

Spouse and family income splitting



Navigating income attribution rules, including prescribed rate loans

Income splitting has been around for as long as the tax system itself. It's a shift of income recognition from a high-rate taxpayer to someone at a lower tax rate. Most often it will involve a spouse/common-law partner (CLP), and can also work with children though less often when they are of minor age.

Importantly, income splitting is not illegal. It is however constrained by tax rules that scrutinize gifts and preferential loans between closely connected people. That being so, it's sensible to review and understand the rules that could undo a planned action, prior to launching into the effort.

The motivation for income splitting

The premise of a progressive tax system is that those more financially capable are asked to bear a larger share of tax. For income tax, a higher rate of tax is imposed on income above each bracket threshold.

Presently there are five federal tax brackets, with rates progressing from 15% up to 33%. Each province has a similar structure, though the rates and number of brackets vary. When combined with federal rates, the top individual marginal tax rate is near or above 50%. Comparatively, the lowest combined rates are roughly in the 20-25% range, and may be close to zero once personal tax credits are applied.

Successful income splitting could cut a portion of a given family's tax bill in half or better.

Attribution with a spouse/common-law partner

Attribution rules include both general and specific Income Tax Act provisions designed to plug holes where tax may leak. The base rule between an individual and a spouse/CLP is that any income, loss, capital gain or capital loss on loaned or transferred property will be attributed back to the transferor.

The rules don't affect or change the legality of the transfer, including the legal right to the associated income or gain. Instead, they simply cause the transferor to pay the tax at his/her marginal tax rate.

The rules apply to direct transfers, as well as to indirect transfers and more complex scenarios, including:

- Transfer to a trust or corporation in which the recipient has a beneficial interest
- Loans without interest, or at interest below the prescribed rate (discussed further below)
- Loans through an intermediary to mask underlying routing of funds back to the recipient
- Third party loans advanced to the recipient, contingent on the guarantee of the high bracket person
- Re-advancing loans paying off an original loan from the same person to whom attribution applied
- Non-monetary loans, such as a loan of real estate or personal property
- Claiming an advantageous split of commingled funds, without any record of respective contributions
- Pre-relationship transfer or loan, with attribution beginning once a spouse/CLP relationship begins
- Substituted property acquired with proceeds of sale of original property that was subject to attribution

Attribution with a related minor child

Where a transfer or loan is made to a related minor child, attribution applies on income up to the year the child reaches age 18. Notably, there is no attribution of capital gains or capital losses, whether realized before or after the child reaches age 18, presenting a significant splitting opportunity. For these purposes, child includes a grandchild, sibling, niece or nephew of the individual or of a spouse/CLP.

Strategies that can avoid the attribution rules

The attribution rules can be circumvented with informed planning. The strategies described below refer to a spouse/CLP, but they apply with appropriate modification when attempting to split with a child.

Prescribed rate loan

While a transfer to a spouse/CLP by way of gift is a problem, a properly documented and serviced loan that complies with the prescribed interest rate rules will escape attribution. The investment income will be taxed to the lower income borrowing spouse, less a deduction for the interest paid. On the other side, the lending spouse will have to include the interest in income.

While a formal written loan agreement is not mandatory, it's prudent to have one to buttress the bona fides of the arrangement, should it be questioned in future by tax authorities. Apart from that,

- Interest payments must actually be made from borrower to lender, paid during the calendar year or no later than 30 days after year-end (January 30th, not 'end of January').
- The lending spouse cannot be the source of the interest for the borrowing spouse, meaning it cannot be simply capitalized to the loan or be part of a revolving loan arrangement.
- The rate must be commercially reasonable, and be no less than the rate prescribed by tax regulations. That rate is set quarterly, calculated as the average yield of Government of Canada 3-month T-Bills auctioned in the first month of the preceding quarter, rounded up to the next whole percentage.
- The prescribed rate is **4% in the first quarter of 2025**.
- Failure to comply with these rules will cause the loan to be offside, with attribution applying thereafter.

As the interest is taxable to the lending spouse, this strategy is less appealing when the prescribed rate is high. But for an existing loan that is properly serviced within these rules, it may continue indefinitely at the posted rate from the quarter when the loan was established, even if the prescribed rate rises in future. And if the prescribed rate falls, the loan could be paid off, and a new loan established at the lower prescribed rate.

Fair market value exchange

If a low bracket spouse gives an asset of fair market value (FMV) in exchange, attribution will not apply. However, if the FMV falls short, full attribution still applies. In other words, there is no pro-rata treatment, so the transfer from the high bracket spouse should be no more than the available asset's FMV.

Examples may be an automobile, antiques or jewelry, as long as the ownership interest did not originate with the high bracket spouse, such as an earlier gift. An interest in a cottage or principal residence may also be possible, but those are more complicated due to land transfer tax (in some provinces), as well as tax on disposition and required tax elections to be made when filing tax returns for that year.

Income-on-income (also known as second/later generation income)

It is only the income on the original gift that is attributable. When that income is reinvested by the receiving spouse, the ongoing income-on-income is taxed to him/her. To prove this distinction if there is an audit (given that the onus is on the taxpayer), it may help to move income on the original investment into a separate account where it can be clearly tracked.

Business income

Generally, the attribution rules are intended to capture passive income from property. If the receiving spouse uses the transferred funds to operate a business and generate active income, then attribution will not apply.

For more information, please consult your advisor and tax professional.

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