NATIONAL POST

SATURDAY, AUGUST 20, 2005

Splitting the difference is easy for some: Ontario doctors, dentists, can flow income to families

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The Pandora's box of income splitting was pried open a little wider in May when the Ontario budget announced provisions that will make it easier for doctors and dentists to split income with family members.

That lawyers and accountants are being excluded from this largess is typical of the uneven way the federal government and provinces approach taxation on income splitting.

Ottawa has done all it can to quash any attempts by high-income earners to transfer taxable income into the hands of spouses or children in lower tax brackets.

"There are fewer and fewer income-splitting opportunities left," says Adrian Mastracci, president of Vancouver-based KCM Wealth Management Inc.

One still-valid strategy is for the spouse in the higher bracket to pay the household bills, while the spouse in the lower bracket invests the non-registered funds so investment income is taxed in the latter's hands.

But Mastracci warns against just putting extra cash "willy-nilly" in joint accounts. If one spouse didn't earn the cash to invest in the first place, attribution rules mean the investment income must be taxed in the sole breadwinner's hands, thereby frustrating the attempt to split income.

As the C.D. Howe Institute noted in a 2002 paper, income splitting between spouses is generally forbidden. A prominent exception is the permitted "sharing" of income paid out by the Canada and Quebec Pension Plans; a second is spousal contributions to registered retirement savings plans. But participants in registered pension plans still cannot split pension income, a fact lobby groups for the retired are challenging.

Historically, the self-employed have had more opportunities to split income with family members. A family business can still pay teenagers or others for actual services rendered.

However, the federal government has clamped down on the once-common practice of flowing passive corporate dividend income into the hands of those under 18. This is the "kiddie tax," known officially as the Tax on Split Income.

But there's more than one way to skin a cat. Ontario's doctors and dentists were handed a gift at Ottawa's expense in the last provincial budget. As of Jan. 1, 2006, Ontario will permit non-professionals to become shareholders in a professional corporation (henceforth, PC).

That seemingly innocuous change should enable income splitting, provided things are handled properly.

It became possible for professionals to incorporate in Ontario in 2002, conferring various tax deferral and capital

gains advantages. As the accompanying table illustrates, this is now standard in all provinces and territories.

Until now, there were pros and cons to PCs. But for doctors and dentists, Ontario's new, gentler approach to income splitting should tip the scales in favour of PCs. With some of these professionals netting upward of $300,000 a year, income splitting could result in tens of thousands of dollars a year in tax savings, says Sandy Cardy, vice-president of tax and estate planning for Mackenzie Financial Corp.

Cardy has been packing them in for a series of seminars on the topic. She warns there are two unsettled questions regarding expanded shareholders. The first involves which relatives will be included in the term "family member."

"While we are certain that married spouses and children will be included, it is unclear what other family members may be," Cardy says.

Also unsettled is whether shares can be held by a family trust. If Ontario agrees to permit such arrangements, Cardy suggests doctors and dentists consider making a trust a shareholder of the corporation, and designating family members beneficiaries of the trust. That would confer more flexibility on income splitting while also providing some protection for the family members' capital.

She provides an example of a family comprised of a fiftysomething couple and three children, aged 16 to 22. Dr. Smith, MD, has a PC and personally owns 100% of the voting shares. The Smith Family Trust owns all the common non-voting shares in the corporation.

All five family members are beneficiaries of the trust. Dr. Smith is the sole breadwinner and all income is distributed as dividend income. His wife can receive $30,000 tax-free from the PC because of her personal tax credits.

The children in university (if 18 or older) can each receive more than $40,000 tax-free due to the added benefit of tuition and education credits. The 16-year-old child will not be paid a dividend until the year in which she turns 18, in order to dodge the kiddie tax.

This example represents tax savings of more than $40,000, compared with an unincorporated practice with the same family situation.

Cardy says Ontario had lagged other provinces in adjusting shareholder rules for corporations. Not all provinces permit non-professionals to become shareholders and hence allow families to practice income splitting.

In Professional Corporations: The Secret to Success, by Timothy Paziuk (aimed at doctors and dentists), Ontario was one of four provinces that did not permit non-professionals to be shareholders. (The others are Alberta, Newfoundland and Quebec.)

Not shown in the table above is whether trusts can be shareholders, or whether shares can be owned by a holding company. In most cases, the answer is the same as the one about non-professionals. Cardy says it's not yet clear what Ontario's plans are for trusts and holding companies.

As for the differential treatment of professions, it appears to be a case of the squeaky wheel getting the grease. During the budget, Ontario Finance officials told me the medical community approached them to request the change.

In this case, the federal government will take the tax hit – ironic given its opposition to most attempts to make income-splitting taxation rules more equitable.

Last October, Daniel Braniff, chairman of the Georgian Bay chapter of the Canadian Association for Fifty Plus (formerly CARP), filed a request to the standing committee on finance to eliminate the "single-income tax penalty" for retired Canadian couples.

Braniff says CARP is working to get the issue on the platform of the Conservative party.

The perceived inequity is that a family living on a single large income ends up paying more tax than a family where two spouses are earning smaller incomes. Braniff provided an example of $60,000 in household income and found a 42% disparity in taxation.

Thus, a sole breadwinner in British Columbia (in 2002) earning $60,000 would pay $12,849 in tax. Compare that to the $9,053 tax paid by a dual-income family where each earns $30,000 a year.

The stumbling point to permitting this change for retirees is the perceived unfairness to couples still in the workforce.

But unfairness seems to be the norm when it comes to uneven taxation on split incomes. Just ask the Ontario lawyers and accountants who are helping medical professionals enjoy a tax benefit they themselves are denied.