The "kiddie tax": Some simple planning

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With much fanfare, the "kiddie tax" was introduced into Canadian tax law effective January 1, 2000. My, how time flies. It does not seem like it was 11.5 years ago that such a tax was introduced to prevent income splitting mischief.

The "kiddie tax" applies on certain types of income ("split income") received by a child (under the age of 18 throughout the year – the "minor") who has a parent that is resident in Canada at any time during the year. If applicable, the minor child will end up paying income tax at the highest personal tax rate that would otherwise be payable on the type of income received. In addition, the parents generally have joint and several liability for the tax.

The most common type of income to which the "kiddie tax" applies is dividend income from a private corporation. It used to be routine planning to have a trust with a minor child as a beneficiary (or have the minor child own the shares directly in the private corporation to the extent that a lawyer would give a legal opinion that the minor child could hold such property) and ultimately pay dividends to the minor child. Prior to the introduction of the "kiddie tax," such a simple plan was an effective income splitting tool since a child could use up their personal tax credits and in many cases pay no personal income tax up to certain levels of income.

Another common plan prior to year 2000 was to have a partnership whereby the child (or a trust of which the child was a beneficiary) would be a partner and have the partnership receive income from a related entity. For example, the partnership could provide management or administrative type services to a corporation owned by "Mom" or "Dad" or both. Such income received by the partnership could then be easily allocated to the partners (of which a minor child would be a direct or indirect beneficiary of such partnership income) thus again providing for simple yet effective income splitting.

Both the dividend sprinkling plan and the partnership type plan described above are subject to the "kiddie tax" to the extent that the income is received by a minor child thus eliminating any income splitting advantage associated with such plans.

One of the most common types of taxable income that is **not** split income and therefore not subject to the "kiddie tax" is capital gains. Accordingly, many plans involving related private corporations were put in place so as to recognize capital gains. The plan generally involved having certain shares of a private corporation being sold to a related company with the resulting capital gain being taxable in the minor child's hands. Prior to the 2011 Federal Budget, such a plan was often used to the extent that the practitioner and their client believed that the general anti-avoidance rule ("GAAR") would not apply. The Canada Revenue Agency, however, was not amused and would often times apply the GAAR to such a plan (with many cases still in the system). The 2011 Federal Budget has introduced a legislative fix to such a plan whereby after March 22, 2011 such capital gains will now be subject to the "kiddie tax." However, other capital gains realized by a minor (for example, from a publically traded portfolio of assets or shares of a private corporation disposed of to an arm's length person) will continue to not be subject

to the “kiddie tax.” As such, capital gains realized and taxable in the hands of a minor either directly or indirectly is still a common and effective income splitting tool.

Further, partnerships or trusts that provide services to arm’s length parties are also not subject to the “kiddie tax.” For example, let us assume that Mom, Dad and a trust for their minor children are partners in a partnership. The partnership carries on the business of selling sandwiches to the public. To the extent that the partnership realizes profits, a reasonable allocation of partnership income can be made to the minor child (either directly or indirectly) without the incidence of the “kiddie tax.” (Section 103 must always be considered when dealing with partnership income allocations since unreasonable allocations might be reallocated by the CRA to a more reasonable allocation after all the factors are considered).

While the “kiddie tax” certainly provides a wrench for simple income splitting plans using minor children, effective planning can still be done today. However, professional advice should always be sought before implementing any income splitting plan. The professionals at Moodys LLP Tax Advisors would be pleased to assist you in developing an effective plan.