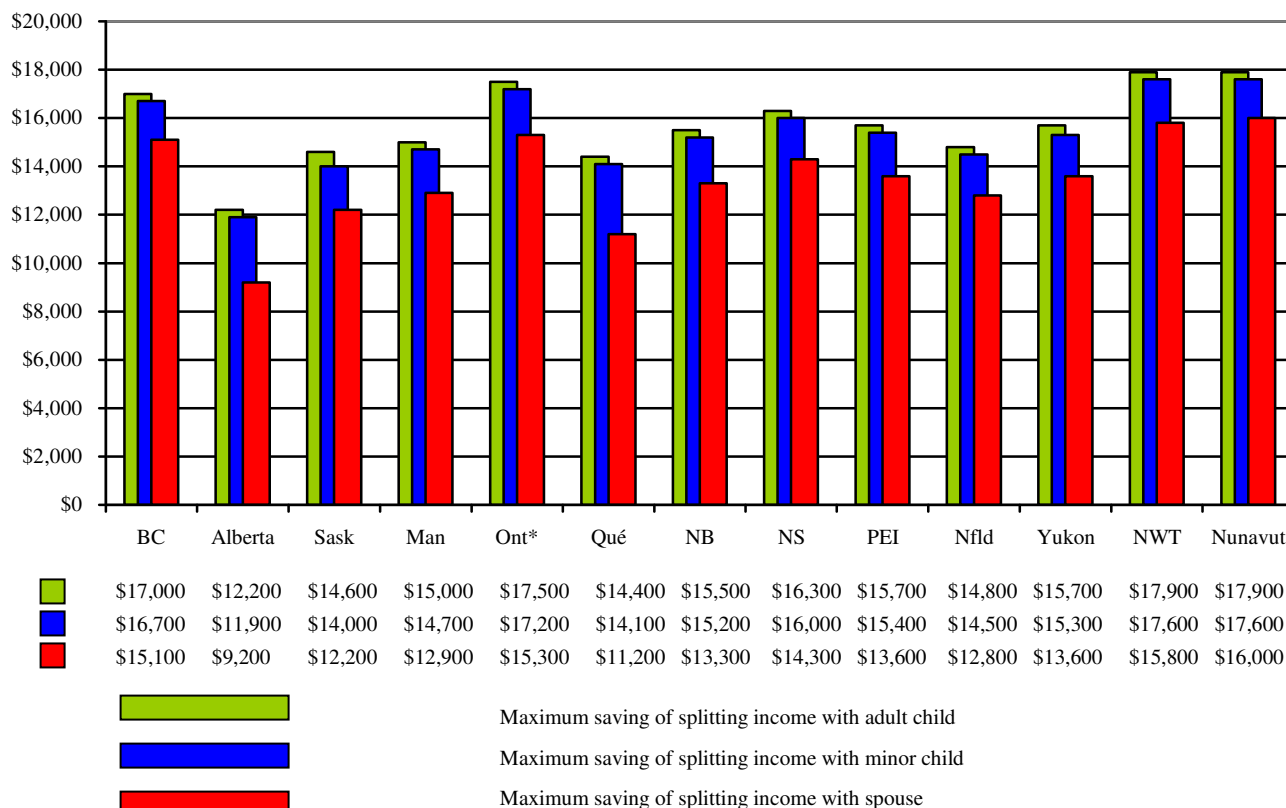
As a result, the average taxpayer probably believes there is very little that can be done to reduce the tax burden. However, reductions are possible within the family unit with the right tax planning techniques. These techniques are known as "income splitting".

Income splitting is the process of redirecting income within a family group to take advantage of the lower tax brackets, deductions and credits available to each family member. Income is split by transferring income-earning assets from high-income to lower-income family members. Generally speaking, the total tax on family income will be lowest when each member earns approximately the same level of income.

