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TAX**MATTERS**

The loan manoeuvre and swap rule are strategies that get income into the right hands

Love and Taxes

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One of the most common questions I get asked is: what strategies are available to get income into a low-tax rate spouse's hands?

If your spouse earns less income or no income at all, then it may be possible to double up on the graduated tax rates. However, all is not fair in love and taxes. Just because you are willing to share your wealth with your better half doesn't mean the CRA is quite as generous.

While a transfer of property between spouses qualifies for an automatic tax-deferred rollover, any income arising from this gifted property doesn't benefit from the same treatment.

The general rule is that any subsequent income generated from transferred property will be attributed back to the transferor-spouse. There are, however, exceptions to this rule.

Making the Most of Independent Capital

When the lower-income spouse has independent capital, the earnings generated on the capital will generally be taxable to the lower-income spouse. A simple rule is to make sure that the lower-income spouse invests their capital, and use the higher-income spouse's earnings or capital for day-to-day living expenses.

Examples of independent capital can include just about anything that doesn't come from the higher-income spouse, such as a gift or inheritance from a parent, or earnings from a lower-income job.

You can maximize a spouse's independent capital in a number of ways. First, use the higher-income spouse for personal expenditures – including paying the lower-income spouse's taxes. Or, if a parent of one of the spouses is thinking of giving some money to the family, it makes sense from a tax-planning perspective if the gift is given to the lower-bracket spouse.

Tax Tip: Make sure that the lower-income spouse's earnings and other independent capital are segregated in his or her own bank account and not commingled with money that comes from the higher-income spouse, as is the case with joint accounts. That way, there should be no question about who pays the tax on the income.

Make sure that these "pure" accounts continue to "track." By this I mean, if the money is invested in stocks, it should go into a separate "pure" brokerage account in the sole name of the lower income spouse.

The Loan Manoeuvre

I often write about the Loan Manoeuvre strategy. You can avoid the attribution rules if the investment is funded by a loan from you, the higher-income spouse, provided that the spouse pays you interest at the "prescribed rate" in effect at the time the loan is made (currently one per cent).

Moreover, the interest on this loan has to be paid no later than January 30 of each year. If you miss even one deadline, the attribution rules

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will apply forevermore.

If you don't have cash to loan to your spouse, consider doing a loan in kind. For example, if you have a securities portfolio in your name, transfer the portfolio to your spouse and have your spouse issue a demand promissory note reflecting the prescribed interest rate for an amount equal to the fair market value of the portfolio at the time of the transfer.

However, this transfer may be subject to capital gains tax by you, the transferor, as the transaction would have to be made at the portfolio's fair market value.

The Swap Rule

Special rules allow your spouse to pay tax on income or capital gains from an asset which you transfer – provided that your spouse "buys it" from you, and pays for it with an asset having at least an equivalent value. Obviously, this technique works best if the spouse pays for the investment with personal-use (i.e., non-income-earning) assets that he or she directly owns.

One drawback is that, to qualify for this break, you are subject to tax rules that treat you as if you sold the investment at its current market value. As a result, you are potentially subject to capital gains treatment on any appreciation in value when you swap the investment.

But if you have capital losses, you may be able to offset the gains exposure, or you may be sitting on a number of stocks that are in a loss position. In that case, you may want to consider swapping those stocks and trigger a loss.

In many cases the swapped investments may not have appreciated in value in the first place, and therefore no capital gains exposure would have occurred. This will usually be the case, for example, with bank accounts, GICs, and so on.

Watch out for rental or business real estate, though: even if it hasn't appreciated in value, previous years' depreciation claims could be included in your income ("recaptured") if you transfer real estate. Moreover, you could be triggering land transfer tax on transfers of real property, regardless of whether it's for business or personal use.

Of course, there is a problem if your spouse does not have swappable assets to begin with. In most families, however, something is usually available e.g., interest in a home held jointly, or perhaps a car.

Alternatively, if you and your spouse are seniors, it is possible to pool your retirement pension income in order to income split. But there are some specific eligibility rules in order to do this:

☛ For those age 65 and over, eligible pension income includes lifetime annuity payments under a registered pension plan, an RRSP or a deferred profit-sharing plan, and payments from a RRIF.

☛ For those under 65 years of age, eligible pension income is limited to lifetime annuity payments from a registered pension plan and certain other payments received as a result of the death of the individual's spouse.

Note that amounts received from a government pension plan (i.e. Old Age Security, Guaranteed Income Supplement, CPP/Quebec Pension Plan) are not eligible for the new pension splitting rules. (While CPP income does not qualify as eligible pension income for the pension income credit, existing rules permit CPP pensioners to split their CPP retirement benefit.)

In order to take advantage of this income splitting strategy, both you (as the recipient of the eligible pension income) and your spouse must agree to the allocation in your tax returns for the year in question. (Note: the allocation must be made one year at a time.) Up to one-half of your pension income can be allocated to your spouse.

Spousal RRSPs had been the preferred route to income split prior to the ability to pension income split, which has only been available since 2007. (A spousal RRSP is an RRSP where you make the contributions, but the plan is owned by your spouse.)

When you contribute to a spousal plan, you receive a personal tax deduction, but amounts received from the plan generally will be taxable to your spouse, not you. Sounds good?

The only problem is that spousal RRSPs do not allow for splitting of other types of pension income, such as RRIFs and employer-sponsored registered pension plans. Now that pension income splitting is allowed, some advisors believe it may eliminate the need for spousal RRSPs, despite the higher age limit for RRSP contributions.

However, while helpful to many seniors, pension income splitting will not ease the tax burden across the board. It will not be of any assistance to seniors who are single, senior couples with equal incomes, or couples where each spouse has more than $118,000 of income or less than $30,000 of income. ❑