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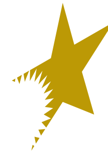
EXPECT THE BEST

Income Splitting Getting Tougher

by Paul L. Schnier
Originally published in *Blaneys on Business* (June 2011)

Paul Schnier practices corporate and personal income tax law with an emphasis on tax planning and implementation, and provides advice on the consequences of proposed transactions. His practice encompasses developing and implementing tax efficient corporate structures for multinational operations. He advises individual clients on estate planning matters. Paul chairs Blaney McMurtry's tax practice.

Paul may be reached directly at 416.593.3956 or pschnier@blaney.com.

We have written before about the benefits of income splitting – structuring one's affairs so that an individual's investment income can be spread among various family members in order to reduce the tax on it to the greatest extent allowable.

Residents of Ontario who are in the highest tax bracket will typically pay tax at rates of roughly 23 per cent on capital gains, 46 per cent on interest income, 28 per cent on dividends from public companies, and 32 per cent on dividends from private companies.

Generally, if this investment income is split among one's spouse and minor children, it is subject to tax at far lower rates. For example, if a minor child has no other income, he or she could receive approximately $10,000 of interest, $20,000 of capital gains or $25,000 of dividends without paying any tax. Similar savings could apply to one's spouse as well.

The people who crafted the *Income Tax Act* are well aware of this opportunity. So, for many years, the Act has contained provisions known as the "attribution rules," which essentially provide that where money is transferred to one's spouse or minor children, the income will be attributed back to the transferor and tax will be paid at that person's (higher) rate. These rules include transfers to a trust where one's spouse or minor children are beneficiaries.

An exception to the attribution rules exists, however, for loans at the prescribed rate of interest.

In a typical income-splitting scenario, one would establish a trust for the benefit of his or her spouse and minor children and lend money to this trust at the rate of interest prescribed quarterly under the Act (currently 1 percent).

So long as the interest is paid to the transferor within 30 days after the end of each year, the balance of any income and/or capital gain earned can be allocated to the spouse or minor children and taxed at their (lower) respective rates without the attribution rules applying. In addition, the prescribed rate of interest in effect at the time the loan is made will prevail for the duration of the loan. So, the current 1 per cent can apply for many years, even if the prescribed rate increases.

This technique of establishing trusts and lending money to those trusts was quite beneficial for shareholders of private companies until several years ago when the "kiddie tax" was introduced. Formerly, rather than owning the shares directly, a shareholder was able to create a trust with his minor children as beneficiaries to own his shares. Provided the attribution rules were satisfied, the

children could receive dividends from the private company at substantially lower tax rates. But, under the kiddie tax, such dividends are taxed at the highest tax rate so long as the children are minors.

The one good thing about the kiddie tax was that it did not apply to capital gains so that any capital gains on the sale of the shares could be taxed in the hands of the kids who could also take full advantage of the enhanced $750,000 capital gains exemption.

But, with the re-election of the Conservative government comes, presumably, the reintroduction of a provision originally contained in the federal budget of March 22 that will end this practice. This provision extends the application of the kiddie tax to capital gains included in the income of a minor child when the gain is attributable to a disposition of shares to which the kiddie tax would have applied.

In other words, if shares in a private company are owned by a minor child or by a trust of which a minor child is a beneficiary, any capital gain arising on a sale of these shares will be taxed at the highest marginal rate for dividends (i.e. 32 per cent - not even at the capital gains rate of 23 per cent).

This eliminates a significant planning tool that was available to small business owners.

The March 22 budget also contained a note of warning to the effect that the government proposes to monitor the effectiveness of the kiddie tax and can be expected to take further action if new income splitting techniques develop.

Clearly, there seems to be an intention to crack down on some of the techniques that have developed to date. Provided that the rules in the Act are followed, however, there will still be opportunities to reduce the family's overall tax burden with careful planning. ■