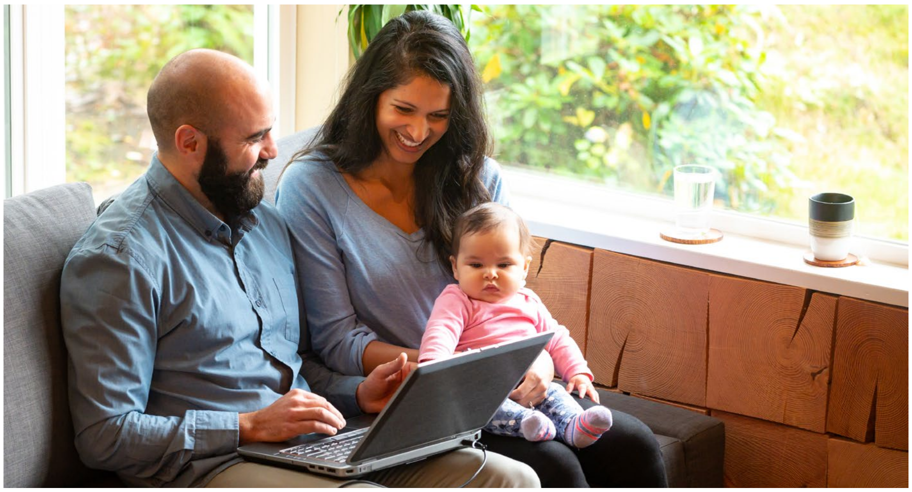
CASE IN POINT

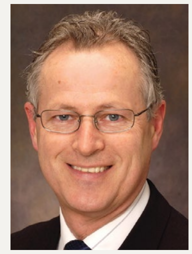
Sales Tax Estate Planning Underwriting & Product Newsletter

Splitting non-registered investment income with a spouse



Canada's income tax system for individuals is generally a graduated or progressive income tax system. The more you earn, the higher the tax rate that will be applied to income. Financial and tax advisors may recommend income splitting strategies to minimize taxes for couples where one person makes a lot more money than the other. Some business owners were sprinkling income amongst family members who may or may not have been actively involved in the business. Rules were passed in 2018 that limit or block the ability of individuals who own private corporations to minimize overall income taxes in a family by applying a tax on split income (TOSI). The objective is to eliminate the tax benefits of income splitting where the relative has not made a reasonable contribution to the family business for the income received. There are also attribution rules that apply the income earned by spouses and children on monies given to them by a spouse or parent respectively back to the person who gave them the money. Does that mean income splitting isn't possible anymore?

Vivek is a successful business owner with a sizeable investment portfolio he owns personally. His high earnings from his work and investments put him into the top marginal tax rate. His wife, Ishani has been a homemaker, raising the couple's three children while also taking care of Vivek's mother. How can Vivek rearrange his affairs to reduce the tax he is paying on his investment portfolio and avoid having the income attributed back to him? Can he split income with his spouse and not get penalized by the tax department?



Peter A. Wouters,
Director, Tax Retirement & Estate Planning Services

Peter works with independent advisors and other professionals raising awareness on issues and concerns faced by affluent individuals, professionals and business owners. He supports efforts in researching and developing optimal solutions for clients aimed at improving their financial well-being and supporting their personal wishes and lifestyles. He has provided 1000s of workshops, seminars and technical support throughout the country on tax, retirement income and estate planning issues, concepts and strategies to both advisors and consumers. As an accredited Registered Financial Gerontologist, a good deal of his time is spent on building awareness and educating people of all professions who work with or specialize in the needs, expectations and issues of elders. Comprehensive lifestyle planning is an important element of these processes.

The Sales, Tax, Estate Planning, Underwriting & Product (STEPUP) team provides internal and broker support, including seminars, education, advanced concept illustrations & Client case technical consultations.

Empire Life

Splitting non-registered investment income with a spouse

Vivek can lend, not give, money to his wife Ishani for investment purposes. He could do the same for his children or for a trust set up for his minor aged children. Take great care when setting up a trust to implement this strategy. In this scenario, Ishani invests the money she receives. Interest must be charged on the loan at the prescribed interest rate in effect at the time Vivek lends her the money. The prescribed rate is an interest rate set by the Canada Revenue Agency each quarter that approximates short-term Treasury bill rates. The current rate is 4%, effective Apr. 1 2023. That rate will remain in effect for the duration of the loan, which may be many years so long as Ishani pays Vivek the prescribed interest rate. It doesn't matter whether the prescribed rate goes up in the future. Ishani may be able to deduct the annual interest on the borrowed funds as an expense against her earned income from the investment.

Ishani, the recipient of the loan, must pay the interest at least annually, and by January 30 of the year following the year in which the interest accrued and for each succeeding year that the loan is outstanding. It's best if all of this is covered in a formal document. If Ishani pays the interest on time each year, then none of the income that Ishani earns on the invested money will be attributed back to Vivek. That includes, interest, dividends and capital gains. Vivek must declare the 4% interest payment he receives as income on his tax return for the calendar year he receives the interest. If the interest is not paid on time, the earnings on the loan will be subject to the attribution rules until it is repaid in full, specifically, the earnings on the original amount Vivek lent Ishani. Reinvested earnings are taxed to Ishani.

The repayment rules are very strict. If a payment is made even one day late for any year, the loan will lose its exemption from the attribution rules for that year and all subsequent years. The income splitting and tax reduction strategy will no longer be effective. Vivek will be right back where he started from.

Properly implemented and followed. this income tax planning strategy can result in reduced total income taxes for Vivek and Ishani as a family unit. It is particularly appealing in the current environment where the prescribed interest rate is low and a stock market rebound is anticipated.

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