Whose Income is It?

By

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I. General Comment

In 1966, the *Carter Commission* recommended that the income tax system should consider the family (spouse and minor children) as the basic unit for determining tax liability. Canada did not accept the recommendation for various political reasons. As a result, the general rule in Canadian income tax law is that each individual member of the family is a separate taxpayer, has an independent status, and is liable for tax on his or her personal income. This has contributed to much of the complexity in the personal income tax system.

The question: “whose income is it?” actually has two answers. For commercial purposes, income belongs to the person who owns it as a matter of personal property law. Under the *Constitution*, this is determined according to provincial law. For federal tax purposes, however, an individual may be taxable on income that he or she does not own in a commercial sense but to whom the income is “attributed”.

The individual income tax structure is “progressive”, which refers to the individual tax rates in section 117, rather than the quality of the tax system. For example, the basic federal rate structure for 2019 is as follows:

Tax Brackets	% Rates
Up to $47,630	15.00
$47,631–95,259	20.50
$95,260–147,667	26.00
$147,668–210,371	29.00
$210,372 and over	33.00

Section 117.1 indexes the rates annually to account for inflation. Provincial taxes apply on top of the federal rates. Hence, the combined federal-provincial rates in the top bracket can exceed 50%. In Ontario, for example, the top marginal rate on income in excess of $220,000 is 53.53% (2019). They are slightly lower in British Colombia (49.80%) and Alberta (48%), and higher in Nova Scotia (54%).

This means that income taxed to only one member of a family will pay higher taxes than another family with an identical amount of income split between spouses. In 2019, for example, an individual in Ontario with $250,000 taxable income would pay $96,010 tax. In contrast, a family of two, each with $125,000 of taxable income, would pay combined taxes of $70,130, for net savings of $25,880.

The progressive tax structure is an incentive for high-income taxpayers to reduce their taxes by shifting income to members of their family in lower tax brackets. The more income that one can sprinkle amongst family members, the lower the overall taxes of the family. Thus, two gross incomes of $100,000 to each of two individuals are much more valuable in after-tax terms than gross income of $200,000 to only one individual.

Hence, where the members of a family have differential marginal tax rates, there is an economic incentive for higher rate taxpayers to shift their income to lower rate family members to achieve an overall tax saving for the family as a whole. Conversely, lower rate members may wish to shift their losses to higher marginal rate taxpayers in the family. There are several targeted anti-avoidance rules (TAARs) [known as the "attribution rules"] to prevent blatant income shifting between spouses[1] and controlled corporations. These rules can attribute income from property from the transferee of the property to the transferor.

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[1] The Act uses a broad concept of spouse to include common-law partners and same-sex married relationships – see: para. 248(1) "common law partner".

Professionals and entrepreneurs can also split business income by using corporations. For example, an individual can incorporate a company and have it issue different classes of shares to each member of his or her family. The corporation can then sprinkle dividends amongst the family members according to their financial circumstances. Dividend-sprinkling would reduce each family member's marginal rate of tax and the overall family tax burden.

In a slightly more sophisticated variation one might interpose a trust between the corporation and each member of the family and have the trustee sprinkle the dividends according to each member's financial circumstances.

The Act has numerous targeted attribution rules that levy a tax on split income (TOSI) to discourage income-splitting amongst the immediate family and in non-arm's length relationships [see, for example, section 120.4]. These rules, which are intended to protect the integrity of the progressive tax rate structure by preventing downward rate-shifting from high-rate taxpayers to their children, are enormously complex and beyond the understanding of most taxpayers. Nevertheless, they impose a significant financial burden for professional advice and compliance, which, in Adam Smith's words, constitute "deadweight loss".[2]

It is important to note that the rules do not affect the underlying property and commercial rights of the parties to property transfers. For example, where an individual transfers shares to his infant daughter to split his investment income, the transfer is valid for purposes of commercial and property law, which are within the constitutional jurisdiction of the provinces. The federal attribution rules apply only for tax purposes.

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[2] Adam Smith, *The Wealth of Nations*, W. Strahan and T. Cadell, London (1776).

Apart from the specific attribution rules, however, there is no general scheme in tax law to prevent income-splitting.[3] Indeed, the Act even promotes income-splitting in certain cases.[4] Thus, we need to evaluate each income-splitting structure on its own facts and rules, which may depend upon the relationship between parties, their ages, and matrimonial status at the time of transfer.

