MONTHLY NEWSLETTER

Family Income Tax Planning

HENDRY WARREN LLP

JACOB MILOSEK, CPA, CA
JENNIFER DAWE, CPA, CA

DECEMBER 2015

Our goal is to provide updates on topical tax issues. Information contained in the newsletters is not meant to be a comprehensive summary of the issues raised. Rather, we wish to bring what we believe to be important issues to the attention of our valued clients. We would be pleased to discuss any questions that you, the reader, might have in greater detail.

Canada's income tax system applies graduated income tax rates to a taxpayer's income. The higher the taxpayer's income, the higher the marginal tax rate for each additional dollar of income earned. For example, a person with modest or no income in a given year could pay no income tax once available income tax credits are applied while taxpayers in Ontario with income in excess of $220,000 would pay 49.53% of tax for each additional dollar earned. The new federal government has proposed changes which would see the highest tax rate in Ontario jump to 53.5% if legislated.

Inequities result when members of a family unit, particularly spouses, have significantly different income levels. Based on current tax rates, if one spouse earned $250,000 of income and the other $0, the total income tax payable would be approximately $97,000. If, on the other hand, the same couple had earned $125,000 each, the combined income taxes payable would be approximately $74,500. The tax differential between the two scenarios is $22,500 even though the total income is the same in each case.

Proper planning is more important than ever as the highest income tax rate continues to diverge from the lower rates. There are a number of planning options which permit income splitting amongst family members that own shares in private corporations. However, most families do not own such shares and thus such planning is not an option. The remainder of this newsletter will focus on other tax saving strategies available to families.

THE FAMILY TAX CUT ("FTC")

The FTC was introduced in 2014. Married or common-law couples with minor children are allowed to effectively transfer up to $50,000 of taxable income from the higher-income spouse to the lower-income spouse when calculating federal income taxes payable. The FTC is a federal non-refundable income tax credit equal to the difference in tax before and after the effective transfer of income, up to a maximum benefit of $2,000. The FTC is a notional transfer and consequently does not change either spouses' or common law partners' net income. Benefits calculated based on net income, such as the GST/HST credit and Canadian child tax benefit (CCTB), and provincial taxes payable are therefore not impacted by claiming the FTC.

The FTC is a promising first step towards solving the inequities described above. As the value of the credit is capped at a total tax savings of $2,000, the FTC does not fully solve the issue. Further, as the credit is only available for families with young children, it does not provide any benefit to couples who do not have children. The new federal government has promised to eliminate this credit. It is likely that such a change will be effective commencing in 2016, so 2015 may be the last year for families to take advantage of the FTC.

PENSION INCOME SPLITTING

Canadian resident pensioners are able to allocate up to one-half of their eligible pension income to their spouse or common-law partner for income tax purposes. The amount allocated in the transfer as a result of pension income splitting is deducted in determining the net income of the person who actually received the pension income, and it is included in computing the net income of the other spouse. Pension income splitting is not a notional transfer like the FTC and consequently benefits calculated based on net income and provincial taxes payable are impacted.

Income eligible for pension splitting is limited by strict rules and most income cannot be split until the pensioner reaches the age of 65. Amounts received from Old Age Security (OAS), the Canada or Quebec Pension Plan (CPP/QPP), and income from a United States individual retirement account (IRA) are not eligible for pension income splitting.

The extent to which pension income splitting will be beneficial will depend on the marginal tax bracket of the pensioner and their spouse or common-law partner as well as the amount of eligible pension income that can be split. In many cases the optimal allocation will be less than the allowable one-half maximum. If one spouse or common-law partner has no eligible pension income to report themselves, it is common practice to transfer at least $2,000 to double the amount of benefit received from the $2,000 pension income amount tax credit. The pension income amount tax credit effectively reduces the federal marginal income tax rate on the first $2,000 of eligible pension income by 15%. The provinces and territories also offer relief on eligible pension income, subject to varying maximum thresholds.

The pensioner and their spouse or common-law partner must make a joint election on form T1032, Joint Election to Split Pension Income, to split their eligible pension income. The form must be completed and signed by both the pensioner and their spouse or common-law partner. The information on each form must be the same. Finally, couples who each have eligible pension income will have to decide who will make the transfer as only one joint election can be made for a tax year.

SPOUSAL RRSPs

Spousal RRSPs offer a mechanism for couples to split income and reduce their overall income tax burden when funds are withdrawn from an RRSP. The contributor is permitted a deduction from their income and withdrawals from the RRSP are taxed in the hands of the taxpayer’s spouse provided the attribution rules do not apply. Where spouses are in different income tax brackets, spousal RRSPs can provide substantial income tax savings. A potential disadvantage is that a spousal contribution becomes the property of your spouse.

