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Income Splitting Strategies

Canada has a progressive tax system that requires the reporting of worldwide income on an individual basis. As a taxpayer earns more money, they graduate into higher income brackets, each subject to increasing tax rates.

For the 2020 taxation year, every individual has a federal Basic Personal Amount that effectively results in the first $13,229 of ordinary income earned not being subject to federal income tax[1]. An individual enters the highest federal tax bracket of 33% once their net income exceeds $214,368. While provincial/territorial tax brackets and rates vary, the general result is that an individual in the highest federal tax bracket would be subject to a marginal tax rate in excess of 50%.

As a result, there is a long-standing tradition of taxpayers attempting to split income with family members. This concept involves an individual who earns substantial income, and is therefore subject to personal tax at the highest marginal tax rate, attempting to shift income into the hands of a family member(s) who is subject to tax at a lower marginal rate.

The Canadian Income Tax Act ("the Act") provides limited opportunities for an individual to split income or share tax credits with family members. The legislation includes comprehensive, and sometimes punitive, attribution rules, tax on split income rules and other provisions (such as requiring that the payment of salaries to family members be reasonable for the services provided) in attempts to curb income splitting.

[1] Legislative proposals have introduced an Enhanced Basic Personal Amount for 2020 and future tax years. The Enhanced Basic Personal Amount for 2020 is $13,229, and it is reduced once income exceeds the top of the fourth tax bracket ($150,473). As a result, high-income earners who have had their enhanced amount eliminated will have a Basic Personal Amount of $12,298 for the 2020 taxation year. The Enhanced Basic Personal Amount will gradually increase to $15,000 as of the 2023 taxation year and both the Basic Personal Amount and the Enhanced Basic Personal Amount will be indexed to inflation annually.

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ATTRIBUTION RULES

In general, the attribution rules apply in situations where a taxpayer transfers or loans funds to a family member and that family member uses the funds to acquire income-producing investments. In cases involving a minor, interest and dividend income are subject to the attribution rules and will be included in the taxpayer's income. Capital gains and losses earned by a minor are not subject to the attribution rules. For loans and transfers to a spouse, all investment income will be attributed back to the taxpayer. However, in all cases there is no attribution on secondary income (i.e., income earned on investment income).

An exception to the attribution rules applies in situations where fair market value consideration is provided as part of the transaction. This means that income splitting will not work in situations where funds are gifted to a family member. However, income splitting strategies are effective when a loan is made for the benefit of a family member and bears an interest rate at least equal to the prescribed rate and the interest is paid no later than 30 days after the end of the year.

The prescribed rate is established by the Canada Revenue Agency ("CRA") quarterly and represents an average of the rates for 3-month Treasury Bills for the first month of the preceding quarter.

INCOME SPLITTING OPPORTUNITY

The CRA has announced that the prescribed interest rate will be 1% for the third quarter of 2020, beginning July 1.

If an individual is in the top tax bracket and has non-registered assets (e.g., cash and investments) in their name, the investment income generated from the portfolio is subject to tax at the highest marginal tax rate. The following table illustrates the overall tax result assuming the highest marginal tax rate is 50%:

PERSONAL NON-REGISTERED INVESTMENT ACCOUNT

Non-registered investment assets	$1,000,000
Rate of return (assuming interest and 50% taxable portion of capital gains)	6%
Taxable income	$60,000
Tax payable on income	$30,000

If the high-income individual is using their after-tax investment income to help fund expenses for various family members, for instance tuition fees or household items, a significant portion of the investment income is consumed by taxes, as noted in the above example.

In order to improve the tax efficiency of the situation while providing the family members with the financial resources they require, the high-income family member may gain access to the lower marginal tax rates of their family members by using a Family Income Splitting Trust or a Spousal Loan strategy.

FAMILY INCOME SPLITTING TRUST STRATEGY

This strategy involves the high-income individual's qualified legal advisor establishing a Family Income Splitting Trust. Generally, the high-income individual would be a trustee of the Family Income Splitting Trust and the low-income family members would be the discretionary beneficiaries.

The high-income individual would make a loan to the Family Income Splitting Trust using funds from their existing non-registered investment assets. If any existing investments are sold, or transferred in-kind to the Family Income Splitting Trust, to fund the loan, this could result in a tax liability in respect of any net capital gains realized[2].

The loan document would bear interest at the prescribed rate, payable within 30-days of the end of the calendar year. The prescribed rate that is in effect the date the loan is made will continue to apply for the duration of the loan. If the prescribed rate increases in future quarters, the interest rate on the existing loan does not change; however, any additional amounts loaned to the Family Income Splitting Trust would have to be made at the prescribed rate prevailing at the date the additional loan was made. Failure to pay the interest by January 30 of the following calendar year will result in adverse tax consequences.

The funds loaned to the Family Income Splitting Trust would be used to acquire income-producing assets, such as an investment portfolio. The Family Income Splitting Trust will use a portion of the annual income earned from the investments to pay the interest on the loan. The high income family member will be subject to personal tax annually at their marginal rate on the interest income received.

The net income remaining in the Family Income Splitting Trust could be allocated to the low-income family member beneficiaries and taxed at their marginal tax rates. Since the Family Income Splitting Trust is discretionary, the trustee(s) have the ability annually to allocate the net income to whichever beneficiaries they choose and in whatever proportion they decide. Distributions to low-income family member beneficiaries may result in nominal or no taxes owing on the Family Income Splitting Trust's net income. Any net income not distributed for tax purposes by the Family Income Splitting Trust would be taxable in the trust at the highest marginal tax rate.

