

Income Splitting Between Spouses

The purpose behind income splitting is to shift income from an individual in a high tax bracket to an individual in a lower tax bracket. The result is tax dollars saved and therefore more family income and capital in the hands of the lower income individual. However, there are attribution rules contained in the Income Tax Act that are designed to prevent you from giving your spouse money to invest.

The attribution rules with respect to spouses stipulates that if property including cash, is transferred or loaned to your spouse directly or indirectly, that all income or loss from property, and any capital gain or loss on the disposition of the property will attribute back to the spouse.

Taking the above into consideration, are there any income splitting opportunities left? Luckily, the answer is YES!!

Two great yet seldom used income-splitting strategies between spouses are the use of a spousal loan and, the 'Income on Income' approach.

Spousal Loans

Because of our current low interest rate environment now is an especially good time to consider a spousal loan. From January 1, 2006 through March 31, 2006, Canada Customs and Revenue Agency's (CCRA) prescribed rate of interest for family loans is only 3%. Therefore, where assets are expected to produce a return that is well in excess of this rate, it makes sense to loan assets to your spouse and charge the 3% rate of interest to avoid the application of the attribution rules. The excess yield from the assets over the amount of interest charged will then effectively be transferred to the lower-income spouse without triggering the attribution rules.

How does this strategy work?

The higher income-earning spouse lends a sum of money to the lower-income spouse. Under a written loan agreement, the lower-income spouse agrees to pay interest at the prescribed rate of 3%. The lower-income spouse then invests the borrowed funds at a rate greater than 3% to make this strategy as tax effective as possible.

For example, Bob lends Sandra (the lower-income spouse) \$100,000 by way of a promissory note and charges her interest of 2%. Sandra then invests this money and earns a 5% rate of return. Sandra reports \$5,000 of investment income on her tax return ($\$100,000 * 5\%$ rate of return) and gets a tax deduction for the \$3,000 of interest she pays to Bob. ($\$100,000 * 3\%$ prescribed interest rate). Bob reports on his tax return \$3,000 of interest income. As a result of this \$100,000 loan, \$2,000 of annual income has been shifted from Bob to Sandra.

For this strategy to work Sandra must pay Bob the interest (this is tax deductible to Sandra as an interest expense) by the following January 30th of each year and Bob must report the interest received as income. This couple has effectively split income and therefore saved some tax.

One of the best advantages of this process is that you are locking in this low rate of 3% indefinitely even if the prescribed interest rate rises.



Income on Income

As mentioned above, the attribution rules tax income earned on money transferred to a spouse back to the transferring spouse. This income however, is then the capital of the spouse receiving it for reinvestment purposes. The income earned on this reinvested capital (income on income) is not attributed back but is instead taxed in the hands of the transferring spouse.

Keep in mind that the income on the original capital transferred will continue to be taxed each year in the hands of the transferring spouse. Over time this strategy is a very effective method of transferring capital from a spouse in a high tax bracket to a spouse in lower tax bracket. This type of arrangement requires that you maintain two accounts so that attributed and non-attributed income is easily separated.

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