Income-splitting opportunities for your family

In Canada, you pay income tax at graduated marginal tax rates. The more money you make, the more income tax you pay on the next dollar. Income splitting shifts income from a higher-income earner to a lower-income family member. This allows you to take advantage of the lower tax rates for a lower-income-earning person. In some cases, you gift money to the lower-income earner. In others, it is a notional split on your tax return. However, the Income Tax Act (ITA) has attribution rules that prevent you from income splitting. For example, if you gift money to your spouse or common-law partner. In this case, the ITA attributes income and capital gains back to you for reporting purposes. If you gift money to your child under 18, the ITA attributes income back to you, but not capital gains. In both cases, you'll need to report the attributed amount on your tax return at your higher tax rate.

Luckily, the ITA contains exceptions to the attribution rules. For example, attribution doesn't apply to second generation income (income on income). Also, attribution doesn't generally apply to money you gift to your adult children. We also review below several strategies you can use to your advantage to grow your family wealth. Whether you're working, saving for a child's education, or retired, several strategies can make income splitting work for you. Reducing your family's tax burden puts more money in your pockets. It also enables you to reach your financial goals faster.

Spousal Registered Retirement Savings Plan (Spousal RRSPs)

Spousal RRSPs are a registered investment account owned by your spouse. However, you contribute to the spousal RRSP and claim the deduction for yourself. Contributions reduce your own RRSP contribution limit. Your spouse's contribution limit isn't affected. If you're the higher-income earner, the deduction provides greater tax savings. When your spouse withdraws from the spousal RRSP, they include the income on their tax return. It works best to contribute at a higher tax rate and your spouse withdraws at a lower tax rate.

You may contribute to both your own RRSP and a spousal RRSP. This evens out the balances in your registered accounts to allow flexible withdrawals in retirement. Or you may maximize contributions to a spousal RRSP if the contributing spouse expects high income throughout their life.

Spousal RRSPs primarily focus on long-term retirement savings and not short-term tax shelters. Therefore, the ITA attributes amounts you contribute back to you rather than your spouse if withdrawn too soon. Attribution occurs if you contributed to any spousal RRSP in the year of withdrawal or previous two calendar years. As an example, let's say your last contribution to a spousal RRSP was in 2022. Your spouse can withdraw the money any time after January 1, 2025, without any attribution. The ITA also doesn't apply attribution to registered retirement income fund (RRIF) minimums.

Tip: Because of eligible pension splitting restrictions before 65 (see below), spousal RRSPs remain a flexible income splitting tool. Contribute to a spousal RRSP if you expect your spouse to have lower income than you during retirement. Also, consider making spousal RRSP contributions by December 31 instead of the first 60 days of the year. CRA considers the year you make the contribution for attribution purposes, not the tax year you deduct it.

Tax Free Savings Account (TFSA)

TFSAs provide access to tax-free growth, tax-free withdrawals, and a form of income splitting. As mentioned, spouses and common law partners typically cannot gift money to their spouse to invest without attribution. However, the ITA exempts money gifted from a spouse when invested in a TFSA from the general attribution rule. This makes the TFSA a great tax-savings and income-splitting opportunity.

You give money to your spouse to contribute to their own TFSA when your spouse has available contribution room. They then invest the money within the TFSA. Keep in mind you cannot use the TFSA as an intermediary to avoid the attribution rules. If your spouse withdraws from the TFSA and invests in income producing property or an RRSP, attribution applies. It results in you reporting and paying tax on income and capital gains earned on the substituted investment.

Tip: Consider gifting money to your spouse or adult children to maximize savings inside their TFSA. Keep in mind they need their own available TFSA contribution room.

Registered Education Savings Plan (RESP)

An RESP is a special savings account to save for someone's post-secondary education. Except for family plans, anyone can open an RESP account: parents, guardians, grandparents, other relatives, or friends. This person is the subscriber. The beneficiary is the person named who eventually withdraws the money for their education. While you can open a plan for a minor, you can also name yourself or another adult as beneficiary.

