

Never think **Never**

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Income splitting – a strategy to reduce your tax burden

There are three ways to lighten your tax burden: maximize your tax deductions and credits, defer income over time, or spread what you earn among the members of your family, sometimes referred to as “income splitting.” If you have a spouse¹ and children, you can split your income in multiple ways.

■ What is income splitting?

We have what’s called a progressive tax system, meaning we pay taxes at higher rates as our income levels increase. While tax rates are low – or negligible – in the lowest income brackets, they’re greater in higher tax brackets. Income splitting therefore involves allocating earnings so each recipient can take advantage of the lowest possible tax rate, as long as certain rules are met. When the higher earner in a couple transfers part of that income to a spouse, the couple’s total tax obligation goes down. Income needn’t be divided up equally to make this strategy worthwhile; everything hinges on the amounts involved and the allocation that works for those involved.

Nor is this a matter of spouses actually handing money over to one another. You simply need to indicate on your respective income tax returns that you wish to make such allocations. Income splitting is more likely to pay off for couples who have greater wage disparities.

Note that when preparing your tax return, both spouses must indicate that they approve the income split, particularly since one will have a higher tax bill. And it’s important to always calculate the actual final benefit for the entire family, not for just one person.

Income splitting can also be a smart strategy because certain tax credits – such as those that are age-related – depend on your income level. Judicious income splitting with your spouse could let each of you qualify for the maximum Old Age Security benefit, which is based on individual taxable income.

Lastly, it’s important to know that income splitting conditions depend on the source of income and whether the annuitant is under or over age 65. For example, a person of any age who is part of an employer-sponsored pension fund can split income with a spouse, while someone receiving annuity disbursements from Registered Retirement Income Funds (RRIF) or Life Income Funds (LIF or Restricted Life Income Fund, RLIF) may do so only starting at age 65. Note that the recipient spouse need not be age 65 to pay income tax on the money received from the split.

INCOME SPLITTING

Judicious income splitting with your spouse could let each of you qualify for the maximum Old Age Security benefit.

1. For tax purposes, the term “spouse” is used in this text to designate the person with whom you have been united in marriage or a civil union, or who is your common law spouse.

Ten more income-splitting strategies that work

Between spouses

- Let the spouse with the higher wages pay household expenses while the other spouse's earnings are invested, to gradually build a nest egg.
- Higher-salaried persons can set up spousal RRSP contributions in such a way that the amounts invested belong to their spouses. This strategy can be particularly useful if you expect to derive a large part of your retirement income from investments.
- Making loans between spouses at prescribed rates lets you shift taxes on income-generating investments to the spouse with lower income, taking advantage of lower tax rates. Technically, the spouse with higher wages loans the other one money that is put into investments generating taxable earnings. The prescribed interest rate for this type of loan is adjusted each quarter; it's currently 1% (until June 30, 2011). These loans come with very stringent requirements.
- Spouses with lower wages who own assets that don't produce any income – like homes, for instance – may “exchange” them for investments that have similar market values. The revenues that are generated go to the spouse who earns less. To keep this arrangement transparent in the eyes of the tax authorities, this strategy requires that ownership of the home actually be transferred.
- A business owner may pay a salary to a spouse as long as the latter performs a corresponding amount of work for the amount of compensation received.
- Spouses receiving benefits from Régie des rentes du Québec (RRQ) or Canada Pension Plan (CPP) may request that their payments be allocated to create better financial equilibrium for the couple. This involves adding together the contributions each has made during the course of their lives together and then dividing by two. Each person then receives his or her portion of the accumulated funds.
- Spouses who each have Tax-Free Savings Accounts (TFSA) can split their tax-sheltered investments. Along this line, withdrawals will have no effect on the amounts received from programs such as Old Age Security.

Among children

- Don't overlook investments in Registered Education Savings Plans (RESP), which let you defer taxes and split the resulting investment income with your child. This solution lets you take advantage of substantial governmental grants (30% or more, in some cases) and your child will be responsible for paying taxes on the contribution amounts – but not until he or she makes withdrawals. RESP beneficiaries can access funds only once they begin post-secondary studies. Make sure you read the applicable rules and conditions carefully to take full advantage of the many benefits of an RESP.
- Think about opening savings accounts for your children and depositing any tax benefits you receive in them. The income earned will be the responsibility of the child.
- As soon as a child turns 18, you may give him or her an amount to contribute to a TFSA where investment income will grow tax-free.

Some precautions

- In the event that a couple's marriage or civil union is terminated, the RRSP of the annuitant or spouse will be subject to distribution rules in force in the province where he or she resides.
- If you contribute to an RRSP in which your spouse is the annuitant and the spouse makes a withdrawal from this account during the two calendar years after your contribution, you will be responsible for paying tax on the withdrawal. After this time period, your spouse will become responsible for paying tax on the withdrawal.
- Parents relinquish all control of money given to youngsters once the children attain 18 years of age.
- The tax authorities have put certain rules in place to prevent income splitting abuses. In general, the rules state that income resulting from money given as a gift to a spouse or minor child must be included in the tax return of the person who has given the gift. However, a gift made to a spouse in order to allow the latter to contribute to his or her TFSA is not subject to distribution rules as long as the money remains in the TFSA. Similarly, the person who makes such a transfer will not be taxed for this amount.

To learn more, contact your Desjardins financial advisor,² who can put you in touch with other specialists like tax or legal advisors, if necessary. To determine whether income splitting is appropriate for your financial situation, ask for a preliminary simulation. This way you can be sure you're comfortable with all aspects of your decision.

2. Financial planning services at the caisses are provided by representatives of Desjardins Financial Services Firm Inc.



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