People are often surprised at the magnitude of tax savings that can be achieved through simple income splitting. As an example, assume an individual earns income which places him well into the top marginal tax bracket. By transferring enough income to another family member, he can bring that person's income up to the cut-off for the top marginal bracket. Income previously taxed at the top rates will now be taxed in the lower brackets, with more after-tax cash remaining within the family unit.

The chart on page two sets out the maximum amount of tax that individuals in each province could save in 2007 by splitting income with a spouse, an adult child or minor child who has no income. Your actual savings may be lower if your spouse or child has other sources of income. Please note that references to a spouse throughout this bulletin include a common-law partner.

Maximum Savings by Province in 2007



* includes Ontario Health Premium tax

As you can see, the savings can be substantial and will multiply with each family member with whom you split income. Note the difference between spouses and children. When you split income with your spouse, you lose the marital tax credit. Although there's a Federal non-refundable tax credit for dependent minor children (and in Saskatchewan and the Yukon), the credit is smaller, so the savings from splitting income with children can be greater. The maximum saving arises when splitting income with an adult child who is not a dependant.

Savings can be achieved in a number of ways: from strategies as simple as making interest-free loans to more complex arrangements involving corporations and trusts. The range of techniques available to you depends on your particular financial situation.

Unfortunately, the Canadian government is well aware of the potential tax savings from income splitting and over time has enacted several rules to prevent it. The "attribution rules" cause income (or capital gains in some cases) to be attributed back to you to be taxed in your hands. In addition, an income splitting tax on minor children, known as the kiddie tax, was introduced in 1999 as a result of the government taking action to attack

business splitting arrangements after taxpayer victories in court (most notably the Supreme Court decision in Neuman). A basic awareness of all of these rules is necessary to carry out effective tax planning.

The attribution rules

The main idea behind income splitting is to transfer assets to low-income family members to enable them to earn income. The attribution rules potentially apply whenever a property is transferred or a loan is made at little or no interest to a family member. The most important rules are as follows (limited exceptions are available, which we will address):

- ♦ If you make a loan or give property to your spouse, any income or capital gains from the transferred assets will be attributed to you.
- ♦ If you make a loan or give property to a minor child (a son, daughter, niece or nephew under 18 or some other minor child with whom you do not deal at arm's length), income from the funds will be attributed to you, but any capital gains arising from the property will be taxed in the hands of the child.

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- ◆ If you make a loan to an adult child or other adult relative, income from the funds may be attributed to you if the purpose of the loan was to reduce taxes. Any capital gains will be taxed in the hands of the relative.

Although the attribution rules for loans and gifts significantly reduce income splitting opportunities, many possibilities still exist. This bulletin lists the more common ways you can arrange your family finances to split income with family members. Note the ones that interest you and discuss them with your BDO advisor.

Family income splitting

The following opportunities exist to split income with other members of your family:

Make an interest-free loan to your spouse or children for investment purposes.

Under the attribution rules, income earned by your spouse or child on the funds will be taxed in your hands, just as it would have been had you not made the loan. However, that income becomes their property and can be reinvested without further attribution. Over time, family members can build up a large pool of funds which earn income taxed in their hands. Be sure to deposit the income in a separate bank account so that it can be properly tracked and separated from the funds advanced as a loan. Also, you may want to consider setting up a trust to manage the funds if minor children are involved.

The attribution rules do not apply to loans that bear interest at the prescribed rate—an interest rate set quarterly by the Canada Revenue Agency (CRA) that approximates short-term Treasury Bill rates. If you loan funds to your spouse or child and the funds are invested so that the rate of return is higher than the prescribed rate, the excess income will be taxed in their hands. Note that interest on the loan must be paid no later than 30 days after the end of the year. Where the interest is not paid on time once, the loan will be subject to the attribution rules until repaid. The interest rate on the loan does not have to be adjusted each time the prescribed rate changes.

Loan funds to family members other than your spouse to invest in assets that produce capital gains.