There is a lifetime limit on contributions of $50,000 per beneficiary. Although you contribute your after-tax income, you benefit from tax-deferred growth inside the plan. You also get up to $7,200 in matching government grants and $2,000 in government bonds depending on your income.

Contributing to an RESP is a form of income splitting. A beneficiary can withdraw contributions tax-free when they attend a qualified post-secondary institution. They pay tax only on withdrawals of the grants, bonds, and growth on the contributions. You achieve income splitting because the beneficiary is usually in a low tax bracket when they remove the money.

If the beneficiary doesn't attend a qualified post-secondary institution, you return the grants and bonds to the government. As the RESP subscriber, you receive contributions back tax-free. But, you pay tax on growth plus an additional 20% penalty if you don't use it for education purposes. You have an opportunity to defer the tax and avoid the 20% penalty. To do this, you must transfer the growth to your RRSP, assuming you have sufficient contribution room.

Tip: What happens if the beneficiary chooses not to continue their education after high school? Don't worry, you can wait to see if they change their mind. RESP accounts can stay open for up to 36 years. Alternatively, you can transfer the money from one RESP to an RESP for another beneficiary under certain conditions.

Eligible pension income

Pension income splitting is an attractive strategy that notionally transfers pension income between spouses or common-law partners. As a result, you reduce your overall household tax burden. Spouses and common-law partners can transfer up to 50% of eligible pension income when you file your tax return. This allows you to shift income from the higher income-earner's tax return to the lower-income earner's tax return.

In Quebec, you must be 65 or older on December 31 to split income on your provincial tax return. Federally, and in all other provinces and territories, you can split certain incomes both before and after age 65. Various sources of retirement income may qualify as eligible pension income. Limited sources qualify before age 65 (e.g., defined benefit pension) with wider sources after age 65 (e.g., RRIF withdrawals). The spouse or common-law partner receiving the split income can be any age. Please refer to our article, **Pension income splitting – quick reference guide** for more details.

Tip: Most eligible pension income also qualifies for the pension income tax credit for the initial recipient. This is a 15% federal tax credit on up to $2,000 of eligible pension income for the year. A similar tax credit is available in all provinces, but the thresholds and rates vary. The split income recipient must meet the age requirement for that type of income to qualify for the credit. Example: if you're 65 and receive RRIF withdrawals, you qualify for the tax credit. If your spouse is 62, and you split $2,000 of RRIF withdrawals, your spouse doesn't qualify for the credit. If your spouse is 62, and you split $2,000 of defined benefit pension, your spouse qualifies for the credit.

Canada Pension Plan (CPP)/Quebec Pension Plan (QPP) sharing

CPP/QPP does not qualify as eligible pension income for pension income splitting purposes. However, Service Canada allows you to share the pension. It benefits couples where one expects to receive more retirement benefits than the other. To benefit, couples need to apply to share the CPP/QPP benefit. Once approved, a portion of the higher CPP/QPP recipient's pension transfers to the lower CPP/QPP recipient's pension. Sharing is available only when both are eligible for and commencing retirement benefits. If only one spouse was a contributor, they're eligible when they start CPP/QPP and the other spouse is at least 60. It is not a 50/50 split. The amount you can share depends on the number of months you live together and contribute to CPP/QPP. This is the 'joint contributory period.'

Tip: The amount of each CPP/QPP payment and the T4A for both change when you share the pension. It's not a notional split like eligible pension income. Further, sharing doesn't apply to the post-retirement benefit (PRB). You receive the PRB if you elect to begin CPP/QPP while still working and contributing to the CPP/QPP program.

In trust for (ITF) accounts

Many individuals set up investment accounts for their minor children using the words 'in trust.' If you set up an ITF account properly, you may achieve income-splitting associated with capital gains on those investments. However, tax on income (e.g., interest and dividends) still attributes to the contributor until the minor is 18. You avoid attribution on capital gains only if the contributor doesn't retain control over how to distribute the assets. Therefore, to achieve income splitting on capital gains, its' better if the contributor isn't the only trustee. Keep in mind that assets held in an ITF account is property of the beneficiary. The contributor can't access the money in the account for their own personal use. Further, when the child reaches age of majority, they can demand the money and use as they please. Age of majority is 18 or 19 depending on your province of residence. Before placing money in an ITF account, speak with your tax advisors about any potential pitfalls of this strategy.

