TD Wealth

Family Income Splitting Basics

Income splitting is a tax planning technique which results in income being transferred from a high income earner to a family member in a lower tax bracket, thereby decreasing the overall tax burden to the family. Although income splitting with family members is an acceptable tax planning method, the attribution rules contained in the Income Tax Act restrict the ability to split income.

These rules were designed to prevent taxpayers from transferring assets between family members in an attempt to reduce taxes. Under the income attribution rules, income earned on capital that has been transferred (as a gift/loaned) will be attributed back to and taxed in the hands of the transferor.

The table below provides an overview of whether attribution applies when investment income is earned with respect to transfers of gifts and loans to Partners and children:

	Income earned on Gift/Loan For example:		
	Fixed income investment	**Income from publicly traded shares**	
Person/Strategy	**Interest**	**Dividends**	**Capital Gains**
Minor Child under 18			
Gift	Attribution	Attribution	No
No Interest Loan or Below prescribed rate loan	Attribution	Attribution	No
At or Above Prescribed Rate Loan (see #2 below)	No	No	No
Income on Income (see #5 below)	No	No	No
Adult Child 18 and over			
Gift	No	No	No
No Interest Loan or Below prescribed rate loan	No	No	No
At or Above Prescribed Rate Loan (see #2 below)	No	No	No
Income on Income (see #5 below)	No	No	No
Partner			
Gift	Attribution	Attribution	Attribution
No Interest Loan or Below prescribed rate loan	Attribution	Attribution	Attribution
At or Above Prescribed Rate Loan (see #2 below)	No	No	No
Income on Income (see #5 below)	No	No	No

Note: The chart above assumes that earned income is from a non-related business.

The following discusses general income splitting rules and opportunities and does not take into consideration the newly expanded tax on split income (TOSI) rules that were enacted in 2018 and effective for tax years after 2017. While beyond the scope of this article, TOSI can impact taxpayers that receive directly or indirectly dividends, interest, and certain types of capital gains from a related business, partnership or trust. If caught under these new rules, the amounts will be deemed to be split income and will be taxed in the hands of the individual at top marginal tax rates.

Income Splitting Opportunities

1. Contributions to a spousal RRSP

Contributing to a spousal RRSP offers future tax benefits because it provides an opportunity for Partners to equalize income during retirement. Spousal contributions can be made by the higher earning Partner to a plan where withdrawals will be taxed in the hands of the lower-income Partner. Contributions need to remain in the spousal plan for at least three years otherwise attribution rules will apply and the amount withdrawn will be attributed back to the contributing Partner. However, RRIF (Registered Retirement Income Fund) withdrawals are not subject to the attribution rules in the year of contribution or the two previous years as long as only the minimum amount is withdrawn. Please note that the minimum RRIF withdrawal in the year of conversion is zero, and no benefit will be derived from spousal RRSPs if at retirement both parties are in the top tax bracket.

2. Prescribed rate loan

Under this strategy, the higher earning Partner loans money to the lower-income Partner at Canada Revenue Agency's (CRA) prescribed interest rate at the time the loan is made. As long as a formal loan agreement is executed, and interest payments are paid within the required timeline, attribution will not apply. All income and capital gains earned from this loaned money will be taxed in the hands of the lower-income Partner. The lower-income Partner will deduct the interest paid while the higher income Partner will report interest income on the loan; however, this should be offset by the greater return generated on the money in the hands of the lower income Partner.

If the deadline for the interest payment is missed, all of that year's income and all future years' income will be attributed back to the lending individual. For more details on prescribed rate loans, please refer to our article - *Prescribed Rate Loan*.

Note that attribution does not apply to business income; therefore loans to a Partner which are used to finance a business will not be attributed back to the Partner that provided the loan. Also note that for tax purposes, the interest paid on the loan may be considered tax deductible.

