AIC TAX SMART BULLETIN

Income splitting to reduce family taxes

TAX-SMART INVESTING®

In a country like Canada, where taxes can be almost 50% of your taxable income, saving taxes should always be a priority.

At AIC, our investment approach incorporates tax planning to minimize your investment tax bill each year. This approach to maximize your after-tax returns is evidenced by our commitment to tax-smart education, a strong corporate philosophy grounded in tax minimization and our tax-smart investment products.

A tax-smart portfolio is a portfolio that focuses on maximizing after-tax investment returns. After all, it's not how much you earn, but how much you keep that matters most.

AIC believes in maximizing after-tax wealth (i.e. your bottom-line cash flow). We are proud of being Canada's tax-smart investment manager and a committed educator of Canadians in matters of investing, tax planning and an integrated tax-smart investment approach.

This brief is one in a series on tax-smart investing. We believe you will find this brief, along with our tax-smart investment products, helpful in maximizing the value of your taxable investment portfolio.

If you're like most Canadians, your goal is to beat the taxman and reduce your total tax liability. But you should not only be concerned about your own tax bill – you should be looking at the total amount of tax paid by your family. The problem is that, in many families, one spouse is the primary income earner so reducing the family's tax burden is a difficult challenge.

Income splitting saves tax

In simple terms, income splitting means moving income from an individual in a high tax bracket to someone in a lower tax bracket. By having this income taxed in the hands of a lower-income individual, the total tax burden can be reduced. Let's look at an example.

Robert currently earns $120,000 per year. His wife, Denise earns $20,000. Robert earned $10,000 of investment income this year, and since his marginal tax rate is 45 per cent he paid approximately $4,500 in tax on that income.

What if Robert's investments were held by Denise and that $10,000 of investment income could be taxed in her hands instead? Due to the fact that she is in a lower tax bracket, with a marginal tax rate of just 20 per cent she would pay just $2,000 on this investment income – a savings of $2,500! What would you do with an additional $2,500 of cash in your pocket?

The attribution rules

Income splitting, in theory, sounds very easy. If you are taxed at a high marginal tax rate you could transfer cash or assets to another family member, who is taxed at a lower rate, and that family member could simply use those funds to invest in his or her name. Presto, you've now managed to split income – or have you?

You see, the *Income Tax Act* contains attribution rules designed to thwart many income-splitting schemes. If caught under these rules, you, and not the person you're attempting to split income with, may be taxed on all income, and even capital gains earned on the investments made by the lower-income family member. The Canada Revenue Agency (CRA) doesn't care so much about whose name is on the

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investment account – the department cares about whose money is in the account.

So what exactly do these attribution rules say? Here's a summary:

Your spouse. For starters, if you attempt to split income with your spouse, either by gifting assets or through a no- or low-interest loan, all investment income including dividends, interest and capital gains will be taxed in your hands.

Your minor children. If assets are transferred to a minor child, whether through a gift or no- or low-interest loan, you will be taxed on any dividends and interest – but not capital gains. Capital gains will generally be taxed in the hands of the minor child. By the way, for the purposes of the attribution rules, a minor child includes a child, grandchild, niece or nephew under the age of 18.

Your adult children. A gift of assets to an adult child will not give rise to income or capital gains subject to the attribution rules. But in the case of a loan, you have to be careful. If the CRA concludes that the loan was made specifically to reduce or avoid tax, all income and capital gains will be attributed back to you – the parent lending the money.

Be aware that if you transfer assets that have appreciated in value to your family members in order to income split you have more than just the attribution rules to worry about. When you give up beneficial ownership of an asset, you are deemed to have disposed of that asset for fair market value proceeds. This means that you have to report the appreciation in value on your tax return and pay tax on any resulting capital gain. As cash does not generate capital gains, a transfer of cash would not give rise to immediate tax liabilities (although you still have to consider the attribution rules with cash).