Tip: Many times, an ITF account has little to no paperwork expressing the terms of the trust. We recommend you ensure you have written documentation of intentions for the account(s) to avoid any unintended consequences.

Prescribed rate loan

A prescribed rate loan takes existing personal non-registered money, and loans it to a spouse or common law partner. You may also use a trust when you also want to split income among children under 18. The loan structure allows the borrowing taxpayer to invest the money. They then claim the net income and capital gains (after they pay and deduct the interest). The higher-income lender pays tax on the annual interest. You achieve income splitting by taking advantage of the spread between the low prescribed interest rate and the taxable income your invested money produces. By shifting the spread to a lower-income earner, there's a lower total tax bill on the same income.

You set the loan's interest rate at the CRA's prescribed rate in place when you lend the money. You can set it for the life of the loan. We recommend you have the loan in writing. You usually evidence the loan agreement in the form of a written promissory note. You must pay annual interest by January 30 of each year to maintain the strategy and avoid attribution rules. For more information see our article titled **Creating tax efficiencies with prescribed rate loans.**

Tip: Ensure you're aware of any capital gains associated with your non-registered investment account before setting up the loan. Implementing this strategy can trigger a taxable disposition on which capital gains tax could become payable.

Permanent life insurance

There are two main types of life insurance: term and permanent. Both term and permanent life insurance offer a tax-free death benefit to your beneficiaries. Under a term policy, you're covered for a set amount of time. Permanent life insurance (or whole life insurance) covers you for your whole life. Some permanent plans can build cash value as well. Cash value is a savings component that grows over time. You can borrow against it or use it as collateral for a loan. You may also withdraw your cash value, but this may reduce your policy's death benefit.

There are several options when it comes to permanent life insurance. One option is participating life insurance. Participating life insurance combines permanent life insurance protection with an opportunity for tax-deferred cash value growth. You have guaranteed base insurance protection for life if you pay the premiums on time. You can also earn policy dividends and build tax-deferred cash value savings. This provides you with an opportunity to achieve intergenerational wealth transfer that leads to income splitting opportunities. Reach out to your advisor to discuss insurance options that achieve this goal.

For example, you can purchase life insurance on your child or grandchild to protect their financial future. You can also direct a portion of your premiums to the tax-deferred savings component. When you are ready, you transfer the policy to your child or grandchild on a rollover basis. They then have a policy with accumulated tax-deferred cash value. They can access the cash value in several ways as mentioned above.

Tip: Transferring a life insurance policy is a disposition which may incur tax. Only specific transfers qualify as a tax-deferred rollover. For example, a parent can transfer a policy on a child's life to their child or grandchild. Speak with your advisor to discuss options for transferring during your lifetime. Alternatively, ensure you name a qualifying contingent owner to receive the policy in the event of your death.

Income from your business

If you own a private corporation, you may want to use it for income splitting with your family. For example, you may look to pay dividends to your spouse or children. However, with the introduction of tax on split income (TOSI) rules in 2017, the ITA severely restricts income splitting. If TOSI applies, the recipient pays tax at the highest marginal tax rate. Limited exceptions to the TOSI rules may allow you to split income with your spouse or related children. For example, you may be able to pay a dividend to a spouse once you are over 65. Or you may be able to pay dividends to a related person who performs sufficient work in the business. The rules are complex and require tax advice before paying a dividend to a related person.

However, you can still pay a related person a reasonable salary without attribution applying. This includes your spouse or children who may work for your business. Keep in mind the salary needs to be reasonable for the work or services performed. Therefore, you cannot pay a child $50,000 for sweeping the floors.

Tip: Speak to your tax advisor about TOSI exemptions or whether you can pay your spouse or child a reasonable salary.

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