The Institute™
for Advanced Financial Education

COMMENT

Edition 318 - Nov/Dec 2019

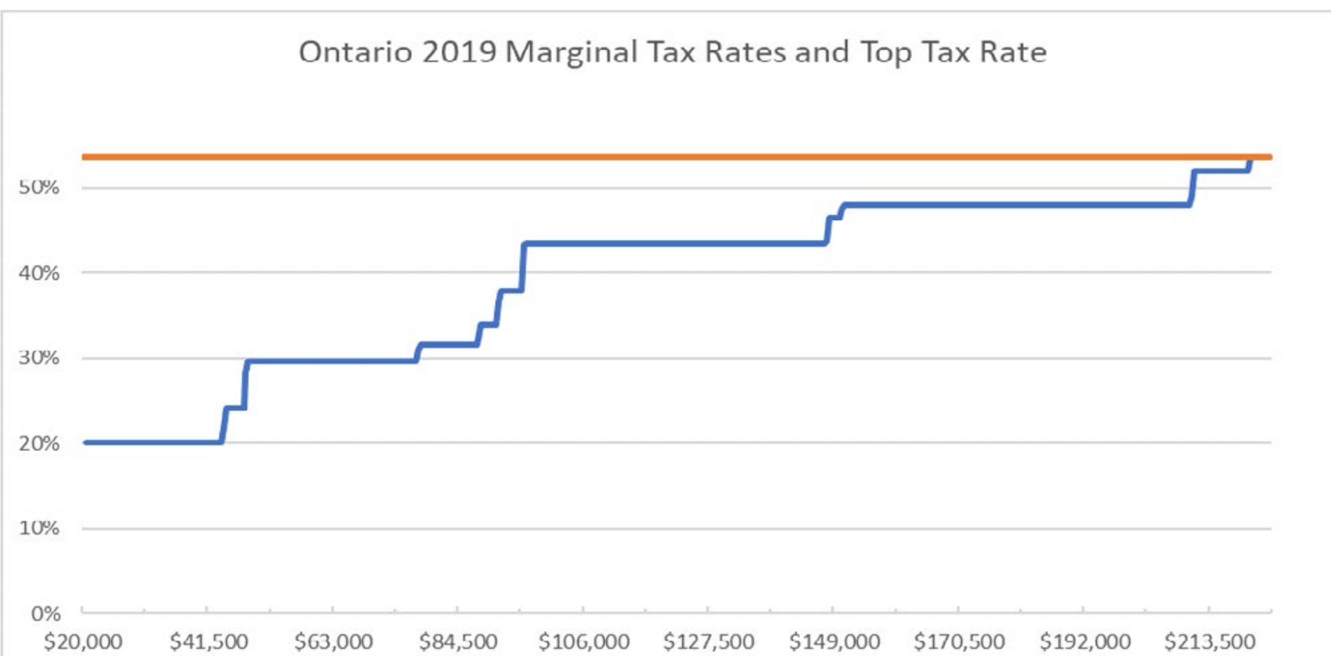
INCOME SPLITTING: *AN EFFECTIVE WAY TO INCREASE CASH FLOW*

The concept of income splitting involves shifting income from one family member, who is in a higher marginal tax bracket, to another family member, who is in a lower marginal tax bracket, with the primary objective of paying less income tax overall across the family unit. Paying less tax usually means there is more money remaining for consumption and savings.

Income splitting strategies can work when the individuals involved are in different marginal tax brackets and provided the transfer of income between the individuals is acceptable within the rules of the *Income Tax Act*. The concept of income splitting is considered one of the most effective ways to decrease taxes and maximize cash flow within a family unit.

The federal government has focused a great deal of attention on income splitting in recent years, from the perspective of what is permissible and what is no longer permissible.

The following chart provides a way to visualize how much tax could be saved through income splitting between a taxpayer in the top tax bracket and a taxpayer in a lower tax bracket. The orange line depicts the 2019 top marginal tax rate, federal and provincial rates combined, for a taxpayer living in Ontario. The jagged blue line represents the 2019 marginal tax brackets for all income ranges for a person also living in Ontario. The area between the orange and blue lines depicts the potential tax rate savings that could be achieved depending upon the marginal tax rates of the two taxpayers who are income splitting.



