FINANCIAL POST

Here are your income splitting options now that the private corporation avenue is dead

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With top marginal tax rates for high-income earners over 50 per cent in more than half the provinces in 2018, there are still a bunch of perfectly legal income-splitting strategies you may want to consider for this tax year.*Brent Lewin/Bloomberg*

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On Mon. Jan. 1, the ability of small business owners to sprinkle income among family members was greatly curtailed. Draft legislation introduced last month proposes to extend the current "kiddie tax" anti-**income sprinkling rules to a**

spouse or partner as well as to adult children who are not “actively engaged on a regular, continuous and substantial basis in the activities of the business.”

While there are some limited exceptions to the new rule (e.g. a spouse of a business owner over age 65 or related adults of non-professional corporations who meet certain share-ownership criteria), for the most part, income splitting via a private corporation is dead.

That being said, with top marginal tax rates for high-income earners over 50 per cent in more than half the provinces in 2018, there are still a bunch of perfectly legal income-splitting strategies you may want to consider for this tax year.

But before we launch into what you can still do in 2018 to split income, here’s a quick refresher on income splitting.

What is income splitting?

Income splitting can be defined as the transferring of income from a high-income family member to a lower-income family member to reduce the overall tax burden of the family. Since our tax system has graduated tax brackets, by having the income taxed in the lower-income earner’s hands, the overall tax bill of the family can be reduced. Of course the Income Tax Act has a series of longstanding anti-avoidance rules, known as the attribution rules, that generally prevent us from income splitting by attributing the income back to the splitter. But, there are a few notable exceptions.

Pension income splitting

Seniors can still split eligible pension income with a spouse or partner. Any pension income that qualifies for the federal pension income credit also qualifies to be split. Specifically, this would include annuity-type payments from an employer-sponsored registered pension plan, regardless of age, and also includes Registered Retirement Income Fund (RRIF) or Life Income Fund withdrawals, but only upon reaching age 65.

Another opportunity for income splitting in retirement is to contribute to a spousal RRSP. This is particularly beneficial if you think that, upon retirement, you will have a higher income or have accumulated more retirement assets than your spouse. By contributing to a spousal RRSP, you can accomplish post-retirement income splitting, since withdrawn funds are taxed in one spouse's (the annuitant's) hands instead of the other's (the contributor's). If one spouse is in a lower tax bracket than the other in the year of withdrawal, there may be an absolute and permanent tax savings.

Note that with a spousal RRSP, you can effectively have all of your RRSP/RRIF withdrawals taxed in your spouse's or partner's name, whereas with pension-income splitting, you are limited to 50 per cent of RRIF withdrawals.

Spousal income splitting

If your spouse or partner is in a lower tax bracket than you, consider a prescribed rate loan strategy whereby the funds are loaned to your spouse or partner to invest. Provided you charge at least one per cent on the loan (the current prescribed CRA interest rate until at least March 31, 2018), you can income split any excess returns.

The advantage of setting up this loan when the prescribed rate is one per cent is that the Income Tax Act only requires you to use the prescribed rate at the time the loan was granted. In other words, if you make a demand loan to your spouse today, you can use the one per cent rate for the duration of the loan, which could be many years or decades. The only caveat is that the interest on the loan must be paid by Jan. 30 annually, otherwise the strategy falls apart for 2018 and all future tax years.

Here's how the income splitting strategy works, using an example of Rob, who is in the top tax bracket, and his partner, Katy, who is in the lowest bracket. Let's say Rob loans Katy $300,000 at the current prescribed rate of one per cent secured by a promissory note. Katy invests the money in a portfolio of Canadian dividend-paying stocks with a current yield of four per cent. Each year, she takes $3,000 of the $12,000 in dividends she receives to pay the one per cent interest on the loan to Rob.

The net tax savings to the couple would be having the dividends taxed in Katy's hands at the lowest rate instead of in Rob's hands at the highest rate. This benefit would be offset slightly by having the $3,000 of interest on the promissory note taxable to Rob, but the interest paid would be tax deductible to Katy, since the interest cost was incurred for the purpose of earning income.

Income splitting with kids

When it comes to income splitting with minor kids, capital gains earned on money gifted to those under age 18 are not attributed back but the prescribed rate loan strategy discussed above can be used, with some modification, to income split interest or dividend income with your kids.

The modification generally advised is to use a family trust to avoid making a loan directly to your minor children. With this strategy, you establish a discretionary family trust, naming your minor kids as beneficiaries of the trust. A loan is then made to the family trust at the one per cent prescribed rate and the trust invests the funds. Any income the trust earns above the one per cent prescribed rate that it pays on the loan can be distributed to your minor kids, or, more commonly, used by the family trust to pay the kids' expenses, which can include private school, extracurricular activities, summer camp and clothing, among other things.

In most cases, minor children will have little or no other income and thus pay no tax on the trust income distributed to them.

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