Chartered Accountants

255 Duncan Mill Road
Suite 402, North York,
Ontario M3B 3H9
Phone: (416) 510-8888
Fax: (416) 510-2699
Email: dcy@dcy.ca

Tax Traps Associated with Using Family Members to Save Taxes - Volume 27

by David Chong Yen

Please note: This is the 1st of a 4 part article; in the 1st segment, we will identify tax traps. In the subsequent segments (2nd, 3rd and 4th), we will identify solutions.

Income splitting is a fundamental tax-planning tool and is synonymous with saving taxes. It usually involves deflecting income away from the higher income family member (taxed at a higher rate), to the lower income family member (taxed at a lower tax rate) to reduce the family's overall tax bill. However, to discourage income splitting among family members, the Canada Revenue Agency (CRA) enforces strict rules known as the attribution rules to prevent abuse of this concept.

Attribution rules or "tax traps relating to gifts" are as follows:

1. Spouse - If you gift money to your spouse and your spouse invests this gift, any capital gains/dividends/interest realized/earned from the investment will be taxed in your hands; i.e. will be included in your personal tax return.
2. Grandchildren/children 18 years of age or older (18+) - If you gift money to your grandchildren/children (18+) for investment, any capital gains/dividends/interest realized/earned from the investment will be taxed in their hands; i.e. will be included in their personal tax returns.
3. Grandchildren/children under 18 years of age (<18) - If you gift money to your grandchildren/children (<18) for investment, any capital gains realized from the investment will be taxed in their hands. However, if the investment earns dividends or interest, you will be taxed on this income.

Please note, the attribution rules do not apply if you sell property to your spouse at the fair market value; however, such a sale will likely result in a tax bill if there is a capital gain on the sale.

Attribution rules or "tax traps relating to interest free loans" are as follows:

1. Spouse - If you lend money to your spouse and do not charge interest and your spouse uses this loan for investment, any capital gains/dividends/interest realized/earned from the investment will be taxed in your hands; i.e. will be included in your personal tax return;
2. Grandchildren/children (18+) - If you lend money to your grandchildren/children (18+) on an interest free basis for investment, then any capital gains/dividends/interest realized/earned from the investment will be taxed in their hands.

3. Grandchildren/children (<18) - If you lend money to your grandchildren/children (<18) interest free for investment, any capital gains realized from the investment will be taxed in their hands. However, if the investment earns dividends or interest, you will be taxed on this income.

On the other hand, if the loan is interest bearing, then all investment income earned by your spouse will be reported on their tax return. The interest rate you must charge is set by the Canada Revenue Agency (4th quarter 2006 rate is 5%: i.e. if you lend money to your spouse, you must charge interest at 5%) and the annual interest must be paid by January 30 of the following year. When you set up an interest bearing loan with family members, it is advisable to document it by signing a promissory note detailing the date, amount of the loan, interest rate charged and the repayment terms etc.

Although we have detailed the attribution rules intended to prevent income splitting, there are still several legal opportunities that exist to split income and save taxes among family members which we will discuss in parts 2 through 4 of this article.

David Chong Yen, CFP, CA with an international firm background and more than twenty-four years of experience, advises healthcare professionals and owner-managers. Additional information can be obtained by phone (416) 510-8888, fax (416) 510-2699, or Email david@dcy.ca.
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