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Tax Letter

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INCOME SPLITTING AND ATTRIBUTION RULES

The Canadian income tax system employs a graduated tax rate system, which means that the higher your taxable income, the higher tax rate or tax bracket that applies to the income.

As such, if you are in a high tax bracket and a family member is in a low tax bracket, it obviously would be beneficial to shift some of your income to them. For example, if you are in a 50% tax bracket and your spouse (or common law partner) is in a 20% tax bracket and you could shift $40,000 of income into their tax return, your family would save $12,000 of income tax, that is, $40,000 x (50% – 20%).

On top of that, every taxpayer in Canada gets at least one tax credit, being the basic personal tax credit. This credit effectively exempts from tax about $13,000 of taxable income (the actual number varies from year to year, as it is indexed to inflation, and the provincial amounts vary).

However, there are some significant barriers to income splitting amongst family members.

For example, you cannot simply direct that some of your employment income or business income be paid to your spouse or children with the expectation that you have achieved income splitting. Rules in the Income Tax Act will shut that down and ensure that you are taxed on that income at your tax rates.

Perhaps more significantly, there are also income attribution rules, which can apply to most forms of passive investment income. These rules can apply where you transfer or lend money or property to your spouse or minor child, and they use the property to earn income from property such as interest, dividends, or rent. When these rules apply, the income from the property is “attributed” to you and included in your income rather than their income.

In the case of a transfer or loan of property to your spouse, if they subsequently realize taxable capital gains from a sale of the property, the attribution rules can also apply and attribute the taxable capital gains to you, and you will therefore include them in income.

The attribution rules apply to losses as well as income. That is, if the transferred or lent property generates property losses or allowable capital losses, those losses are attributed to you.

The income attribution rules do not normally apply to taxable capital gains (or allowable capital losses) realized by your minor children. Therefore, you have a legitimate way of capital gains splitting with your children. For example, you could purchase common shares or equity mutual funds in their name (or as a bare trustee for their benefit), and any resulting taxable capital gains will be taxed in their hands rather than yours.

The income attribution rules can apply to income from “substituted property” (or, in the case of your spouse, taxable capital gains from substituted property). For example, say you transfer some shares to your spouse and the attribution rules apply to any income or gains from the shares. If your spouse sells the shares and uses the proceeds to buy other shares, or bonds, mutual funds or indeed any other income-producing property, the attribution rules can continue to apply to income or capital gains from that other property.

Fortunately, there are various exceptions where the income attribution rules do not apply.

Exceptions

The rules do not apply to you if you cease to be resident in Canada, or after your death.

In the case of transfers or loans to your minor children, the attribution rules do not apply in the year in which they turn 18 years of age and subsequent years.

The rules do not apply after you divorce (or cease to be common-law partners). If you are separated and living apart due to the breakdown of your relationship, the regular income attribution rules do not apply, but the capital gains attribution rules can apply while you are separated (and not divorced) unless the two of you jointly elect otherwise in a form filed with your tax returns.

The rules do not apply to business income. Therefore, for example, you can give cash or other property to your spouse or minor child which they use in their business, and any resulting business income is not subject to attribution.

The attribution rules obviously do not apply to property that generates no income or capital gains, or cash that is used simply for personal purposes. Therefore, for example, you could pay your spouse’s or child’s personal expenses or their income tax bill, thereby freeing up their own cash resources which they can invest without the attribution rules applying.

The rules do not apply if the property or cash you transfer to them is included in their income. For example, if your minor child works in your business and you pay them a reasonable salary that is included in their income (and deducted from your business income), any investment income that they earn by investing that salary is not subject to attribution. Of course, paying that salary is itself a valid method of income splitting, as it will reduce your income.

There is a "fair market value consideration" exception from the attribution rules. This exception applies if you sell property to your spouse or child and they pay you at least "fair market value" for the property. If they pay you by way of debt – that is, they owe you the fair market value amount – you must charge them at least the prescribed rate of interest under the Income Tax Act at the time of the debt (currently 1% per year), and they must pay you the interest on the amount owing in each year or by January 30 of the following year. If they are late or miss even one payment of interest, this exception no longer applies. Furthermore, in the case of a sale to your spouse, under the fair market value conditions exception you must elect out of the tax-free "rollover" that normally applies to prevent any capital gain when you transfer property to your spouse.

In a similar vein, there is a fair market loan exception. This exception applies where you lend cash or other property and charge them at least the prescribed rate of interest at the time of the loan. The prescribed rate of interest is set each quarter of each year, and is currently 1%. As above, this exception continues to apply only if they pay you the interest on the loan each year while it remains outstanding or by January 30 after the year. Interestingly, this exception can apply regardless of the term of the loan.

Example of fair market loan exception

You lend $1 million to your spouse when the prescribed rate of interest is 1%. The term of the loan is ten years. Over the ten years, your spouse uses the money to earn investment income and / or taxable capital gains at a rate of 6% per year ($60,000 per year).

