"What's yours is mine and what's mine is also mine"

The Canadian tax system is designed to tax individuals as opposed to family units. This results in Income Tax Act section 74, dealing with Attribution.

In its' simplest form the Attribution Rules imposed by the Income Tax Act state that "the taxpayer who earned the income pays tax on the income, and will pay tax on income earned from the income." As in most cases, there are exceptions to every rule.

The most common form of income being attributed back to the source is investment income between spouses. ITA section 74.1(1) outlines:

"Where an individual has transferred or lent property (otherwise than by an assignment of any portion of a retirement pension pursuant to section 65.1 of the Canada Pension Plan or a comparable provision of a provincial pension plan as defined in section 3 of that Act or of a prescribed provincial pension plan), either directly or indirectly, by means of a trust or by any other means whatever, to or for the benefit of a person who is the individual's spouse or common-law partner or who has since become the individual's spouse or common-law partner, any income or loss, as the case may be, of that person for a taxation year from the property or from property substituted therefor, that relates to the period in the year throughout which the individual is resident in Canada and that person is the individual's spouse or common-law partner, shall be deemed to be income or a loss, as the case may be, of the individual for the year and not of that person."

HUH? Let's try that again.

The working spouse earns the income, gives $10,000 to the non-working spouse who then invests the funds and earns $5,000 in investment income. The $5,000 is taxed on the working spouse's tax return. End of translation.

The application of this rule results in the higher income spouse paying tax on the $5,000 at their marginal tax rate rather than the much lower rate that would apply to the non-working spouse. In other words, "No Income Splitting."

Fortunately, the ITA also allows the spouses to jump through a series of hoops in order to by-pass this rule.

The working spouse will loan the funds to the non-working spouse. There will be a promissory note, with interest at the quarterly rates prescribed by CRA. The interest will be calculated and paid by the non-working spouse to the working spouse, no later than

January 30th, NOT January 31st of the following year. There will be a paper trail, therefore no cash or "deemed paid" interest payment; a cheque from one bank account to another is needed. The working spouse will claim the interest received from the non-working spouse as income, the non-working spouse will claim the investment income and also the interest carrying charge expense paid to the working spouse and the result … Income Splitting!

Simple right? So let's confuse the issue a little more and toss in minor children. We'll use the same situation. The working parent gives $10,000 to a minor child who then earns $2,000 in dividend income on the investment. Same result, the dividend income is attributed back to the working parent.

Let's say that the minor child invested the $10,000 in a publicly traded stock for a company developing a new video game. As luck would have it, the company stock skyrockets on the games' release and the minor child sell the stock for $50,000. Result is a $40,000 capital gain.

Section 74.2(2) addresses this situation. Attribution rules **do not** apply to Capital Gains and Losses and the resulting gain is deemed to be the income of the minor child. The minor child then purchases new computers, video games, a plasma television, a lifetime supply of junk food and retreats to their room until the age of 19.

Child Tax Benefits are paid to a supporting parent. In many cases the parents invest this monthly payment for the future educational benefit of the minor child. As the source of the funds is the supporting parent, the investment income earned is taxed in the hands of the supporting parent.

ITA section 74.2(2) also addresses attribution rules on this investment income, if you once again, structure things correctly. CTB payments received should be deposited into a separate and distinct investment account in the minor child's name. By doing this, and not mixing the benefits with other income sources, the resulting investment income is **not** attributed to the parents but is taxed in the hands of the minor child, again at a much lower or non-existent marginal tax rate.

In 2006 legislation was introduced to allow for qualifying pension income to be split between spouses. Pension income splitting became effective with the 2007 tax year and is the first time that the words income splitting have entered into the Income Tax Act equation with a positive connotation for the taxpayer.

What if …

So let's spend some time and "play" with the interpretation of the legislation.

"What's mine is mine and what's yours is also mine." All married couples have heard this saying. When dealing with the ITA attribution rules, is this still the case?

As outlined above, section 74.1(1) is pretty specific. It basically says that "What is mine will always be mine and what is yours will always be yours." ITA Section 74.5(11) refers back to the attribution rules and appears to contradict them.

> *"ITA 74.5(11) – Artificial Transactions: Notwithstanding any other provision of this Act, sections 74.1 to 74.4 do not apply to a transfer or loan of property where it may reasonably be concluded that one of the main reasons for the transfer or loan was to reduce the amount of tax that would, but for this subsection, be payable under this Part on the income and gains derived from the property or from property substituted therefor."*

If we take a moment and "decipher" this section, "Notwithstanding" means "regardless of what is stated anywhere else." Therefore, does ITA section 74.5(11) say that if the transfer or loan of property between spouses and reducing income taxes is the main reason for the transaction, then the attribution rules outlined in 74.5(11) do not apply?

CRA has published an Interpretation Bulletin on this topic, IT-511R, which addresses section 74.5(11). The example given in the interpretation bulletin states that; if you want to transfer attributable income from the lower income spouse to the higher income spouse, go ahead. My question is why would you want to do that?

In order to provide you with a little background on Federal Legislation let me cover the high points. Federal Legislation is interpreted as outlined in the Interpretation Act. Section 8.1 of this Act outlines the procedures regarding Property Rights.

Property Rights, for Federal legislation interpretation purposes, are governed by the common law (civil law in Quebec) of the Province of Residence. So follow this thought process:

If all Federal Legislation, including the Income Tax Act, is to be interpreted based on the common law of the Province of residence and the common law of the Province says that all property is joint and equally devisable, then shouldn't the income from joint investments also be considered the property and income of the joint spouses and taxed to their best overall advantage?

Perhaps one day the ITA legislation will be re-written to allow spouses to arrange their individual financial affairs to their best overall advantage, but for the time being, Attribution Rules remain.

As with all tax strategies and planning, structure is everything. Something to think about and keep you awake at night.

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