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*TAX*STRATEGY

With prescribed rates at historical lows, here are several ways to take advantage of…

TAX SPLITTING OPPORTUNITIES

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Earlier this year I wrote about the "prescribed loan strategy." This strategy allows you to loan funds to your spouse at the current low prescribed interest rate of one per cent, set by the CRA. The aim is to split income with your spouse without any penalty.

This is still a great strategy because the low rate is still in place. Recently I came across a file in which I wanted to apply a similar income-splitting strategy. There was a complication with this file, however — there were no liquid funds available to make a prescribed loan.

It occurred to me that this is probably a common scenario for many families. With that in mind, I thought it would be worthwhile to explore other income splitting options where cash might not be as handy to access.

Attribution:

Before we talk strategy, we should talk about the largest roadblock standing in the way of income splitting: the "attribution rules".

Although transfers of property between spouses do not trigger capital gains tax, the general rule is that any subsequent income arising from the transferred property will be attributed back to the transferring spouse.

There are, however, exceptions to this general rule. Most notably, when the transfers are made for fair market value (i.e. a loan at the prescribed rate, or cash or in-kind property of equal value). Here's how these exceptions can work.

Making the Most of Independent Capital

When the lower-income spouse has independent capital, the earnings generated will usually be taxable to the lower-income spouse. So keep this simple rules in mind — make sure the lower-income spouse invests his or her capital, and use the earnings or capital of the higher-income spouse for day-to-day living expenses.

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

You can maximize a spouse's independent capital in a number of ways. For example, use the resources of the higher-income spouse for personal expenditures – even for paying the lower-income spouse's taxes. Likewise, if a parent is thinking of giving some money to the family, in terms of tax planning, it's better to give it to the lower-bracket spouse.

Tax Tip - Make sure that the

> **The Prescribed Rate**
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> The prescribed rate is set each quarter by Canada Revenue Agency and is based on the average rate of 90-day treasury bills during the first month of the preceding quarter.

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lower-income spouse's earnings and other independent capital are segmented in his or her own bank account and not commingled with money that comes from the higher-income spouse, like a joint account. That way, there should be no question about who pays the tax on the income.

Make sure that these "pure" accounts continue to "track" cleanly. For example, if the money is invested in stocks, they should go into a separate "pure" brokerage account in the sole name of the lower income spouse.

The Loan Manoeuvre

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" at the time the loan is made (currently one per cent). Moreover, the interest on this loan has to be paid by no later than January 30 each year. If you miss even one deadline, the attribution rules will apply forevermore.

What if you don't have cash to loan your spouse, as in the case I mentioned at the beginning? Consider a loan in kind. For instance, if you have a securities portfolio in your name, transfer the portfolio to your spouse. Your spouse would then 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 transferring spouse, since the transfer would be done at the portfolio's fair market value. But, as mentioned below, you may have capital losses that can be used to offset any resulting capital gain.

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 the equivalent value. Having the lower-income spouse pay any tax is a clear advantage, of course.

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 personally owns.

There is a drawback.. 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 — so you are potentially subject to capital gains treatment on any appreciation in value when you swap the investment.

If you have capital loss balances you may be able to offset the capital gains exposure. Or you may be sitting on a number of stocks that are in a loss position. Thus you might consider swapping those stocks and triggering a loss.

In many cases the swapped investments may not have appreciated in value in the first place, so there would be no capital gains exposure. This will usually be the case with bank accounts, GICs, and other fixed-income assets.

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 that real estate. Moreover, you could be triggering land transfer tax.

Of course, there may still be a serious obstacle. Your spouse may not have assets to swap to begin with. In most families, something can usually be made available for the purpose. For example, an interest in a home held jointly could qualify, or perhaps a car.

Income Splitting – Pensions & RRSPs

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

For those of you who are 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.

If you are under 65, 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: the 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. Although 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 measure, 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 have traditionally been the preferred route to income split prior to the ability to split pension income, the latter strategy being available only since 2007.

A spousal RRSP is a plan in which you make the contributions, but your spouse owns the plan. When you contribute to the plan, you receive a personal tax deduction. But the amounts received are generally taxed to your spouse, not you. Sound good? The only problem is that spousal RRSPs do not allow for the 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.

While this may be 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, couples with equal incomes, or couples in which each spouse has more than $118,000 of income or less than $30,000 of income.

There is almost always a way to split your tax burden effectively, but it takes careful planning and sound advice to put the right strategy together. ❏

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