II. Indirect Payments

A taxpayer who transfers income or property to another taxpayer may be deemed to have "constructively received" the diverted income or property.[5] For example, an individual who directs his employer to deposit his pay cheque directly into his spouse's savings account is liable for tax on the salary, even though the taxpayer relinquishes commercial ownership and control over the property. For tax purposes, the taxpayer retains "constructive" ownership of the property. This rule prevents taxpayers from artificially reducing their taxable income by diverting funds to family members with lower marginal tax rates. The constructive ownership doctrine does not apply where a taxpayer directs that a portion of his or her Canada Pension Plan be paid to his spouse.[6]

Subsection 56(2) applies the doctrine of constructive receipt of income where a taxpayer transfers property:[7]

1. To a person;

2. At the taxpayer's direction, or with the taxpayer's concurrence;

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[3] *Neuman v. M.N.R.*, [1998] 3 C.T.C. 177, 98 D.T.C. 6297, [1998] 1 S.C.R. 770 (S.C.C.).

[4] See, for example, the rules permitting deductions to spousal RRSPs (para. 74.5(12)(a) and subs. 146(5.1)) and the pension income splitting rules in para. 60(c).

[5] Subs. 56(2); see also IT-335R2, "Indirect Payments" (September 11, 1989).

[6] Including a prescribed provincial pension plan (see regulation 7800).

[7] Subs. 56(2). IT-335R2, "Indirect Payments" (September 11, 1989).

3. For the benefit of the taxpayer or a person whom he or she wishes to benefit, *and*

4. The payment or transfer is of a type that would ordinarily have been included in the taxpayer's income if he or she received it directly.

In these circumstances the Act deems the transferor to receive the payment or transfer directly.[8]

In *Neuman*, the Supreme Court held that the doctrine of constructive receipt does not normally apply to family income-splitting arrangements involving dividends.[9] The directors of a corporation who declare a dividend do so in their capacity as directors and fiduciaries. The income belongs to the corporation until it is declared as a dividend. The fourth condition implies an "entitlement requirement", that is, unless the taxpayer had a pre-existing entitlement to the dividend income paid to the shareholder of the corporation, the fourth precondition is not satisfied. An unpaid dividend remains in the corporation's retained earnings if it is not paid to the shareholder of record. Thus, subsection 56(2) cannot apply to dividends if the fourth test is not satisfied.[10]

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[8] *Neuman v. M.N.R.*, [1998] 1 S.C.R. 770, [1998] 3 C.T.C. 177, 98 D.T.C. 6297 (S.C.C.); *McClurg v. M.N.R.*, [1990] 3 S.C.R. 1020, [1991] 1 C.T.C. 169, 91 D.T.C. 5001 (S.C.C.) (income not attributed to director of corporation for participating in declaration of corporate dividend); *Boardman v. The Queen*, [1986] 1 C.T.C. 103, 85 D.T.C. 5628 (F.C.T.D.) (shareholder taxable on diversion of corporate assets to settle financial obligations on divorce); *M.N.R. v. Bronfman*, [1965] C.T.C. 378, 65 D.T.C. 5235 (Ex. Ct.) (directors of corporation liable for taxes on account of gifts to relatives in need of financial assistance; combining subs. 15(1) and 56(2)); *Reininger v. M.N.R.*, 58 D.T.C. 608 (corporate loan to wife of principal shareholder taxable to him under subss. 15(2) and 56(2)); *Perrault v. The Queen*, [1978] C.T.C. 395, 78 D.T.C. 6272 (F.C.A.) (waiver of dividend by majority shareholder in favour of minority shareholder was dividend income); *New v. M.N.R.*, [1970] Tax A.B.C. 700, 70 D.T.C. 1415 (T.A.B.) (controlling shareholder in receipt of income for benefit conferred on son through rental of corporate property to son at less than fair market value).

[9] *Neuman v. M.N.R.*, [1998] 1 S.C.R. 770, [1998] 3 C.T.C. 177, 98 D.T.C. 6297 (S.C.C.).

[10] *Neuman v. M.N.R.*, [1998] 1 S.C.R. 770, [1998] 3 C.T.C. 177, 98 D.T.C. 6297 (S.C.C.) (dividends paid to controlling shareholder's spouse not taxable in his hands despite absence of any "contribution" by spouse). *The Queen v. McClurg*, [1988] 1 C.T.C. 75, 88 D.T.C. 6047 (F.C.A.); affd. [1991] 1 C.T.C. 169, 91 D.T.C. 5001 (S.C.C.), *per* Urie J.:

The language of the subsection [56(2)] creating the essential ingredients required in its application, viewed in light of its purpose, is simply not apt, in my opinion, to encompass the acts of a director when he participates in the declaration of a corporate dividend unless it is read in

For example, in a closely held family corporation, dividends to the taxpayer's spouse on her *independently* purchased shareholdings do not come within the doctrine of constructive receipt. This is so even if the taxpayer waives his right to receive a dividend, because the waived dividend remains in the corporation's retained earnings. The situation is different, however, if the shareholder of record directs the corporation to pay his dividend to his spouse.

