Tax planning advice

Many ways of splitting family income

EDITOR'S NOTE: The following article is the second in a series on tax planning prepared by McCabe, Burns and Hubley Chartered Accountants.

An income-splitting plan which had gained considerable popularity in recent years was the use of the "family trust" or "children's trust."

This usually involved setting up a trust (and several of the brokerage houses would do this for a very small fee), and then having Dad loan funds interest-free to the trust.

The trust would earn income, and then arrangements would be made to have the beneficiaries of the trust (usually the low income members of the family, and usually children under 18) pay tax on the trust's income.

A trust is a taxpayer, and this type of trust would itself be subject to tax (at the top rate) on the income, but a trust receives a deduction from income for amounts which are paid or payable to a beneficiary, or for amounts which are subject to a "preferred beneficiary election."

This election effectively allows the children to be taxed on the income without physically receiving the cash, a result which is frequently popular with Dad.

The present rules relating to this type of "loaning" arrangement are exactly the same as those for a loan directly to a spouse, ie. there is no attribution of income to Dad in respect of a "pre" loan during 1985, 1986 and 1987, but if the loan is still outstanding after the end of 1987, attribution of the related income will commence in 1988. Income related to "post" loans attributes to the lender.

It is important to remember that loans, transfers, gifts, etc., to children which are over 17 years of age are not affected by the attribution rules. Only spouses and individuals under 18 are "caught."

There is also a fairly complicated family trust arrangement which has been in use for several years which involves a family trust owning participating shares of the family business corporation. Properly implemented, this arrangement still "works", but is not cost-effective for many situations.

Another income-splitting plan which has been used in the (more distant) past involved Dad loaning money to a corporation in which Mom and the kids owned common shares.

The idea was that the company would earn income, pay tax thereon, and distribute the after-tax profits to Mom and the kids as dividends.

Where the income being earned by the company was interest, this didn't often achieve much in the way of tax savings, as the income would be taxed in the corporation at the high rate, with some "refundable tax" when taxable dividends were actually paid (with a net tax rate to the corporation of about 33%).

Since the introduction of Part II tax on "low rate" business income, the tax cost to a company that earned business income and distributed the after-tax cash to shareholders has also been (theoretically) 33%, the potential tax savings in this situation again were often not remarkable. The current position on this type of approach would involve the following:

1. Interest-free loans to a corporation which are made after November 21, 1985 may give rise to some attribution implications. The relevant rules are very complicated and are not going to be discussed here.

Suffice it to say that if Dad loans money (or makes some other "transfer" of property for less than fair market value consideration) to an investment corporation at low interest, and Mom or the (under 18) kids receive dividends which relate to income earned on the loaned funds, those dividends will be taxed in Dad's hands.

2. Interestingly, there are no "phase-in" rules relating to such an arrangement. If a plan of this sort was put into place before November 22, 1985, it appears that it will "work" permanently, at least for the property transferred or loaned before that date.

3. These rules do not apply where the borrower is a "small business corporation" (SBC). An SBC is a company where substantially all (ie 90%) of the assets are used in an active business. In other words, splitting business income is OK, but splitting property income is not.

4. Remember that salary income generally does not attribute to anyone as long as it is reasonable and legitimately earned by the recipient. Where family members can reasonably be paid salaries by a company, there may be some advantage to incorporating investment income. What is reasonable? The case law is rapidly evolving in this area. A professional advisor should be consulted.

Under the "old" rules, having a spouse pay fair market value for a transferred asset did not remove the effect of the attribution rules. Now, paying fair market value will put the transfer outside the attribution rules, as long as there is no "rollover" of tax position between the parties.

Usually, non-arm's length transactions are deemed to take place at fair market value, with a specific rollover provided where capital property is transferred to a spouse. Spouses can "elect" not to have a rollover.

The new attribution rules include a variety of anti-avoidance rules . . .