Consider loaning funds interest-free to low-income family members other than your spouse. They can use the funds to purchase investments with low returns, but with the potential to produce capital gains. Capital gains arising on these investments will not be subject to attribution.

Many mutual funds invest in growth stocks with low dividend rates. Such investments are well-suited for this

plan, as any distribution from these funds are often a distribution of capital gains.

If a child's in-trust account or a trust for the child has investments with accrued gains, consider triggering these gains each year to the extent the child's personal exemptions are not otherwise utilized. This will help ensure that the child won't have a large gain that will be taxed at some point in the future.

Make gifts to adult family members.

If you support adult family members, such as children at university or elderly parents, consider giving them assets which they can invest to earn their own income. The income will be taxed in their hands, not yours, and they'll have more after-tax funds than if you had earned the income and paid their expenses.

This situation can arise where an adult child needs money for his or her education, or where your parents are dependent on you for support. Bear in mind that a gift means you give up control of the asset. If making gifts to low-income parents, you may want to ensure that the assets will be left to you in their wills. Also, if you give property other than cash to any relative, you're deemed to dispose of it at fair market value, which could result in a taxable capital gain.

Ensure the high-income spouse pays all family expenses, while the low-income spouse saves.

Often, both spouses contribute equally to household expenses, where each have a source of income. This may seem fair and reasonable, but it's poor tax planning. To the maximum extent possible, the low-income spouse's salary and other earnings should be saved for investment purposes, while the higher income spouse pays for expenses such as food, clothing, mortgage payments etc. You can even pay your spouse's taxes. This ensures that the family's total investment income is taxed at the lowest possible rate.

Loan or give funds to family members to purchase a principal residence.

If you support a child in residence at university or pay rent for elderly parents, consider loaning or giving them funds to purchase a separate residence. This will reduce your investment income subject to tax and, since the funds aren't earning income, there's no attribution. Also, if the property increases in value, the family member may be able to use the principal residence exemption.

Invest the Child Tax Benefit and the Universal Child Care Benefit in the name of your children.

The Child Tax Benefit is based on family income. Consequently, higher income families do not qualify for the benefit. The Universal Child Care Benefit is available to all parents for children under the age of six and is paid in instalments of \$100 per month per child. To the extent

that you receive these benefits, you should invest the funds in a separate account in trust for your children. Investment income on these funds will not be attributed to you.

Invest inheritances for the benefit of your children.

If your child inherits money, make sure that you segregate these funds and invest them in the name of the child. If you or your spouse will inherit funds from a relative you can split income from that inheritance as well, if your relative names your child as a beneficiary. Keep in mind that if a child's inheritance from a relative, that is not their parent, includes shares of a private company, the dividends will likely be subject to the kiddie tax (which we discuss later in the section entitled "Income splitting through corporations").

Treat educational support to your spouse as a loan.

If you're supporting your spouse while he or she is in attendance at a school, college or university and the spouse is expected to eventually be the high-income earner, treat the amounts spent on his or her education as a loan. Later, when the individual earns income, the amount can be repaid to you for investment purposes. You should document the amounts spent and have a written loan agreement.

Shift assets between spouses.

The attribution rules don't apply if you transfer assets to your spouse in return for assets of equal value. If your spouse has non-income-producing property (i.e. such as a cottage), consider purchasing these assets for cash (or other income-producing assets) at their fair market value. You and your spouse can continue to enjoy the assets, as your spouse earns income from the funds.

Usually, assets can be exchanged between spouses with no tax consequences. However, to avoid attribution, you and your spouse must elect to have the sale occur at fair market value. If the assets transferred have accrued gains, a capital gain will result. If the election is made, any future income or capital gains on the income-producing property would not be attributed back to the transferring spouse.

Contribute to a Registered Education Savings Plan (RESP).