3. Transfers for fair market value

Attribution rules do not apply when property is transferred in exchange for consideration equal to the property's fair market value. Consideration may include debt, but interest must be charged at least at the CRA's prescribed interest rate as discussed above. This strategy may be beneficial when the property transferred is expected to generate high capital gains upon the eventual disposition, as it will be taxed in the hands of the lower tax bracket individual.

4. Higher income Partner pays for family expenses

This strategy requires the higher earning Partner to pay all general living expenses (e.g. groceries, mortgage payments / rent, interest on investment loans, income tax liabilities) such that, the lower-income Partner can maintain a larger investment base from which to earn future income.

5. Income on income

Although income is attributed back to the person who initially transfers or lends funds, income earned on the re-invested income is not attributed back to the transferor; rather it is taxed in the hands of the recipient, who is in a lower tax bracket. Consider maintaining two separate bank accounts so that the income attributed back to the transferor and the non-attributed income are accounted for separately.

Example:

Lee gives $10,000 to his partner, who in turn earns $1,000 in interest in the first year. In the first year, the $1,000 in interest income is attributed back to Lee. In the second year, the Partner invests the $1,000, which in turn generates a further $100 in interest. This secondary interest of $100 is not attributed back to Lee, and will be taxed in the Partner's hands. See the table below for an illustration. Note that a second account would be opened in order to separate the attributed and non-attributed income.

	Bank Account #1		Bank Account #2	
(End of year)	Balance	Income Attributed to Lee	Balance	Income taxed in hands of Partner
Year 1	$10,000	$1,000		
Year 2	$10,000	$1,000	$1,000	$100
Year 3	$10,000	$1,000	$2,100	$210

6. Transfer capital property to minor children

Because attribution rules do not apply to capital gains with respect to minor children, you can transfer assets to them which you expect to grow in value. Although dividend income will be attributed back to you, any capital gain resulting from the sale of those assets will not be attributed back.

Parents often set up in-trust accounts with their minor children as beneficiaries. These accounts are designed to principally provide capital gains (e.g. by investing in equity mutual funds) so that the eventual capital gains taxes upon sale will be paid by the children. If you are a parent contemplating the use of this strategy, ensure that the in-trust account is properly set up otherwise you may contravene Section 75(2) of the Income Tax Act. This rule provides that, if the terms of the trust stipulate that the trust property may only be disposed of with the consent of, or in accordance with, the direction of the settlor, capital gains as well as income may be attributed back to the parent (i.e. the settlor). CRA has generally interpreted this to include the situation where the settlor is also the sole trustee of an in-trust account.

Here are a few general anti-avoidance rules which further limit income-splitting opportunities:

Rule	Example
If a Partner or minor child receives a loan based only on a guarantee of the other Partner, this loan will be treated as if that Partner had loaned the funds directly, and attribution will therefore apply.	Bobby receives a loan at the bank based solely on the fact that her Partner Jesse has fully guaranteed the loan. In this case it will be deemed as though Jesse has directly loaned the funds to Bobby, and attribution will apply.
If an individual transfers property or loans money to a third party, who in turn transfers or loans that property to the Partner or minor child of the original transferor, the amount will be treated as if the Partner had loaned or transferred the funds directly, and attribution will therefore apply.	Blair Smith loans money to Leslie Jones, who in turn loans that money to Blair's Partner Pat. In this case it will be deemed as though Blair Smith has directly loaned the funds to Pat Smith, and attribution will apply.

If a person indirectly transfers property to a trust for the benefit of the Partner or minor child, it will be treated as if that transfer was made directly, and attribution will therefore apply.	Mr. Smith transfers money to a trust specifically for the benefit of his minor child. In this case it will be deemed as though Mr. Smith has directly loaned the funds to his child, and attribution will apply.

Consider:

Due to the complex nature of the attribution rules briefly discussed in this article, consider speaking to your TD advisor and tax specialist prior to implementing any of these tax-planning strategies.

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