

Income-splitting to reduce your tax bite

A partnership of equals—except when it comes to taxation and investing.

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Most of us would agree a spousal relationship works best when it's a partnership of equals—except when it comes to taxation and investing. When one spouse earns more than the other, it opens up new potential for reducing taxes and increasing your after-tax investment income through the application of a few simple income-splitting strategies. And that is especially true right now thanks to the current—and very low—government prescribed interest rate on taxable benefits. Here's how you can benefit from splitting income with your spouse.

Low interest rates deliver bigger benefits

Each quarter the federal Canada Revenue Agency (CRA) establishes a new prescribed rate on taxable benefits. When the rate is low, it unlocks a dynamic tax-effective option if you have a spouse in a lower tax bracket.

Here's how it works: When one spouse loans money to another for investment purposes and does not charge an interest rate at least equal to the going market rate, or the CRA's prescribed rate at the time the loan was made, any resulting income and

capital gains are taxed in the hands of the spouse who made the loan. But, if the higher-earning spouse loans money to the lower income spouse and charges the prescribed rate of interest in effect at the time the loan is made, all income and taxable gains are taxed in the hands of the lower income spouse. The lower income spouse also deducts the interest paid—thus paying tax only on the net amount of investment income.

In order for this to work, the lower income spouse must actually pay the amount of interest owed to the higher income spouse within 30 days of each calendar year-end. The 'lending' spouse is then required to report the prescribed interest charged as taxable income. However, when the return from investment exceeds the prescribed rate, there is a gradual shifting of taxable income from the higher income spouse to the lower income spouse. The benefit is clear: Over time, if investment returns continue to exceed the cost of the loan, the investment grows at a more effective tax rate. For this strategy to work, it is very important that the borrowing spouse actually pays the interest on a timely basis.

Should interest rates rise, the loan rate need not be increased as long as the original loan remains in place. This "locking in" of the prescribed rate delivers a unique opportunity that can benefit you for years to come.

Take advantage of a Spousal RRSP

A higher-earning spouse who contributes to a Spousal Registered Savings Plan (RRSP) can reduce his or her taxes now, and the couple's combined taxes after retirement. Each tax year, the higher earning spouse makes the spousal contribution and claims the deduction. After retirement, the lower-earning spouse will likely be able to withdraw the RRSP proceeds and pay less tax than if one spouse received the bulk of the couple's retirement income.

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You can contribute to both your RRSP and a Spousal RRSP, although total contributions cannot exceed your available RRSP contribution room. Your spouse's own RRSP contribution limit is not affected by your contributions to a spousal plan. Remember, however, that by contributing to a spousal RRSP your contribution becomes the property of your spouse.

Pension income splitting

A person who receives "eligible pension income" (i.e. regular payments from a registered pension plan) or, if at least age 65, RRIF payments can allocate up to 50 percent of this income to the spouse for taxation purposes.

Decide who should buy the groceries

You can improve your long-term financial health and reduce taxes by deciding that the higher income spouse should spend and the lower income spouse should invest. If your income levels vary significantly, it's a good idea to have the partner with the lowest tax rate do most or all of the investing while the higher-earning partner pays for groceries and other daily living expenses. That way, over time, more investment income will be earned in the hands of the lower income spouse, and this should reduce the taxes on investment earnings and put more money in your pockets over time.

Income-splitting strategies are an important part of an effective financial plan. Talk them over with your Investors Group Consultant and put them into practice to reduce your tax bite and increase your after-tax investment returns.

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