If your spouse pays you the 1% interest ($10,000) each year or by January 30 after the year, the $60,000 will be included in their income and not subject to attribution. They can deduct the $10,000 interest paid to you, leaving them with a net $50,000 return, and you will include that $10,000 interest in your income.

Because of this exception, you have effectively shifted the net 5% annual return to your spouse. If you are in the highest tax bracket and your spouse is in a lower tax bracket, the tax savings over the ten years can be significant.

Loans to adults

Normally, the income attribution rules do not apply to transfers or loans to your children or adult relatives (other than your spouse) if they are 18 years of age or older.

However, there is a special attribution rule that can apply if you *lend* money to a related adult. Unlike the regular attribution rules, this rule can apply only if it can be reasonably considered that one of the main reasons for the loan was to reduce or avoid tax. The "main reason" does not have to be shown for the regular attribution rules.

To ensure this special rule does not apply, you should charge the prescribed rate of interest (currently 1%), and, like the exception discussed earlier, make sure they pay you the interest each year or by January 30 of the following year.

Lastly, even if the income attribution rules do not apply, certain types of income, such as dividends from private corporations, and income earned through a trust or partnership by providing services to a business of a related person, may be subject to the "Tax on Split Income" (TOSI) rules. We have discussed these rules in previous Tax Letters and will revisit the issue in a future Letter.

EXTRA DEDUCTIONS FOR COMMISSIONED SALESPERSONS

Employees are allowed fairly limited deductions in computing their employment income for tax purposes. For example, they can normally deduct union dues, professional fees, the cost of supplies, and home office expenses for items like rent, supplies, heat, utilities and maintenance. Certain conditions must be met. We provided information about deductible home office expenses in our June 2020 Letter. (As discussed in the next section of this Letter, the CRA will allow a simplified "flat rate" method for employees working at home during the Covid-19 pandemic.)

Additionally, and again subject to certain conditions, employees can deduct non-car travel expenses, such as airfare, train, taxicab, hotel and 50% of out-of-town meal costs incurred in the course of their employment duties. They can also deduct car expenses incurred in the course of employment like gas, maintenance, insurance, and car leasing costs. The deductions are not allowed if the employee is reimbursed by the employer, or if the employee receives a tax-free travel or car allowance, as the case may be.

Employees who are paid partly or wholly by commission based on sales or negotiation of contracts ("commissioned employees"), and who are ordinarily required to work away from their employer's place of business, can deduct certain additional expenses that are not allowed for other employees. These additional expenses include:

- Promotional and advertising expenses
- Leasing costs (say, from leasing a computer)
- Meal and entertainment expenses for clients or customers (but normally only 50% of these expenses are deductible)
- If they have a home office, a *pro-rata* portion of their property taxes and home insurance premiums

Commissioned employees can deduct the travel and car expenses listed earlier. If the travel and car expenses are less than their commission income for the year, they can deduct the additional expenses, but only to the extent that the total travel, car and additional expenses do not exceed the commission income.

Example

You are a commissioned employee and your commissions for the year are $40,000. Your salary is $80,000.
You incur $10,000 of the additional expenses listed above.

Scenario 1: You incur travel and car expenses of $45,000. In this scenario, you can deduct the $45,000, but not the additional $10,000 of expenses because the travel and car expenses already exceed your commissions.

Scenario 2: You incur travel and car expenses of $35,000. In this scenario, you can also deduct $5,000 of the additional expenses, for a total of $40,000, since the total deduction is limited to your commission income.

Note that the above rule does not apply to car costs that are interest expense on a car loan or capital cost allowance (tax depreciation) on the car. These expenses are claimed separately from the above rule, but are subject to certain monetary limits. The monetary limits are noted later in this Letter.

In all cases, the employee is required to have Form T2200 signed by their employer, certifying that they meet the conditions for the deduction.

EMPLOYEE HOME OFFICE EXPENSES:
FLAT RATE METHOD DURING COVID

As noted above and discussed in more detail in our June 2020 Tax Letter, employees can deduct certain home office expenses. Normally, you need to keep records or receipts, certain conditions apply, and the Form T2200 must be signed by their employer.

Obviously, during the current COVID-19 pandemic, many employees have been working from home. As a result, the Canada Revenue Agency will allow an alternative, simplified "flat rate" method for deducting home office expenses for the 2020 year. If you qualify and choose this method, you do not need to keep records or receipts or obtain the Form T2200.

You are eligible to use the flat rate method if you worked more than 50% of the time from home for a period of at least four consecutive weeks in 2020 due to the pandemic. If you were not required to work at home but your employer gave you the option to work at home because of COVID-19, you can still qualify. You can use the flat rate method only if you do **not** claim other employment expenses. In other words, you can use the method if you claim only home office expenses.

