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Perhaps the greatest change to tax planning in the past decade has been the government's approach to income splitting. In the past, CRA used the attribution rules to prevent income splitting. The Department of Finance has done an "about face" and rather than adopt the American approach of allowing couples to file joint tax returns; they introduced various tax amendments that encourage income splitting within the family unit. If it is appropriate in your circumstances, we strongly recommend that our readers consider implementing the prescribed rate income splitting strategy. This is a very effective income splitting tool, but it will become less appealing when interest rates start to rise. This will be reviewed in depth later in the article.

In this edition of the Canadian Tax Planners Newsletter, we shall provide a brief review of the attribution rules and the classic tax strategies to offset these rules. However, many of these strategies have become less important as a number of new income splitting strategies have been sanctioned by the government. We shall review various income splitting strategies that have been introduced in recent budgets. These include:

- prescribed rate strategy
- Tax Free Savings Accounts
- Registered Educational Savings Plans
- taxable dividends
- pension splitting strategies
- optional spousal claims

Income Splitting

Successful income splitting strategies allow a family to achieve three legitimate financial planning objectives:

- 1) reduce the family's total tax liability by shifting income to family members with lower tax rates;
- 2) restructure family income to utilize the various credits and deductions that are available; and
- 3) distribute assets prior to death as part of an estate planning strategy to minimize taxes and probate fees.

In certain circumstances individuals may have the hidden objective of transferring assets prior to declaring bankruptcy. These transactions may be set aside if the courts can prove that protecting assets from creditors was the motivation for the restructuring of family assets.

Attribution Rules

From CRA's perspective, income splitting unless specifically sanctioned by the Income Tax Act is viewed as an artificial reduction of family taxes. The attribution rules are designed to restrict an individual's ability to shift income to family members with lower marginal tax rates. They restrict transfers and loans to spouses and children under the age of eighteen. They state if an individual transfers or loans property, either directly or indirectly, by any means to a spouse or certain individuals under the age of 18, any income will be that of the person who made the transfer.

The attribution rules restrict transfers and loans made "either directly or indirectly" and "by any other means whatsoever." This would appear to be a comprehensive approach to restrict income splitting among family members. Despite these rules, there are still numerous opportunities to implement an effective income splitting strategy. Before examining these strategies, it is important to be aware of two anti-avoidance provisions in addition to the attribution rules that may apply to income splitting situations.

One anti-avoidance provision is applicable to interest free or low interest loans. It will apply to transactions when a loan is made to a non-arm's length person and the purpose of the loan is to reduce an income tax liability. The section would apply when a parent loans funds to a child over the age of seventeen and the purpose of the loan was to generate investment income in the hands of the child, rather than the parent. The standard defence, if CRA attacks the loan is to show that the primary objective was not to reduce taxes; rather it was to achieve a family objective such as funding an education or providing savings for the future purchase of a home. The attribution rules would not apply to this transaction as they only apply to loans to children under the age of eighteen.

Note – The remainder of this article is only available to subscribers of the Canadian Tax Planners Newsletter. If you elect to subscribe and wish to receive a copy of this newsletter, advise us accordingly and the complete article will be forwarded by return mail.