An RESP is a vehicle through which you can defer taxes, split income with your children and save towards their post-secondary education all at the same time. Unlike a Registered Retirement Savings Plan (RRSP), contributions to the plan are not deductible. However, income earned in the plan is not taxed until distributed as educational assistance payments to someone named by you as a beneficiary under the plan. At such time, the

income is taxable in the hands of the recipient, presumably at a lower rate, and the original contributions are returned tax-free.

Before the 2007 Federal budget, you were allowed to contribute up to \$4,000 annually to an RESP – with a cumulative lifetime contribution limit of \$42,000. Changes announced in the 2007 Federal budget eliminated the \$4,000 annual RESP contribution limit and the lifetime RESP contribution limit was increased to \$50,000. What this means is that you can contribute \$50,000 immediately to an RESP. Note that if more than one plan has been set up for a particular beneficiary, you and the other contributors must share the contribution limit. The plan itself must be wound up after 25 years.

There are two types of plans—individual plans and group plans. In addition, there are two kinds of individual plans – non-family plans and family plans. A non-family plan is a plan you set up for just one beneficiary, and there are no restrictions on who can be a beneficiary of such plan. A family plan can have more than one beneficiary; however, each beneficiary must be connected by blood or adoption to each living subscriber under the plan or have been connected to a deceased original subscriber.

A group plan (also referred to as a pooled plan or a scholarship plan), is a set of individual non-family plans that are administered based on a specific age group. Individual plans are more flexible, as they give the contributor more control over the investments made and the timing and amount of educational assistance payments made to beneficiaries. It is important to review all plans carefully to fully understand the provisions of the plan in the event that beneficiaries do not attend college or university within the required time period.

An added benefit of using an RESP is the Canada Education Savings Grant (CESG). The CESG is a federal grant that is added to your eligible contributions. Changes in the 2007 Federal budget increased the maximum annual RESP contribution qualifying for the 20% CESG to \$2,500 from \$2,000, which increases the maximum annual CESG per beneficiary for 2007 and subsequent years to \$500 from \$400. Similarly, the maximum CESG for a year has been increased to \$1,000 from \$800 if there is unused grant room because of contributions of less than the maximum amount in previous years. It is worth noting that the \$7,200 lifetime CESG limit is unaffected by these changes.

Despite these beneficial changes, it may still make sense to use both an RESP and an "in-trust" account when saving for a child's education. For more information, see *Are You Getting a Passing Grade on Education Savings?* in the 2008-01 issue of *The Tax Factor*.

Pay your spouse's interest-bearing debts.

If your spouse has incurred interest-bearing debts such as a car loan, consider paying off these debts on behalf of your spouse. The reduction in interest expense is not subject to attribution. Your spouse will then have more funds to invest in the future.

Note that this plan does not work if the debts were incurred to acquire income-producing properties. If you pay off these debts, any income from the properties will attribute to you.

Provide for a testamentary trust in your will.

Rather than leaving your estate directly to your spouse, children or other dependants, consider leaving some funds in a testamentary trust for the benefit of these individuals. A testamentary trust pays tax as though it were an individual. Income from the funds will be taxed in the trust and will thereby benefit from an additional set of lower marginal tax rates. It is even possible to set up multiple testamentary trusts under your will, one for each beneficiary, which can multiply the availability of lower marginal tax rates on the income earned by the assets in your estate. The capital and after-tax income can be distributed over time to your beneficiaries free of tax. Your BDO advisor can help you select the method which best suits your needs and can assist you in other areas of estate planning.

Business income splitting

If you carry on a business, other income splitting opportunities are available to you:

Make your spouse a partner of your unincorporated business.

If you operate an unincorporated business in which your spouse is active, you may be able to establish that he or she is your partner, eligible to share in the profits or losses of the business. To be considered a bona fide partner, your spouse must either devote a significant amount of his or her time, specified skills, or training to the business or must have invested his or her own property in the business. You must ensure that your spouse's share of income is reasonable compared with the amount of work or capital put into the business. A partnership agreement is recommended.

