

Income Splitting with Married Couples

Many married couples (including common-law partners) can save thousands of dollars in taxes over their lifetimes by splitting their incomes as evenly as possible amongst each spouse. The available savings are as a result of our marginal tax rate system. One or more of the following ideas may help reduce a couple's tax bill.

Retirement assets

The pension income splitting rules allow spouses to split eligible pension income by electing on their income tax returns. For taxpayers under the age of 65, this covers payments in respect of a life annuity out of a pension plan. For taxpayers over the age of 65, the other common payments covered, in addition to a life annuity out of a pension plan, include: an annuity payment under a RRSP, payments under a RRIF and U.S. social security. The savings from splitting eligible pension income can run in the thousands of dollars per year.

Notwithstanding the above, it can still make sense for a higher income spouse to make contributions to a spousal RSP for the benefit of the lower income spouse.

As an additional measure, retired couples could ask the government to split their CPP entitlements. By splitting the retired couple's income more evenly, the above measures reduce overall taxes paid during retirement and the claw-back of government benefits.

Loans to spouse

The higher income spouse makes a loan to the lower income spouse at the prescribed rate of interest (which is 1% for the 2nd quarter of 2011). If the lower income spouse can generate a return of greater than 1% on that loan, the overall tax burden of the couple will fall. The spouses should document the amounts advanced and the interest rate by way of a long-term promissory note. The prescribed rate of interest at the time that the loan was advanced remains in effect for the term of the loan. It is essential that the interest on the loan is paid to the higher income spouse no later than 30 days after the end of the year, otherwise the income attribution rules apply.

Use of funds

The higher income spouse should direct his or her income towards household and other personal living expenses while the lower income spouse directs his or her income towards investing. The lower income spouse should maintain accounts registered in his or her name only. This would improve the after-tax return on the couple's non-registered investments because of lower income spouse's lower marginal rate of tax.

Shifting losses

This is best explained by way of an example. Mr. A, who has never realized a capital gain or loss in the past, owns 100 shares with an accrued loss, whereas Mrs. A has realized gains in the year.

Mr. A sells his 100 shares into the market. Mrs. A acquires 100 shares of the same stock in the market within 30 days after the sale by her husband. The superficial loss rules act to add the capital loss of Mr. A to the 100 shares acquired by Mrs. A. When Mrs. A disposes of the 100 shares after 30 days have passed, she would be able to recognize a loss and offset her other gains.

Capital gains splitting

This is also best explained by way of an example. Mr. A owns 100 shares with a fair value of \$100 and a cost of \$40. Mr. A transfers 50 shares to his spouse on a rollover basis under 73(1). Mr. A transfers another 50 shares to his spouse for fair market value consideration of \$50, he elects out of the 73(1) rollover on these 50 shares and reports a capital gain of \$30.

The average cost of the 100 shares to Mrs. A is \$70. She sells the 100 shares and realizes a gain of \$30; of which $\frac{1}{2}$ is taxable to Mrs. A and $\frac{1}{2}$ is attributable to her spouse. The result is that $\frac{1}{4}$ of the original gain has been transferred to Mrs. A. It is the author's opinion that GAAR is not applicable on the capital gains splitting aspect of this transfer. Although this may or may not be the case where Mrs. A subsequently claims the enhanced capital gains deduction or deducts capital loss carry-forwards.

Private business owners

If one spouse operates a profitable business it may be desirable to split the income of the business between the spouses. This could be accomplished by introducing the other spouse as a shareholder by way of a "freeze" or paying them a reasonable fee for services rendered. Having a spouse as a shareholder would also multiply access to the \$750,000 capital gains deduction on the potential sale of the business in the future.

Testamentary spousal trusts

Where one or both spouses have accumulated significant assets they may want to establish a testamentary spousal trust in their wills. All of the income and none, some or all of the capital of the trust would be available to the surviving spouse during his or her lifetime. Income earned in the trust will be subject to a lower rate of tax than if combined with the spouse's other sources of income. The will of the deceased would detail the contingent capital beneficiaries of the trust.

It is important to remember that there are non-tax implications to the above planning ideas that should be carefully considered.