There are special rules for the transfer of assets between spouses, specifically, the transfer is deemed to take place at the asset's adjusted cost base, therefore no realization of capital gains automatically takes place. However, in order to take advantage of any income-splitting strategies (which we will get to in a minute) it is necessary to elect to transfer the assets at fair market value, meaning you will have a potential tax liability if you transfer assets that have appreciated in value to your spouse in order to income split.

The top ten strategies

Although the attribution rules are quite stringent, there are legal ways to side-step these rules to accomplish a splitting of income. Here are the top ten strategies:

1. Lend money at fair market value interest

One way to avoid the dreaded attribution rules is to lend assets to your spouse, instead of giving the assets or cash directly to him or her. The catch is, you have to charge interest on the loan. The rate to charge is the lower of the *Income Tax Act's* prescribed interest rate or current market rates. The interest must actually be paid by January 30 following each year the loan remains outstanding.

Let's go back to Robert and Denise. Suppose Robert had $75,000 to invest. If he earns eight per cent annually ($6,000) on this investment, he will be faced with an additional tax liability of $2,700 annually at his marginal tax rate of 45 per cent. Rather than Robert investing the money, what if he were to lend it to Denise for her to invest? Let's assume that the prescribed interest rate is three per cent. What would happen in this case?

At the end of the year, Denise's investment income would be $6,000. This income will not be attributed back to Robert since she will pay him interest on the loan. Denise will have to pay $2,250 ($75,000 x 3%) in interest to Robert. Since the interest is paid to earn investment income, Denise can claim the $2,250 as a deduction against her income. Denise's taxable investment income of $3,750 ($6,000 - $2,250) leaves her with a tax bill of $750 ($3,750 x 20% marginal tax rate).

But the story doesn't end there. Since Denise paid $2,250 of interest to Robert, he must report this amount as income. Because of Robert's higher tax bracket, he has to pay tax of $1,013 on this income. As shown below, $937 of tax is saved annually as a family by arranging for Robert to lend the money to Denise.

	ROBERT INVESTS		DENISE INVESTS	
	Robert	Denise	Robert	Denise
Investment Income	$ 6,000	$ -	$ 2,250	$ 6,000
Interest Expense	-	-		(2,250)
Taxable Income	6,000	-	2,250	3,750
Marginal Tax Rate	45%	-	45%	20%
Tax Liability	2,700	-	1,013	750
Family Tax Savings				**$937**

Assumptions:
Robert charges Denise the prescribed rate, assumed to be 3%.
Investment of $75,000 earns 8% rate of return.

Be sure to document the loan properly with a promissory note. The note should include the date of the loan, amount, interest rate charged and the terms of repayment (which could simply be "due upon demand" if you'd like). Finally, make sure Denise signs the promissory note.

2. Create second-generation income

If you'd prefer to not charge interest on the money lent to your spouse, there's still a way to split income. In this scenario you can lend the money or other assets to your spouse for investment purposes, but then take back those assets in five years (or longer if you'd like). Any investment returns earned while the loan is outstanding are subject to the attribution rules, so any interest, dividends or capital gains earned will still be taxed in your hands. However, these returns (the first-generation income) can be reinvested by your spouse and any further income, known as second-generation income, is not subject to the attribution rules. By lending money to your spouse for five years or more, there will be enough time for the second-generation income to grow and take on a life of its own. By the way, it's recommended that the first-generation income be deposited into a separate investment account in your spouse's name so that it is easy to determine which returns are subject to the attribution rules and which are not.

Here's an example. Let's say Melanie is taxed at a high tax rate, while her husband Raymond is taxed at a lower rate. Melanie lends $20,000 to Raymond to be invested in his name and no interest is charged on this loan. Assuming the investment made by Raymond returns $2,000 of income this year, this income is subject to the attribution rules and must be taxed in Melanie's hands. However, Raymond can then deposit the $2,000 of income in a separate investment account and any returns in this separate account will be taxed in Raymond's hands exclusively. Income splitting on this second-generation income has been achieved!