Pay your spouse and children a salary.

If your spouse or children work in your business, consider paying them a salary. The salary must be reasonable given the services performed. A good rule of thumb is to pay them what you would have paid a third party for the same services. A record should be kept of

the time actually spent and the services actually performed.

When you pay salaries to your spouse or children, you usually must make withholdings for income tax, Canada/Quebec Pension Plan (for individuals over 18 years of age) and any applicable provincial payroll taxes. There will generally be no liability for employment insurance on remuneration paid to members of your family.

Pay your spouse a director's fee.

If your spouse is a director of your corporation, consider paying your spouse a director's fee for services performed. A director's services usually include attending directors' meetings, directing the management and affairs of the business, approving financial statements, declaring dividends, approving changes to share capital and electing officers of the company. Note that your spouse will also be jointly liable with the other directors for the fulfillment of certain regulatory requirements, such as salary withholdings and GST collections.

Pay a guarantee fee to your spouse.

If your spouse is required to pledge assets or to otherwise guarantee a business loan, he or she can be paid a fee by the business.

Again, the amount paid must be reasonable in the circumstances. In determining reasonableness, one would look at the amount of the loan, subsequent ability of the business to repay the loan and the amount that would have otherwise been paid to an arm's-length party to guarantee the loan. The fee will also help in establishing deductibility of the loan for your spouse, should the debt become bad and the guarantee ever be called.

Loan funds to your spouse to start-up a business.

Only income from property is subject to attribution. Income from a business is not. If your spouse has a promising business venture, you can provide interest-free financing without any attribution. If the venture is risky, you should consider that an interest-free loan would not qualify for capital loss treatment should the venture fail. If this is the case, you might want to make a capital contribution to the business as a partner and share in the start-up loss. When the business becomes profitable, you can make interest-free loans to the business for further expansion. A gift could also be used to finance a new venture. Your spouse's share of profits from the venture can be invested by your spouse and would not be subject to income attribution.

Income splitting through corporations

In the past, income splitting was possible with all members of your family through your corporation by issuing shares to your spouse and children, as long as you were careful to overcome certain obstacles. Dividends paid by the corporation to the shareholders would be taxed in their hands, provided you did not give or loan them the funds interest-free to acquire the shares. However, with the introduction of the kiddie tax, the government created yet another obstacle when it comes to income splitting with minor children. In order to implement a corporate income splitting plan that is successful, you must be aware of all of the obstacles that prevent income splitting.

The first obstacle is a set of rules commonly referred to as the corporate attribution rules. Without these rules, you could avoid attribution by simply making interest-free loans to a corporation where your spouse and children are shareholders, instead of directly to them. The corporate attribution rules provide that, if you make a low-interest or interest-free loan or transfer any property to a corporation with the main purpose of reducing your income and benefiting your spouse or minor children, you are deemed to receive interest on the loan or the value of the property transferred at the CRA's prescribed rate. This income inclusion to you is reduced by any interest, by 5/4ths of any ineligible dividends and 145% of any eligible dividends you actually receive from the corporation. This deemed interest arises even if no income is earned by the corporation and no dividends are paid to your spouse or children. Consequently, it is a penalty provision that should be avoided.

The rules do not apply during any period that the corporation is a small business corporation (SBC). An SBC is a Canadian-controlled private corporation (CCPC) in which at least 90% of the assets (on a fair market value basis) are used in operating an active business in Canada. Therefore, as long as your corporation carries on business and does not accumulate significant investment assets, your spouse and children, particularly those 18 years of age and older, can be a shareholder and receive dividends.

The second obstacle is the kiddie tax, which prevents the transfer of income from high-income individuals to their children under the age of 18. Rather than redirecting income and taxing it in the hands of the high-income family member, the rules provide for a tax on minors who receive income under an income splitting arrangement.

Beginning in the year 2000, minor children are taxed at the top federal personal tax rate on dividends or business income received from a family business.