The following table illustrates the tax results associated with the Family Income Splitting Trust on an annual basis, assuming the highest marginal tax rate is 50% and that there are four beneficiaries of the Family Income Splitting Trust, each of whom have no other sources of income:

[2] Refer to our article "Capital Loss Planning" to understand the superficial loss rules that could apply to any capital losses that are realized as part of this planning.

	Personal Non-Registered Investment Account	Family Income Splitting Trust Account
Assets in the account		$1,000,000
Loan outstanding	$1,000,000	
Rate of return (assuming interest and 50% taxable portion of capital gains)	1%	6%
Investment Income		$60,000
Loan Interest	$10,000	($10,000)
Taxable income	$10,000	$50,000
Tax on income	$5,000	$0

Compared to the original situation, the Family Income Splitting Trust has reduced the family's overall tax burden on an annual basis by $25,000 based on these assumed facts. As a result, the family has additional financial resources available to fund their expenses.

The tax savings for a particular family will vary depending on their circumstances. Based on the highest marginal tax rates in effect for the 2020 calendar year, an individual who has no other taxable income may receive approximately $52,000 of eligible dividends (i.e., dividends from publicly traded Canadian companies), $13,000 of interest income or $26,000 of capital gains as distributions from a Family Income Splitting Trust without triggering a personal tax liability.

When the Family Income Splitting Trust allocates income to a beneficiary in the year for tax purposes, the amount must be paid (i.e., cash deposited into an account in the sole name of the beneficiary) or made payable to the beneficiary via a demand note. In lieu of providing the beneficiary with cash, the Family Income Splitting Trust could pay for expenses of the beneficiary directly. The demand note can be drawn down in future years by having the Family Income Splitting Trust pay for expenses of the debt holder (e.g., to pay university tuition or make a down payment on a house).

If income from the Family Income Splitting Trust is used to pay for a beneficiary's expenses, the expenses must unequivocally benefit the beneficiary. Payments benefiting someone else or used for ordinary household expenses will result in adverse tax consequences.

An official list of expenditures that qualify as directly benefiting a beneficiary does not exist; however, according to the CRA, qualifying expenditures can include amounts paid for the support, maintenance, care, education, enjoyment and advancement of the beneficiary. If the Family Income Splitting Trust pays for expenses of the beneficiary, proper documentation and support (e.g., receipts) for the expenses must be retained by the trustee(s).

SPOUSAL LOAN STRATEGY

In situations where there is a low-income spouse and the high-income spouse's after-tax investment income is being used to help fund the family's expenses, a spousal loan may be an appropriate income splitting solution.

The high-income spouse loans funds, or transfers assets in-kind, to a low-income spouse. The loan will bear interest at the CRA's prescribed rate, payable within 30-days of the end of the calendar year. Consideration must be given to which assets are used to fund the loan, as there could be tax implications to the high-income spouse.

The low-income spouse will use the funds to invest in income-producing assets in a non-registered account in the low-income spouse's name only.

A portion of the annual income earned from the low-income spouse's investments may be used to pay the interest on the spousal loan. The high-income spouse will be subject to personal tax annually at their marginal rate on the interest income received.

The investment income, net of the spousal loan interest, earned by the low-income spouse will be subject to tax in their hands at their marginal tax rate. The after-tax investment income would remain in the low-income spouse's account for use at their discretion.

EXISTING PRESCRIBED RATE LOANS

If you currently have an income splitting loan strategy in place and you would like to take advantage of a lower prescribed rate, the CRA has taken the position that you cannot simply change the interest rate on the loan document. In order for the attribution rules not to apply, the existing loan must be repaid, which may result in the realization of taxable capital gains and transaction costs. However, once the existing loan has been repaid, a new loan can be made at the current prescribed rate.

U.S. PERSONS

In general, income splitting transactions and strategies are complicated in situations where there are U.S. persons involved. Further, these strategies can result in unintended tax consequences from a U.S. tax perspective. U.S. persons should seek the advice of qualified cross-border tax and legal professionals before undertaking any such planning to ensure the potential additional tax and compliance costs still provide an economic benefit based on the particular facts of their situation.

SUMMARY

While the options to income split with family members are limited, opportunities exist for high-income individuals to use their family members' lower marginal tax rates in certain situations. Shifting personal non-registered investment assets using the CRA's prescribed interest rate can reduce a family's overall tax burden and enhance its financial resources.

Since the strategies described above involve the use of loans, rather than gifts, the high income individual should keep in mind that they are not giving away their capital. Rather, they are using the return on their capital in excess of the prescribed rate to fund their family's expenses and, in the process, utilizing the lower income family members' tax rates.

With the prescribed rate going down to 1% on July 1, the timing is optimal for families to start thinking about taking advantage of these opportunities.

This article contains strategies and solutions that are based on our understanding of the tax legislation as of the date of publication. The information presented is not intended to provide legal, tax, or insurance advice. You should obtain professional advice from a qualified tax, legal and/or insurance advisor before acting on any information contained in this article to ensure that your particular facts and circumstances have been properly considered.