Subsection 56(2) does not apply to assignments to a spouse or common law partner of any part of the taxpayer's 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 the *Canada Pension Plan*. Section 65.1 of the *Canada Pension Plan* allows for the assignment of a portion of a contributor's retirement pension to his or her spouse or common-law partner in certain circumstances. The assigned amount will be included in computing the income of the recipient spouse.

Subsections 56(2), (4) and (4.1) do not apply in respect of amounts included in a minor's split income. Thus, amounts taxed as split income in the hands of a minor child are not also attributable to another person.[11]

A. Transfers of Rights to Income

The doctrine of constructive receipt also applies where a taxpayer transfers *rights to receive income* (as opposed to the income itself) to another individual.[12] The essence of this type of transfer is that

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its most literal sense. To do so ignores the existence of the corporate entity. Only the most explicit language, which is not present in subs. 56(2), would justify the notion that a director acting as such could be seen as directing a corporation to divert a transfer or payment for his own benefit or the benefit of another person, absent bad faith, breach of fiduciary duty or acting beyond the powers conferred by the share structure of the corporation, none of which bases have been alleged here.

See also: Vern Krishna and J. Anthony VanDuzer, "Corporate Share Capital Structures and Income Splitting: *McClurg v. Canada*" (1992-93), 21 Can. Bus. L.J. 335 at 367.

[11] Subs. 56(5).

[12] Subs. 56(4).

the individual transfers the right to all future income but not the ownership of the underlying income-generating property. Thus, the transferee then owns the *right to all future income or revenues* that the property may yield, but does not own the property itself. For example, in *Boutilier*[13] in a blatant form of income diversion, the Tax Court applied subsection 56(4) to a financial planner who directed that "trailer fees" from his sales commissions be paid to his corporation.

B. Interest-Free or Low-Interest Loans

A taxpayer can also shift her tax burden by loaning money at rates lower than the commercial rate of interest. For example, in the simplest case, an individual can make an interest-free loan to her spouse. Where one of the main reasons for making the loan is to reduce or avoid tax in a non-arm's length transaction, the borrower's income from the loan is deemed to be the income of the lender.[14] Any income from property substituted for the loan, and income from property purchased with the loan, is also included in the lender's income.

Example

Jane loans $50,000 to her spouse, who earns 10 per cent by depositing the money in a high-yield bond. If one of the main reasons for the loan is to shift her income to her spouse, Jane will taxable on the $5,000 interest income for the year.

Similarly, if Mark loans $100,000 to his niece (Audrey) at 5 per cent interest per year so as to reduce his tax burden, and Audrey purchases an investment certificate yielding 8 per cent per year, the *net* income of $3,000 from the investment certificate will be taxable to Mark.

The phrase "one of the main reasons" appears is several provisions of the *Income Tax Act* and, unfortunately, is interpreted too broadly to mean *any* purpose, rather than its more natural meaning of the "driving purpose" of the transaction[15]. See, for example, the interpretation of the Federal

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[13] 2007, TCC 96.

[14] Subs. 56(4.1).

[15] See, for example, subs. 83(2.1).

Court of Appeal in *Groupe Honco*, 2013 FCA 128: "one of the main purposes" … "…implies that a taxpayer may have more than one main motive in acquiring shares"; and Hogan J. in *Mady v. The Queen,* 2017 TCC 112: "Even if I accept that one of the purposes of the transfer … was to ensure compliance with the new … share ownership restriction…, this does not override…that the other main purpose of structuring the transaction … was to trigger the application of the attribution rules.