Specifically, this tax will apply on the following sources of income:

- ◆ Taxable dividends received directly by a minor, or indirectly through a trust or partnership. Dividends from publicly traded corporations are excluded.
- ◆ Income inclusions required under the Income Tax Act, in respect of the ownership by any person of shares of the capital stock of a corporation. Shares of a class listed on a prescribed stock exchange are excluded.
- ◆ Business income from a partnership or trust, where the income is from property (prior to 2003, this reference was to goods) or services provided to, or in support of, a business carried on by:
 - a person related to the minor, including a relative who is a partner of the partnership earning business income,
 - a corporation where a relative of the minor owns 10% or more of the corporation's shares, or
 - a professional corporation where a relative of the minor is a shareholder.

The reference to business income earned in support of another business carried on by a relative appears to be designed to prevent you from having your management company or partnership bill third parties directly, rather than your own business, for services rendered. Generally effective for 2003 and subsequent years, the government has proposed to extend the income splitting tax to catch rental or interest income earned by a trust or partnership from a family business and received by minor children.

Personal tax credits cannot be claimed to reduce this tax. However, the minor will be allowed to claim the dividend tax credits and foreign tax credits, where applicable, to reduce the tax.

Although limited, there are some exceptions to the kiddie tax:

- ◆ the tax will not apply where both of the minor's parents are non-residents of Canada,
- ◆ the tax will not apply on income from property inherited from a parent, and
- ◆ if the child is going to college or university, or is disabled, income from property inherited from others won't be subject to the tax.

With the tax on minor children, it is difficult to achieve business income splitting through a corporation with minor children. However, income splitting with your spouse and children who are 18 years of age and older is alive and well. In a typical corporate income splitting arrangement, shares with nominal value are issued to the spouse and children. Dividends are later paid on these shares as income is earned by the corporation. The dividends paid often exceed the amount paid for the shares. Since different classes of shares are usually issued to different family members, it's possible to determine the dividend amount to each person to minimize tax. (Note that the dividends paid to minor children will now be subject to the income splitting tax.)

This process, called “dividend sprinkling”, was the subject of a 1990 Supreme Court case (*The Queen v. McClurg*). The following guidelines were drawn from the outcome of that case:

1. If you’re setting up multiple classes of shares, you should ensure each class is different in some respect from the others—for example, one class of shares can be voting while the others are not, some shares can share in growth while other shares are redeemable at a set price. By varying the attributes of the shares, it is possible to have several unique classes of shares.
2. Fair market value consideration must be paid by your family members in exchange for the shares issued. This may be difficult if the shares have high value and the family members have no independent source of funds. Income splitting arrangements are often accompanied by a “freeze” in the value of the company. This is accomplished by having the owner-manager exchange their common shares for preferred shares having a redemption amount equal to the value of the company. Provided the preferred shares have attributes that support this fair market value, any new common shares issued should then have only a nominal value.
3. Each shareholder should pay for the shares using his or her own funds and not funds provided by the owner-manager.

If you have an existing income splitting plan that involves minor children, the kiddie tax will generally now make the payment of dividends to these children unattractive. The best way to optimize your current income splitting plan is to reinvest as much money as possible, that was accumulated in the past under your plan, for the benefit of your child. Your BDO advisor also has other more sophisticated income splitting strategies that might make sense for you.

Corporate income splitting is still very much an option with your spouse and children who are 18 years of age and older. Remember to consider the corporate attribution rules where a spouse will be a shareholder. Great care is required when developing a corporate income splitting plan and your BDO tax advisor should be consulted prior to undertaking any arrangement.

Income splitting in retirement

Pension Income Splitting.

Under new rules that apply for 2007 and subsequent taxation years, a recipient of eligible pension income can transfer up to one-half of this income to his or her spouse. Where the pension recipient is in a higher tax bracket than the transferee or the transferee does not have a source of pension income eligible for the pension credit, this splitting of the pension income can result in a

tax saving. If the pension income is eligible for the pension credit, it is also eligible for the new income splitting rules.

