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Vern Krishna: Income splitting promise appears wobbly



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Instead of relaxing income splitting rules, the June 6 budget tightens them and increases taxes on minors, writes tax lawyer Vern Krishna

Image: FOTOLIA

Tax promises, an intrinsic part of every election, can have a short shelf life. Thus, not surprisingly, Prime Minister Harper's campaign promise to allow income splitting between family members already appears wobbly. Instead of relaxing the rules, the June 6 budget tightens them and increases taxes on minors.

Individuals live in family units – typically, father, mother and minor children. However, for most purposes, individuals are liable for tax on their personal income. Since tax rates increase as income rises, the tax paid by a single earner family is considerably higher than would be payable by a two earner family with the same total income.

To be sure, there are various methods of income splitting amongst family members in order to reduce the family's overall tax burden. Most of the techniques are, however, sophisticated, involve professional fees and are subject to strict anti-avoidance rules. Hence, only high-income taxpayers can take advantage of plans that, for example, involve share capital structures to reduce taxes.

Anti-avoidance rules govern transfers of property to spouses, children under the age of 18 and other family members in non-arm's length relationships. For example, a broad rule taxes the lender on income from property that he lends to any non-arm's length borrower if his motive is to reduce or avoid tax.

Since dividends are eligible for the dividend tax credit, adult children can receive substantial dividends without tax. The dividend tax credit wipes out any potential tax liability on the income. Thus, a family with three adult children attending university could, for example, pay no tax on nearly \$90,000 of dividend income in the year.

However, the rules for splitting dividend income with minors are more difficult. A special “kiddie tax” of 29% – the highest federal rate – applies to the minor’s income as if he or she was in the top tax bracket. The latest budget expands the tax to apply also to capital gains. More ominously, the government says that it intends to monitor the effectiveness of the tax on split income and “will take appropriate action if new income-splitting techniques develop.” So much for the election promises!

Taxation of individuals as separate taxpayers penalizes spouses (generally women) who do not work outside the home. Allowing a family to split its taxes between the members of the immediate family would recognize the economic unit and contribution of stay at home women to the family.

To be sure, the tax statute allows patchwork income splitting – for example, spousal registered retirement savings plans under which the higher income spouse can contribute to his spouse’s RRSP – which may be taxable at her lower rate when she takes out money from the plan. We could simplify the Income Tax Act if we removed other prohibitions against income splitting amongst family members.

The tax system does an about face when it comes to collecting taxes from families. If an individual gifts property to his spouse, both spouses become jointly and severally liable for any tax owing at the time of the gift. The liability is equal to the shortfall between the value of the property gifted and the amount that he receives for the property.

The rule, which appears innocent on the surface, is quicksand for divorcing spouses. For example, assume that John owes business taxes of \$100,000 when he separates from his spouse, Mary. As part of the separation, John transfers his one-half equity interest in their \$300,000 home to Mary, who, at the time, is completely unaware that John owes taxes. After the separation, John disappears and emigrates to a warmer climate with his new friend. The CRA will come after Mary for the \$100,000 and throw her out of her house to get their money. There is no time limit on the CRA’s power to assess Mary.

The election of a majority government is an opportunity for leaders to make difficult decisions. The anti-income splitting rules are tax policy hangovers from the era of bell bottom pants. They should be updated to the economic realities of the 21st century. Taxation based on the family unit would be fairer tax policy. If properly implemented, it will simplify tax law, ease administrative compliance and reduce litigation, all with reasonable revenue loss. Expanding the kiddie tax is heading tax policy in the wrong direction.