The jaggedness of the blue line arises because the federal and provincial governments each have their own unique set of tax brackets and Ontario has a two-tiered surtax system.

The following are common acceptable income splitting strategies.

- *Prescribed Rate Loan*
  The taxpayer in the higher marginal tax bracket lends capital to the taxpayer in the lower marginal bracket. The loan is documented and an interest rate equal to at least the government's prescribed rate in effect at the time the loan is established is charged by the lender and paid by the borrower within 30 days after the end of the calendar year. The lender must include the interest in his or her income, while the borrower may deduct the interest assuming income earning investments were purchased with the borrowed funds.
- *Pension Income Splitting*
  Up to 50 percent of eligible pension receipts can be notionally shifted from one spouse's income tax return to the other spouse's income tax return.
- *CPP/QPP Income Splitting*
  There are specific circumstances under which a couple is permitted to share a prescribed portion of their CPP/QPP income, although post-retirement benefits cannot be shared. The rules to share a pension depend on whether one spouse or both spouses contributed to CPP/QPP. The portion of each spouse's pension that can be shared is based on the number of months each spouse or common-law partner lived together during their joint contributory period.
- *Cash Damming*
  To the extent a couple is already accumulating savings in a non-registered portfolio, there could be a benefit to having the lower-income spouse use his or her income to purchase investments, while the income from the higher-income spouse is used to pay all of the household expenses.
- *Dividends from Family Business*
  Business owners may be able to pay dividends to family members; however, the new tax on split income rules could apply and create an additional tax burden rendering any income splitting opportunity ineffective. Traditional approaches can no longer be relied upon without professional guidance.
- *Spousal RRSP*
  A spousal RRSP permits a couple to derive immediate tax savings when a contribution is made. The contributing spouse uses his or her contribution room, but the benefit is derived by the couple because the RRSP belongs to the annuitant spouse, who is typically expected to have the lower income during retirement. This strategy provides an opportunity to balance income across the family unit when the funds are later drawn upon.

The value of income splitting is determined by analyzing the benefits and costs associated with the strategy. Before entering into an income splitting arrangement, the taxpayers involved should take the time to analyze the overall impact.

A shift of income to a lower-income spouse can reduce the overall tax burden of the higher-income spouse and increase the tax burden of the lower-income spouse. The amount of income involved and the taxpayers' positions within their marginal brackets can impact the overall outcome. There is a possibility of moving across more than one bracket, resulting in an additional advantage or additional cost; this can only be determined through a fact-specific analysis.

While some strategies are easy to implement and maintain, it can be wise to seek professional support in analyzing the costs and benefits. The professional's services can have a cost that should be considered. The following are examples of other costs associated with implementing more sophisticated strategies.

- Legal fees to draft a family trust deed and a promissory note to document a prescribed rate loan could be a consideration. A family trust may be necessary if the lower-income taxpayers are minors and cannot sign legal documents or manage an investment account. In addition, a family trust might be necessary to control the investment funds and restrict the access of spendthrift beneficiaries.
- Annual accounting fees in respect of the family trust and other reporting costs, such as the new trust disclosure rules that take effect starting in 2021.
- Legal fees to reorganize a corporation in order to introduce new shareholders may be necessary to enable a dividend paying strategy.

- Accounting and/or legal fees to respond to inquiries from the Canada Revenue Agency (CRA). Even though an income splitting strategy may be completely correct and legal, the taxpayer is required to answer queries and respond to challenges from the CRA. Often documents and other information may be required, and professional support can be helpful when dealing with complex issues.

The benefits of income splitting are often easily recognizable, but the costs and drawbacks may not be as obvious. A careful analysis in advance of undertaking any strategy will help to ensure the net impact is well understood.

THE WINDOW FOR TAX REASSESSMENTS

The Canadian tax system is based on self-assessment, where all taxpayers are obligated to report their income, claim deductions and tax credits and determine their income tax liability. The government, through the Canada Revenue Agency (CRA), reserves the right to reassess a taxpayer and adjust the income tax liability.