Income eligible for the pension income splitting is based on whether you are over or under age 65:

- ◆ For taxpayers who are 65 years of age or older, eligible pension income includes annuity payments from a registered pension plan (RPP), registered retirement savings plan (RRSP) or a deferred profit-sharing plan (DPSP), and payments from a registered retirement income fund (RRIF).
- ◆ For taxpayers under 65 years of age, eligible pension income includes annuity payments from an RPP and certain other payments received as a result of the death of your spouse.

Regardless of your age, eligible pension income will not include:

- ◆ Old Age Security (OAS) benefits;
- ◆ Guaranteed Income Supplement (GIS) benefits;
- ◆ An RRSP or DPSP annuity, or RRIF payment to a recipient who is under 65 (unless the payment results from the death of a spouse)
- ◆ RRSP withdrawals;
- ◆ Payments from a retirement compensation arrangement; or
- ◆ Canada Pension Plan (CPP)/Quebec Pension Plan (QPP) benefits. (CPP recipients can elect to combine and split CPP benefit.)

You and your spouse can take advantage of this income splitting opportunity when you file your 2007 personal income tax returns. At that time, as part of a joint election, the higher income spouse can elect to transfer up to one-half of his or her eligible pension income to the lower income spouse. The amount transferred reduces the higher income spouse’s net income, and increases the lower-income spouse’s net income. The joint election you make only applies for that taxation year. In other words, you can determine whether a transfer is beneficial annually and make the election (or not) accordingly when you and your spouse file tax returns for that year.

Contribute to a spousal RRSP.

It’s possible to make contributions to an RRSP for the benefit of your spouse while deducting the contribution on your return. Although contributing to a spousal RRSP does not result in current income splitting, it can result in a large pool of funds available for future withdrawals by your spouse which would allow for income splitting when you and your spouse retire. Generally speaking, you should make your RRSP contributions to a spousal plan if your spouse’s income at the intended time of withdrawal will be lower than your income.

Withdrawals by your spouse from a spousal plan will be taxed in your spouse’s hands if you have not made a contribution to any spousal RRSP in the current

year or the previous two years, or if the RRSP has been converted to an annuity. If your spouse also has earned income, he or she should contribute to his or her own RRSP.

Even with the new pension splitting rules, spousal RRSPs still make sense because the pension splitting rules only allow you to split up to ½ of your pension income. That is, if you want to increase your pension income for income splitting purposes, you'll be taxed on at least ½ of the extra income. If your spouse has a spousal RRSP, the full amount of the withdrawal will be taxed in the hands of your spouse (subject to the three-year rule just discussed).

Split CPP benefits with your spouse.

Since 1987, recipients of CPP benefits have been able to elect to split CPP benefits with their spouse. Once the election is made, the benefits are split 50/50. This will be beneficial in situations where one spouse has a higher pension than the other (for example, where only one spouse has worked and is receiving a pension). Diverting half of your benefits to your spouse will not result in income attribution as this is specifically excluded from the rules. Also, remember to invest the benefits received in your spouse's name since income earned on the

accumulated CPP benefits will also not be subject to the income attribution rules.

Remember that CPP benefits don't qualify for the new pension income splitting rules, and you must continue to use the CPP election that we just discussed.

Summary

Although the government has put a number of rules in place to prevent income splitting, there are still a number of legitimate ways to split income within the family group and achieve lower overall taxes for you and your family. Most of the income splitting techniques described in this bulletin are fairly straightforward and inexpensive to implement. Other techniques, such as splitting income earned through a corporation, are more complex. In some cases, the plans provide immediate benefits, while others will only result in tax savings over the long term.

It is important that you start now to arrange your family finances to take advantage of as many of these income splitting opportunities as possible. Discuss your personal financial situation with your BDO advisor.

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