With the introduction of pension income splitting in 2007, the value of spousal RRSPs is somewhat diminished. However, they remain a useful planning tool for the following reasons:

1) Income can be split at any age - under the pension income splitting rules, you must be at least age 65 to split income and you must convert your RRSP into a RRIF. Regular RRSP withdrawals do not qualify for pension income splitting. However, with spousal RRSPs, you can split income anytime that the attribution rules don't apply. If a spousal contribution hasn't been made in the current year or the two previous calendar years, any withdrawals from the RRSP will be taxable to your spouse.

2) 50% limitation on pension splitting - After age 65, you can split up to 50% of your pension income with your spouse. With spousal RRSPs, you determine the amount of income to split by deciding how much to contribute to the spousal RRSP, subject to your contribution room.

3) A younger spouse allows for continued RRSP contributions - If you have a younger spouse, you can continue to contribute to the spousal RRSP until the end of the year your spouse turns 71, provided that you still have RRSP contribution room.

4) Legislation is subject to change – pension income splitting is currently permitted. There is no guarantee of what tax changes will come in the future. Therefore, taking advantage of spousal RRSPs provides additional assurance that income splitting will be possible in retirement.

Although pension splitting has reduced the benefit of spousal RRSPs, spousal plans are still an important planning tool that should be considered.

SPOUSAL LOANS

Spousal loan tax planning aims to take advantage of the difference in marginal income tax rates between couples. In situations in which one spouse earns significantly more than the other, the higher income spouse can loan funds to the lower income spouse. The lower income spouse can then invest these funds in securities and other income producing assets. It is important for such a loan to be properly documented to avoid attribution rules in the Income Tax Act which would effectively tax the investment income in the hands of the higher income spouse.

The lower income spouse will report investment income on the funds invested, less interest paid to the higher income spouse for the funds loaned. The higher income spouse, in turn, will report interest income for the amount of interest received on the loan. Income splitting is achieved when the lower income spouse earns a higher rate of return than the interest rate on the loan. The extent to which this strategy will be beneficial will depend on the marginal tax bracket of the couple, the magnitude of investment income earned on the portfolio and the interest rate on the loan.

It should be noted that the higher income spouse must actually lend funds to the lower income spouse. There must be a documented flow of cash from an account in the higher income spouse's name to an account in the lower income spouse's name. The loan must be documented in a promissory note and the stated rate of interest on the loan must, at a minimum, equal the prescribed interest rate set by the CRA. Finally, the interest must be paid by January 30 of the following year.

The prescribed interest rate is currently set at 1%. The current prescribed interest rate presents an excellent opportunity to take advantage of spousal loans as the average rate of return on an investment portfolio should exceed 1%. Couples can maintain the 1% interest rate on their loans so long as the loan is entered into before the prescribed rate increases. If the loan ceases to be tax effective due to changes in income levels or investment returns, the lower income spouse can simply repay the higher income spouse without any income tax consequences.

It is unlikely that the current prescribed interest rate will remain at 1% for much longer; therefore couples who believe this strategy may be beneficial for them should formalize a loan soon.

TUITION TRANSFERS

Tuition fees paid by students enrolled in Canada and, in certain instances, outside Canada to qualifying educational institutions and professional associations are eligible for non-refundable tax credits. Non-refundable tax credits can only be used to reduce taxes payable to zero (they cannot increase a refund). They can also be carried-forward to future years if not fully used in a given year. Most students are unable to immediately benefit from education related tax credits as they are often not taxable while attending post-secondary institutions and must carry these credits forward. The delay in claiming education related tax credits poses a timing issue for students as they are unable to fund their education with these credits. The tuition transfer mechanism alleviates this timing issue.

If a student is unable to use all or a portion of these credits, he or she can transfer up to $5,000 in credits to an eligible person. Non-refundable tax credits have a predefined benefit and do not increase or decrease in value based on the income level of the taxpayer. It is therefore often preferable for students to transfer the maximum amount possible. A tuition transfer of $5,000 translates into a $750 federal tax credit. The provinces and territories also offer their own education related tax credits which further increases the immediate benefit of the transfer.

Eligible persons to claim tuition transferred from a student are spouses or common-law partners, parents, or grandparents. Students can only transfer education related tax credits in the year they were earned – unused credits carried forward from a previous year cannot be transferred. The student transferring tuition must complete form T2202 or the relevant TL11 form for qualifying educational institutions outside Canada and must designate the recipient of the transfer and amount transferred. The student's signature must be present on the form or the Canada Revenue Agency ("CRA") will not permit the transfer of tuition.

CONCLUSION

Unfortunately, the options available to split income and reduce taxes of an overall family unit are somewhat limited. However, the options outlined above present families with opportunities to significantly reduce their overall tax burden. Should you have questions regarding how the application of these options may benefit your family's situation, please do not hesitate to contact us for more information or to set up an appointment.