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TAXSTRATEGY

Tax effective strategies when your kids reach…

The age of majority

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A friend of mine was telling me that her daughter is starting university next year and she needed to get a copy of some records to send to the school.

Seems like just yesterday, she said, that I was getting her ready for her first day of kindergarten and now she's settling into university.

Your child may be growing up quicker than you like, I told her, but if she's turning 18, a whole new world of tax savings has just opened up for you.

Income splitting with minor children can involve some complicated tax planning. However, once they reach the age of majority, your kids can be a source of some easy tax-planning strategies.

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Income splitting

Let's start with income splitting – the arcane art of arranging your financial affairs so that investment income is taxed in the hands of your children or other low bracket family members.

With minors, there are some twists and turns, but if your child has reached the age of 18 years, all you have to do is give money to your child, and he or she can pay tax on the income – be it dividends, interest or capital gains.

Just make sure the investment account is registered in his or her name, so the kids are issued the tax information slips. (One little known snafu is that there's an anti-avoidance rule that could be used against income-splitting loans to a child, unless they are at CanRev's prescribed rate – currently at a historic low of one per cent.)

If you have an incorporated business, a lucrative strategy can be to make your kids shareholders.

That way, they can receive dividends from the company – and pay tax on them at a lower rate. If kids are minors, this strategy is blocked; however, once they reach the age of majority, many restrictions drop away quickly.

Even so, I highly recommend professional advice when it comes to adding your kids as shareholders. If your corporation is valuable, and you simply give your kids some shares, this could result in some very harsh tax consequences.

Estate freeze: A better idea is to make your kids shareholders as part of an "estate freeze" (see my June 2009 article on the subject in *The TaxLetter*).

This is a tried and true strategy which has the added benefit of reducing death tax exposure. Here's why: when shares pass to another generation, our tax rules say that there's a "deemed sale" of the shares at the then-current market value, which can result in costly capital gains exposure.

As the name implies, an estate freeze caps this tax exposure to the parents, based on the company's value at the time of the freeze.

When the death tax exposure is "frozen" at this level, the tax savings can be significant when the parents pass away.

Remember, this could be all-the-more critical if your childrens' financial prospects are limited. And as I said, at the same time, you're putting shares in the name of your kids – shares which carry the right to future growth in the company – so that they can receive low-tax dividends from your company.

In slow economic times and declining markets, it may best to freeze your interest because the value of your company may be lower than normal. Why is this a good thing? Because a lower freeze value will mean lower taxes to pay when you pass away.

Family trust: A variation to an estate freeze would be to put the shares into a family trust rather than directly in your kids' names – this will allow you to shift income between your kids and have a big say in who ultimately gets the shares themselves.

A family trust can also be used for income splitting on investments, as I described earlier – i.e., instead of using the dough to turn investments directly over to your kids, you put it in the family trust.

Payroll: For businesspeople, another tax-saving strategy could be to put a low-income child "on the payroll" of the family business, and write off the salary.

Unlike dividend income, there are no specific age restrictions to this strategy. However, in order for it to be deductible, the amount of the salary must be reasonable compared to the business-related services provided by your kids. Practically speaking, it may be easier to justify a salary to an older child.

Principal residence exemption

For the moment, your kids may be happy to stay in the basement or a spare room (which is probably a step up from their dorm room). But eventually, they will move out and you may want to subsidize the purchase of a home or condo, or even buy it for them.

But if the home is owned by the parents, there could be significant tax exposure if it appreciates and is sold later or transferred to the kids.

This is because of the one-principal-residence-exemption per family restriction. However, if the home is owned by a child who has reached the age of 18 in that year (or is married), he or she will be eligible to claim the principal residence exemption – seperately and apart from your claim.

Be careful, though, about transferring an existing home – or any other investment for that matter – to your kids. Once again, because of the intergenerational transfer, the deemed sale rule is in effect, so the appreciation of the investment is taxable. Yes, it's possible to claim the principal residence exemption to shelter the gain on the transfer. But this will leave a retained home exposed to future capital gains tax due to the one-principal-residence-per-family rule.

Your will

If you're worried that your child's low income status may continue for many years – perhaps even after you die – your will could be the key to other lucrative tax-saving strategies.

When you pass away, your estate is treated as a separate taxpayer, which means it can benefit from low tax brackets. This means that your children can "income split" with the estate.

This opportunity has been made even more lucrative because of a rule that the estate can choose to declare and pay tax on its income even though it is actually paid out to beneficiaries.

To take advantage of this opportunity, your will should clearly state that when you pass away, your estate can continue for a number of years.

Often, the will simply leaves assets to beneficiaries "outright." In such cases, many estate planning experts question whether this favourable tax effect can continue for a prolonged period of time.

So the better thing to do is to make sure that your will makes it clear that your estate can continue. This is done by establishing what tax advisors refer to as a "testamentary trust" within your will.

In fact, this tax-saving concept can be taken even further by establishing several of these testamentary trusts within your will.

Each of these trusts can potentially be taxed separately, so that the income splitting advantages I mentioned previously can be multiplied – i.e., because each testamentary trust is eligible for its own low tax brackets.

One word of warning, though: CanRev has the power to lump beneficiaries together where the bequests ultimately accrue to the same beneficiary or "group or class" of beneficiaries.

Having said this, there are few reported cases which CanRev has successfully taken this position. In any event, there have been some CanRev statements over the past few years that suggest this rule should not to apply when you set up a separate testamentary trust for each child.

If you own both income and non-income-earning assets, you could leave the income-earning assets to children with low income. This is because income from bequests to high-income children will be added to their other taxable income, and result in a significant tax exposure.

As your kids grow up, so do your tax opportunities. ❏