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TAXSTRATEGY

Loans, swaps, splits …
with the one you love

Love and taxes

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If your spouse earns less income than you, or no income at all, 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 Canada Revenue Agency is quite as generous.

While a transfer of property between spouses qualifies for an automatic tax-deferred rollover, the income that might arise from such gifted property doesn't benefit from the same treatment. The general rule is that any subsequent income arising from such transferred property will be attributed back to the transferor-spouse. There are, however, ways to get around these general rules.

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Making the most of independent capital

Where the lower-income spouse has independent capital, the earnings generated on such capital will generally be taxable to the lower-income spouse. So a simple rule is to make sure that the lower-income spouse invests his or her capital, while the higher-income spouse's earnings and capital are used for day-to-day living expenses. Examples of independent capital can include just about anything that doesn't come from the higher-income spouse; e.g., a gift or inheritance from a parent, or earnings from a lower-income job.

Maximize your spouse's independent capital

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

Tax Tip: Make sure that the 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; e.g., joint accounts and the like. That way, there should be no question about who pays the tax on the income. Make sure that these "pure" accounts continue to "track." For example, if the money is invested in stocks, this should go into a separate "pure" brokerage account in the sole name of the lower income spouse.

The loan manoeuvre

As I have discussed in previous articles, 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 by no later than January 30 each year. If you miss even one January 30 deadline, the attribution rules will apply.

No cash? Consider a loan in kind

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 transfer would have to be made at the portfolio's fair market value (see further discussion below).

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 personally owns.

A 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; so you are potentially subject to capital gains treatment on any appreciation in value when you swap the investment.

However, if you have capital loss balances you may be able to offset the capital gains exposure, or again, you may still be sitting on a number of stocks that are in a loss position so you may consider swapping those stocks and triggering a capital 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, for example, with bank accounts, guaranteed investment certificates (or 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 (whether business or personal use).

Of course, one problem is that the spouse may not have assets to swap to begin with. In most families, something should be available. For example, an interest in a home held jointly could qualify, or perhaps a car.

Income splitting: Pensions and RRSPs

Alternatively, if you and your spouse are seniors, it is possible to pool your retirement pension income in order to take advantage of income splitting. There are, however, some specific eligibility rules in order to pension income split:

- For those age 65 and over, eligible pension income includes lifetime annuity payments under a registered pension plan, a Registered Retirement Savings Plan (RRSP) or a deferred profit-sharing plan, and payments from a Registered Retirement Income Fund (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: Amounts received from a government pension plan (i.e., Old Age Security, Guaranteed Income Supplement, Canada Pension Plan (CPP)/Quebec Pension Plan) are not eligible for the 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 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. (Also of note here: 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

Spousal RRSPs had been the preferred route to income split prior to the ability to split pension income (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 RRSP, you receive a personal tax deduction, but amounts received from the plan generally will be taxable to your spouse, not you.

Sounds good, right? 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.

End of the line for spousal RRSPs?

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.

Limits of pension income splitting

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 $220,000 of income or less than $30,000 of income. ❐