Good Times

Rights & Money

How to Save Money With Income Splitting

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If you can move some of your income to someone being taxed at a lower rate, you can reduce your tax burden

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When it comes to reducing your tax bill, one very effective method is the practice of income splitting—transferring some of your own income or investments to a lower-income member of your family so that they'll be taxed at a lower rate. If, for example, your own top marginal tax rate is 40 per cent and your spouse's is 25 per cent, and you shift $10,000 of your income into his or her hands, you'd stand to save $1,500 in taxes each year.

Similarly, a single person might be able to achieve some tax savings if there's any variation in income from one year to the next. Shifting some of that income from a low- to a high-earnings year would produce the same potential benefits.

Income splitting is so potent, however, that the government has come up with laws specifically intended to prevent it. So-called "attribution rules," for example, require that any earnings from investments or money given to your spouse be taxed in your hands. Similar rules apply for minor children and grandchildren, although capital gains are exempted. And shifting income from one year to another is generally deemed a no-no as well—in almost all cases, you must declare income in the year in which it's received, whether it stems from employment or business or is in the form of interest or dividends.

Nevertheless, regardless of your marital status, there are ways you can reduce your tax liability by splitting income; the following are some of your options.

1. While attribution applies to income from money or assets given to a minor child, there's no attribution in the case of adult children or grandchildren. You can give freely, although Janet Gray, an Ottawa-based advice-only financial planner at Money Coaches Canada, cautions that you should be careful not to overdo it: "You don't want to place your own future security in jeopardy."

2. If you receive a pension (including many foreign pensions but not Canada Pension Plan, or CPP, benefits—see below), it can be split with your spouse or common-law partner, although you must be at least age 55 to split a defined benefit (DB) pension. Once you're 65 or older, this splitting provision also applies to RRIF, LIF, or annuity payments—anything that appears on line 11500 of your tax return. (See the article on tax returns on page XX for details.) And while there may be age requirements for the donor, the receiving spouse/partner can be any age.

3. If you receive CPP benefits, or both you and your spouse/common-law partner receive CPP benefits but the amounts you receive aren't equal, you can apply to Service Canada to "share" your benefits equally. Gray points out, however, that this sharing will be applied only to benefits earned during the time you were living together. "There's no minimum age requirement for splitting CPP; you simply have to qualify," she says. "You can share your benefits even if your spouse is 25."

4. You can make contributions to your spouse/partner's RRSP rather than your own at any age. However, any withdrawals from the spousal plan within that year or the following two calendar years will be attributed back to you (to the extent of your contribution); beyond that time period, attribution no longer applies. And if you have a younger spouse, you can continue these contributions even if you are 71 or older and therefore can't own an RRSP yourself; only once your spouse reaches 71 would this no longer be possible. "You do need to have the necessary contribution room available," Gray adds.

5. You can also make contributions to your spouse/partner's TFSA—in a way. "You can't actually contribute to someone else's TFSA, but you can give them the money to do so," Gray says, and there are no attribution rules when it comes to such contributions. "And there's no age limit for owning or contributing to a TFSA," she adds. Since TFSA withdrawals aren't considered income, they won't affect any income-related benefits to which you're entitled, such as Guaranteed Income Supplement (GIS) or provincial tax credits.

6. You can't give property or investments to your spouse/partner without attribution, but you can transfer it at fair market value (FMV) and there will be no attribution. Gray warns, however, that you'll be deemed to have sold the property at that price and will have a tax bill on any accrued capital gains up to the date of the transfer; afterwards, all gains become taxable in the recipient's hands.

7. Similarly, while attribution applies to the income from money given to a spouse, you can lend the money without attribution provided you charge at least the government's "prescribed" rate of interest (and pay tax on this interest every year). This arrangement can provide a benefit as long as the investment yield is higher than the prescribed rate. "The prescribed rate is very low, cheaper than what you would pay for a bank loan," Gray notes. "The rate is adjusted quarterly, but for the first quarter of 2023, it was only four per cent."

8. When it comes to capital gains on equity investments, real estate, or other such assets, these profits become taxable only when the assets are sold. If your income varies from one year to the next and you were planning to sell near the end of the year anyway, it may be more advantageous to do so either before or after January 1, depending on which year's income is going to be lower. Nevertheless, Gray says, investment considerations should always take priority when it comes to the timing of sales.

9. If you own a business, you have various options for splitting income with family members or from one year to the next. You can, for example, hire your spouse/partner (or adult children) to work in the business, and as long as you pay a reasonable salary for their work, the amount won't be subject to attribution. If the business is incorporated, you can choose when to pay yourself dividends, although you need to consider how this might affect the corporation's tax bill. And whether it's incorporated or not, you can choose when—either before or after January 1—to make business expenditures that will reduce your income.

10. Although the income from money or assets given to a spouse or minor child is subject to attribution, no further attribution applies to second-generation income earned by the attributed

income. While this amounts to a relatively small tax break initially, it can become substantial over the long term as a result of compounding.

11. Couples can structure their budgets so that the higher-income spouse/partner pays all the bills while the lower-income partner invests as much as possible of his or her own earnings. That way, the investment income will automatically be taxable in the hands of the lower-income earner. You should, however, retain all the necessary documentation to show that no money actually changed hands.

Finally, it should be noted that in all of these situations, the general aim is to arrange things so that the partners' incomes, or the years' incomes, are equal. In practical terms, though, as long as the incomes are being taxed at the same marginal rate, there's usually no need to go any further. "This is generally true," Gray says, "but if one of your incomes is high enough to be subject to the Old Age Security [OAS] clawback [starting at $86,912 for 2023], there may be a benefit to going further if it enables you to eliminate or reduce the clawback."