3. Swap assets with a family member

We've already mentioned that you can't split income by giving assets to your spouse. And giving assets to a minor child may still result in attribution on all income but capital gains. So why not swap assets instead? You could "sell" these assets (or cash) to your family member in exchange for assets of equal value. The objective here is to put income-producing assets into the hands of the lower-income family member. In this case there will be a fair market value transfer of assets, so the attribution rules can be avoided. In order to maximize the income splitting benefits, the lower-income family member should give you, the higher-income earner, assets that do not produce income of any kind. Examples of assets that can be used in this swap are jewelry, artwork, a rare coin, or even your spouse's share of the family home – provided your spouse actually contributed to its purchase. Keep in mind that a swap is considered to be a sale at fair market value, so there could be tax to pay if the swapped asset has appreciated in value. Where assets are swapped or sold it is important to obtain professional tax advice and properly

document the sale. This is particularly true when the family home is involved since independent legal advice will be required by each spouse.

One final point: If you're going to swap assets with your spouse, each of you will have to make a special election with your tax returns in order for the transaction to take place at fair market value. If this election is not made, you will be deemed to have transferred the assets to each other at the assets' adjusted cost base. This will not allow you to split income. Visit a tax professional or have your financial advisor call AIC's Tax and Estate Planning Group for more information.

4. Have the higher-income spouse pay household expenses

In order to achieve income splitting, you should try to have the lower-income spouse save as much of his or her income as possible to use for investment purposes. However, in many families, both spouses end up contributing part (or all!) of their income to pay for household expenses. An easy way to achieve income splitting is to have the higher-income spouse contribute as much as possible towards the non-deductible household expenses such as groceries, the mortgage, credit card bills and so on. This will free-up cash in the hands of the lower-income spouse to be used for investment purposes. Of course the higher-income spouse should always pay for any tax-deductible expenses, but by having this person pay all non-deductible expenses, including the lower-income spouse's tax bill, more investment assets can stay in the hands of the lower-income spouse and be taxed at this person's lower marginal tax rate.

5. Contribute to a spousal RRSP

Another easy way to split income is to have the higher-income spouse contribute to a spousal RRSP. With a spousal RRSP the higher-income spouse will get the tax deduction in the year the contribution was made (assuming this person has sufficient RRSP contribution room), while the lower-income spouse will be taxed on any withdrawals made during retirement at his or her lower tax rates. Before deciding whether or not to use the spousal RRSP, you should consider the tax rates each spouse will be subject to at the time the funds are expected to be withdrawn. The goal with a spousal RRSP is for each spouse to have an equal income in retirement. It will therefore be necessary to do an estimate of each spouse's income in retirement before this strategy is implemented. If your spouse is expecting a large pension, or even an inheritance that will generate a significant amount of investment income, you might be better off contributing to an RRSP for yourself instead.

A final point. Withdrawals from a spousal RRSP in the same calendar year (or in the two following calendar years) of contribution, will give rise to attribution to the contributing spouse.

6. Invest in a minor child's name

As we have already mentioned, capital gains are not included in the list of income that is caught under the attribution rules if earned in the hands of a minor. This means that it is possible to split income with a minor child by gifting assets to the child that will be used to purchase investments that will primarily earn capital gains. Equity mutual funds are a perfect choice as the focus of these funds is often capital appreciation. Any interest or dividends earned on assets transferred to a minor child will be attributed back to you – so avoid those types of income.

There are situations where you can freely invest in a minor child's name and not worry about the attribution rules at all. The attribution rules do not apply if the child earned the money that is invested in his or her name. So, if your child has a paper route, babysits, or earns other income and wishes to invest those funds, any type of investment return from this investment can be taxed in the hands of the child. Likewise, you don't have to worry about attribution if you invest any Child Tax Benefit payment you receive with respect to your child. It's a good idea to keep these assets in a separate account from any investments made with funds that came from you.