In general, the normal process of filing, assessing and reassessing could be described as follows:

1. A taxpayer completes and files his or her income tax return.
2. The CRA has the right to request additional information before assessing the taxpayer's return.
3. The CRA responds to the taxpayer's submission with a notice of assessment. The assessment may accept the tax return as filed or may recalculate the income tax liability. A notice of assessment includes important carry forward information and contribution room limits.
4. The taxpayer has 90 days, from the date of mailing of a notice of assessment, to submit a notice of objection, if he or she disputes the assessment.
5. The CRA has 3 years from the date of the notice of assessment to reassess the taxpayer's income tax liability. This is an important deadline because many taxpayers gain an element of relief in knowing that their tax filings have passed the date when the return is subject to the CRA's scrutiny.
6. With the shift to online filing, receipts for credits and deductions claimed are not typically provided to the CRA unless requested. It has become common for the CRA to randomly request copies of receipts and documents to support credits or deductions claimed after the notice of assessment has been issued. A taxpayer who cannot provide the documents requested, or in cases where the CRA does not accept the documents in support of the credit or deduction claimed, will receive a notice of reassessment.

The right of the CRA to reassess beyond the 3-year time limit was tested in a recent case before the Tax Court of Canada. The facts of the situation are as follows:

- In 2012, the taxpayer disposed of a piece of land that had been acquired in 1996 with the intention of developing a commercial building. The project did not move forward, and the property remained vacant until it was sold.
- The taxpayer declared a capital gain of $98,577, after taking into account the original purchase price plus the capitalization of expenses he had incurred in respect of the property during his ownership period.
- The CRA issued a reassessment in 2016 and a second reassessment in 2017. The CRA established the capital gain as $227,113 by denying the capitalization of a series of expenses claimed as development costs. The reassessment occurred beyond the normal 3-year period.
- In order to reassess beyond the normal reassessment period, the court had to determine if there was a misrepresentation of the facts attributable to neglect or carelessness, in accordance with the provisions of the *Income Tax Act.*
- The court determined the taxpayer was familiar with the rules for calculating the adjusted cost base (ACB) of the land in respect of expenses incurred for school and municipal taxes and interest on money borrowed to acquire the property. The taxpayer faced a similar situation for the taxation years 2001 to 2003 inclusive, when he disposed of another piece of vacant land.

- The fact that the taxpayer had been faced with a similar situation previously led the court to conclude that the taxpayer did not make an unintentional error but rather mispresented the facts. As such, the court affirmed the CRA was justified in assessing the taxpayer beyond the normal reassessment period.
- The court also ruled that the property was acquired and held on account of capital. This meant that certain expenses in respect of development were not deductible since they were not incurred to earn income and the same expenses could not be added to the ACB of the property because they were not incurred to improve the property.

USING A TAX-FREE SAVINGS ACCOUNT AS COLLATERAL

Tax-Free Savings Accounts (TFSA) have become integral to the financial plans of many Canadians. During the 10-years since inception, the TFSA has proven to be a multi-purpose vehicle helping Canadians meet their long-term savings goals.

When structuring a loan, a TFSA plan holder is permitted to use the interest in their TFSA to secure the loan. This is permissible when the terms of the loan are similar to that of an arm's length loan, and where none of the main purposes of the loan are to enable another person to benefit from the tax-exempt nature of the TFSA.

If a TFSA is used to secure a loan, the plan holder must be prepared for the consequences that arise if the lender claims on the security.

A recent query to the Canada Revenue Agency (CRA) addressed the issue of using a TFSA as security for a loan. The question posed to the CRA was "Would the lender's realization of their security be considered a distribution from the TFSA?"

The CRA's response is that the payment from the TFSA to the plan holder's creditor constitutes a distribution from the TFSA. As such, because the amount paid to the creditor is a distribution from the plan, the same amount is added back to the individual's TFSA contribution room the following year.

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Publication Agreement # 40069004