Under the flat rate method, you can deduct $2 for each day that you worked from home in 2020 because of COVID-19. The maximum you can deduct under this method is $400 (that is, $2 x 200 days). As a result, you should use this method only if you are not eligible for more than $400 of deductions under the regular rules.

The CRA has indicated that the flat method can be used for the 2020 tax year. It has not indicated whether the method can be used for the 2021 year.

PRINCIPAL-RESIDENCE EXEMPTION

If you sell your home for a gain, it is normally considered a capital gain. However, the principal residence exemption allows homeowners to sell their residences at a gain with no or little tax.

WARNING: *the principal-residence exemption does not apply if you bought or built the home with the intention (including "secondary intention") of selling it. Even if you move in and live there, if you sell the home soon afterwards (and certainly if you live there less than a year, or if you do this repeatedly with different homes in succession), the CRA will usually take the position that your gain is business profit, not capital gain. As a result, the CRA will deny you the principal-residence exemption and will assess you on the basis that* ***all*** *of the gain, not just half, is included in your income!*

The principal-residence exemption, when it applies, works as follows.

First, you compute your gain from the sale of the residence. This will be the amount by which your proceeds on the sale exceed your cost of the property and your selling costs (e.g. commissions).

Then, you determine how much of that gain is exempt. The exemption formula is:

> Exempt portion of gain = gain x (1+ # years as your principal residence) / # years you owned the property)

The fraction in the brackets cannot exceed 1 for the purpose of the exemption. (That is, you can't have an exempt amount more than the gain itself.)

Thus, if the property was your principal residence for all years of ownership, or all years but one, the entire gain will be exempt, and you will pay no tax.

In other cases, you may have to report a taxable capital gain.

> **Example**
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> You own a property which was your principal residence for 5 years. You owned the property for 10 years. You sell the property at a gain of $100,000.
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> Under the principal residence exemption, 6/10ths of the gain will be exempt. The other 4/10ths, or $40,000, is a capital gain, but since only half of capital gains are included in income as taxable capital gains, you will only include $20,000 in income.

So when is a home a principal residence for a year? Usually, it means you or your spouse or child "ordinarily inhabit" the home during the year. The CRA is very lenient in this regard, so living in the home for even a few weeks in the year can suffice. The home can thus include a cottage or other vacation property, and can be situated anywhere in the world.

However, you can designate only one property per year per family unit – you and your spouse and unmarried minor children – as your principal residence for that year. (The family unit rule applies for years of ownership after 1981. For prior years, each person in your family could designate one property.) Therefore, if you own more than one residence, when you sell one of them you will have to designate the years for which that property is to be considered your principal residence.

A special deeming rule applies where you have a residence that you inhabit, but subsequently move out and rent it to a third party. In these cases, if you make an election, you designate the property as your principal residence for up to four years while you rent it out, even though you are not living in the property in those years.

> **Example**
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> You buy a condo and rent it out for six calendar years. You then move in and live there for five years, and then sell it at a gain.
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> You can designate the condo as your principal residence for the five years that you lived there, plus four of the years you rented it out, for a total of nine years. Because of the above formula (including the +1 factor), most of your gain (10 / 11ths of the gain) will be exempt and not subject to tax.
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> The catch: You are still subject to the rule under which you can designate only one

property per year as your principal residence. So if you owned and lived in another home for the first six years, you could designate only one of the home or condo for each year.

The other catch: The election only works if you do not claim capital cost allowance (tax depreciation) on the condo while you rent it out.

CAR EXPENSE LIMITS FOR 2021

In 2021, the maximum tax-free car allowance deductible for employers for allowances paid to their employees remains the same as the 2020 amount: 59 cents per kilometre for the first 5,000 kilometres driven, and 53 cents per kilometre for each additional kilometre driven during the year. For the Northwest Territories, Nunavut and Yukon, the maximum deductible tax-exempt allowance is 4 cents higher: 63 cents per kilometre for the first 5,000 kilometres driven, and 57 cents per kilometre above that.

The rate to calculate the taxable benefit of employees relating to the personal portion of automobile operating expenses paid by their employers is decreased by one cent from the 2020 amount, to 27 cents per kilometre. For taxpayers who are employed principally in selling or leasing automobiles, the rate is decreased by one cent to 24 cents per kilometre.

For the deduction of car expenses, the limits have not changed since 2001. They are:

- For capital cost allowance (tax depreciation), the maximum cost of the car is $30,000, before applicable sales tax. (However, for eligible zero-emission vehicles such as electric and hybrid cars, the limit is $55,000, before sales tax.)
- For car lease costs, the maximum deduction is $800 before sales taxes per 30-day period. This can be reduced further if the manufacture's list price of the car exceeds $35,294.
- For interest on a car loan, the maximum deduction is $300 per 30-day period.

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