7. Split the tax bill on your CPP benefits

For those over age 60 and receiving benefits from the Canada Pension Plan (CPP), here is another potential income-splitting idea. If both you and your spouse or common-law partner are over age 60, you can have up to 50 per cent of your CPP payments reported in your spouse's (or partner's) hands. There is a formula that is used to calculate how much of your CPP you are able to split with the maximum allowed being 50 per cent. Assuming your spouse is taxed at a lower marginal tax rate than you are, you will save tax on an overall family basis, regardless of the percentage of the CPP benefits you are allowed to split.

Let's take Mark and Diane for example. They have been married since 1967. Diane has never worked outside the home and Mark currently receives $700 per month from the CPP. After the necessary application is filled out and approved by Social Development Canada, both Mark and Diane will begin to receive $350 a month. Since Diane has no other sources of income, this $350 per month will not attract any tax in her hands. On the other hand, since Mark has a 40 per cent marginal tax rate, he will pay tax of $1,680 annually on the $350 per month he receives. If Mark were to pay the tax on the full benefit of $700 monthly, his tax bill would be $3,360 annually on that CPP benefit. Mark and Diane are saving $1,680 per year in tax by using this strategy!

8. Consider an RESP for a child's education

Registered education savings plans (RESPs) are a great way to build an education fund for your child or grandchild while providing income-splitting benefits at the same time. Although contributions made to an RESP are not tax-deductible, returns inside the RESP do grow on a tax-deferred basis. It's only when funds are withdrawn from the RESP that the growth (but not the original contributions) becomes taxable. So long as the funds are withdrawn when the child is attending a post-secondary educational institution, the withdrawals will be taxed in that child's hands – not the family member who originally set up the RESP. As a student, the child will probably have minimal income and be eligible for the tuition and education tax credits, with the result that there will likely be little or no tax to pay on the withdrawals from the RESP. Finally, contributions to an RESP for an eligible child will attract free money – Canada Education Savings Grants (CESG) – from the government. The grants are worth 20 per cent (up to a maximum of $400 per child) of all contributions to an RESP for each child for each year.

The 2004 Federal Budget proposed that starting in 2005, the first $500 of RESP contributions for children in low- and middle-income families will attract an even higher CESG. For children from families earning less than $35,000 per year the first $500 of RESP contributions will attract a 40% CESG. If family income is between $35,000 and $70,000 a 30% CESG will be paid. All other contributions will continue to attract a 20% CESG, up to the $400 maximum.

A final point. The recent tax rule changes and CESG have made RESPs a very attractive planning tool for educational savings. However, the tax and CESG rules are complicated and proper advice should be obtained in order to receive the maximum advantages of both. See the AIC Tax Smart Bulletin *RESPS – Basic strategies* for further information.

9. Pay family members a salary

If you own a business, have you thought about hiring your family members to help out around the office? So long as the wages you pay them are reasonable for the work performed, your business will be entitled to a tax deduction for the amounts paid, while your family members will be taxed on the income. By deflecting more income from your tax return into the hands of your lower-income family members, you will manage to save tax on an overall family basis. Further, your family will now have their own independent source of funds to use for investment purposes, and the attribution rules cannot be applied to any investment returns on those funds.

Family members receiving salary or wages will also generate RRSP contribution room, which can be used by them to save for retirement.

10. Gift assets or money to an adult child

Although the attribution rules can be far-reaching, one strategy not touched by these rules is a gift of assets or money to an adult child for investment purposes. This works especially well if you have children going to college or university who have little or no other sources of income. You can give assets or money to these children over the age of 18, and if they invest that money there will be no worry that the attribution rules will apply. Remember, if you decide to gift assets to your children, this gift is considered a disposition at fair market value for tax purposes. So, if those assets have appreciated in value, a capital gain may be triggered at the time of the transfer. If possible, it's always best to give cash or other non-appreciating assets to your family members to avoid unwanted tax.

Canadian provinces and territories impose their own tax rates in addition to the federal tax rates. Therefore, depending on where an investor lives, that individual's tax rate may differ from any examples shown. The content of this bulletin is for informational purposes only and in no way should be construed as tax advice. Please consult a professional tax advisor for tax advice related to your specific situation.

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