III. Transfers/Loans to Spouse

An individual who transfers or loans property, directly or indirectly, to his spouse or common law partner or to a person who becomes his spouse or common law partner after the transfer or loan of property, is taxable on any income from the property or from any property substituted for the transferred property. Attribution of any income or loss from the property to the transferor continues during his lifetime as long as he resides in Canada and lives with his spouse or common law partner.[16]

Any gains or losses on capital account that the transferee realizes on the disposal of transferred property (or property substituted therefor) are also attributed to the transferor and will not be taxed in the hands of the transferee if the disposition occurs when the individual was resident in Canada and the recipient was still the individual's spouse or common-law partner. [17]

Thus, in both cases, the transferor is deemed to have constructively received the transferred income (loss) or taxable gain (loss). These rules apply only to income and losses from *property* and do not apply to income and losses from a business.[18]

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[16] Subs. 74.1(1). *The Queen v. Kieboom*, [1992] 2 C.T.C. 59, 92 D.T.C. 6382 (F.C.A.) (income from taxpayer's gift of non-voting shares to wife and children subject to attribution).

[17] Subs. 74.2(1).

[18] See *Robins v. M.N.R.*, [1963] C.T.C. 27, 63 D.T.C. 1012 (Ex. Ct.) where Noel J. had this to say about the predecessor sections to s. 74.1:

There is normally no capital gain realized upon a transfer of capital properties between spouses unless the transferor elects to recognize any such gain [section 73]. However, future gains may be attributed to the transferor spouse when the transferee disposes of the property.

Example

Jennifer gifts shares with a fair market value (FMV) of $50,000 to her spouse (Matilda). The shares produce annual income of $4,000. The $4,000 will be taxable to Jennifer so long as they remain married and continue to reside in Canada [ss. 74.1(1)]. If Matilda sells the shares for a capital gain of $20,000, the gain will also be taxable to Jennifer [ss. 74.2(1)].

Subsection 74.2(2) ensures that the transferor can claim the attributed capital gains for the purposes of claiming the capital gains exemption.

IV. Exceptions to the Spousal Attribution Rules

There are several exceptions to the application of the attribution rules, which do not apply to:

- Business income;
- Second generation income;
- Sales at fair market value (FMV) if the purchaser pays the vendor for the property [ss. 74.5(1)];

Section 21 as well as Sections 22 and 23 are designed to prevent avoidance of tax by transfer of income producing property to persons who are normally in close relationship with the transferor. But what is deemed to be the income of the transferor, and this is clearly stated, is income from property only. Indeed, there is no mention of income from a business such as we have here and, therefore, this section can be of no assistance in determining whether the business profit resulting from a real estate transaction is taxable as income of the appellant or of his wife.

See, also, *Wertman v. M.N.R.*, [1964] C.T.C. 252, 64 D.T.C. 5158 (Ex. Ct.) (spouses' joint investment in building with funds from community property); *M.N.R. v. Minden*, [1963] C.T.C. 364, 63 D.T.C. 1231 (Ex. Ct.) (lawyer advanced money to spouse for investments without documentation, interest or security). For the distinction between income from business and.

    - However, in order for the transferor to opt out of attribution of income and capital gains, he or she must also elect out of the rollover under subsection 73(1) and elect FMV for the transfer.
- Loans for value that bear at least commercial or prescribed rates of interest [ss. 74.5(2); Reg. 4301(c)].
    - However, the borrower must pay the interest within 30 days of the end of the year;
- Spousal RRSPs [para. 74.5(12)(a)];
- Transfers when the "kiddie tax" applies under §120.4 [§74.5(13); or
- Transfers upon marital or relationship breakdown [ss. 74.5(3)-(4)].

V. Separated Spouses or Common-Law Partners

The income attribution rules do not apply when spouses or common law partners are living separate as a result of their marriage breakdown [ss. 74.5(3)]. Any income arising from the transferred property will be included in the transferee's taxable income. This rule is automatic and no election is required.

The CRA's view is that "living separate and apart" due to breakdown of a common-law relationship does not require the 90-day continuous relationship for the purposes of determining the separation period in the relationship [see, for example, 2012-0438021E5].

However, attribution of capital gains will continue unless the separated parties file a joint election when property is transferred pursuant to a written agreement or court order.

Hence, on separation, the transferee will probably want the attribution rules to apply and the transferor will not.

Similarly, the attribution rules in respect of transfers to corporations (other than small business corporations)[19] in which the spouse has a direct or indirect interest generally do not apply to the period during which the spouses are living separate and apart by reason of a breakdown of their marriage.[20]

VI. Transfers/Loans to Persons Under 18 Years of Age

An individual who transfers or loans property to a person under 18 years of age with whom he does not deal at arm's length, or is the transferor's niece or nephew, is taxable on any income that the transferee earns on the property.[21] Thus, any income and losses that the transferee realizes from the transferred property are attributed to the person who transferred or loaned the property.

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[19] Para. 74.4(2)(c).

[20] Subs. 74.5(4).

[21] Subs. 74.1(2).