

Income Splitting 2

Working with a spouse or not, income splitting can have advantages.

When my wife agreed to marry me, I was a delivery driver/installer for a small insurance service company in Vancouver, re-installing stolen-insured stereo and TV components in people's homes. Mine was a very rewarding job, seeing happy people reunited with brand new equipment after the violation of a home break-in. Even if it required deciphering stereo instructions several times a day, my day was always a positive experience.

As the wedding approached, my brave wife-to-be was hired as a forewoman for one of those summer student painting outfits.

My job turned out to be temporary, as the business model changed and the company laid off all its installers just prior to our wedding. And so, my new boss was my wife. She was a better painter than me, but mostly patient with my inadequacy. I'm not sure what legacy a couple of starry-eyed newlyweds left on the homes we painted in Surrey and Langley, but I do recall my boss looked pretty cute with a paint-stained ball cap turned backwards and a pair of faded jeans.

Income splitting as a tax planning strategy – part 2

Note that any reference to "spouse" in this article also refers to a common-law partner.

The strategy of income splitting takes advantage of our progressive tax system where as an individual's taxable income increases, their marginal tax rates increase. A sound income splitting strategy enables spouses to shift income from a higher income spouse to a lower income spouse. Simply gifting cash to a lower income spouse for investment purposes is not an effective plan as the income attribution rules will likely apply. These rules will result in any first generation investment income earned on the cash gifted to attribute back to the higher income spouse for tax purposes.

Buying a non-income producing asset

If you are a high income earner and have a spouse who earns less or no income, you may want to consider income splitting. An income splitting strategy that may be available involves having you, the higher income spouse, buy a non-income producing asset from your lower income spouse for fair market value. A non-income producing asset could include personal-use items such as a family car, a piece of artwork, or jewelry. The income earned on the sale proceeds is not subject to income attribution as you received an asset of equal value in return for the cash you paid your spouse.

Let's consider the following example which assumes that your spouse has a lower income than you:

Suppose your spouse currently owns a painting that they received by way of an inheritance. Since the painting does not create any annual taxable investment income (i.e., interest, dividends, or capital gain distributions), it is considered a non-income producing asset. You could buy the painting from your spouse for a price equal to the fair market value of the painting. Your spouse can then invest the sale proceeds and the attribution rules will not apply. This means that any investment income earned on the investments will be taxed in the hands of your lower income spouse.

Since capital property is automatically transferred between spouses on a tax-deferred, rollover basis, your spouse will have to elect out of this spousal rollover provision on the sale of the painting to you on their tax return. Electing out of this rollover means that the transfer between you and your spouse will occur at fair market value as opposed to cost. If the painting appreciated in value since the time your lower income spouse acquired it, they may have to report a capital gain in the year of the sale to you.

There is a special rule that deems both the adjusted cost base and the proceeds of disposition of a personal-use property (such as a painting, car, boat, furniture, etc.) to be at least \$1,000. This means that a disposal of personal-use property will never produce a capital gain and be subject to tax unless the proceeds of disposition exceed \$1,000. Please note that there is no requirement to report a capital gain if the property being sold is classified as personal-use property (which a painting would be) and both the adjusted cost base and the sale proceeds do not exceed \$1,000.

Other considerations

It is critical that the exchange be made at fair market value. Therefore, it is highly recommended that a professional appraiser be retained to determine the fair market value of the particular non-income producing asset being and document this value. It is also advisable that the payment for the non-income-producing asset between you and your spouse be documented to provide a paper trail for the Canada Revenue Agency, should they ever audit your tax returns.

It is very important that the non-income-producing asset sold by your lower income spouse did not originate as a result of a gift from you. If this is the case, this strategy will not work because the attribution rules will apply. Due to this, you and your spouse should both be prepared to prove how and from whom your lower income spouse originally acquired the non-income producing asset.

Conclusion

This strategy could be useful in reducing your family's overall tax burden by effectively transferring investment income from the higher income spouse to the lower income spouse. Speak with a qualified tax advisor to assess if this strategy is right for your family and to make sure that the proper steps are taken in implementing this strategy.

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