

Split Your Income - Save Tax!

“The hardest thing in the world to understand is the income tax” – Albert Einstein.

“Prescribed Rate Loan”

Well you don't have to be Albert Einstein to know that in Canada's marginal tax rate system it would be most beneficial to get income taxed at a lower rate perhaps by having it taxed in the hands of your spouse or children.

One way to achieve this income splitting is through the use of a “prescribed rate loan” and the time to set one up has never been better. From now until at least June 30, 2009 the Canada Revenue Agency (“CRA”) prescribed interest rate is set at 1% - an all-time low!

The prescribed rate is the base interest rate used in the calculation of all interest rates referenced in the Income Tax Act. It is established each calendar quarter as the effective yield (rounded to the next higher whole percentage) on a 90 day Government of Canada Treasury Bill issued during the first month of the preceding quarter. The prescribed rate is also used to determine whether or not an income splitting arrangement between spouses or minor children is allowable.

Normally, the income attribution rules apply if you gift or lend (at less than the prescribed rate) money to your spouse or minor children. The result is that any income earned on the borrowed funds is taxed in the lender's hands. The attribution of the income eliminates the tax benefits of making the gift or loan.

However, if you properly set up a “prescribed rate loan” the attribution rules do not apply and you can effectively split income with a lower income family member. A properly set up loan requires a written agreement that stipulates interest be paid at an amount at least equal to CRA's prescribed rate in effect at the time the loan was made. In order to remain outside, the interest must be paid within 30 days of the end of the calendar year in each and every year the arrangement exists. It should be noted that the prescribed rate used to determine attribution is set at the time the loan is made and will not change even if the prescribed rate changes. This makes locking in now all the more important.

Assume a husband and wife are in a situation where the husband is taxed at the lowest rate while the wife is taxed



at the highest rate. If a \$100,000 loan at 1% is made to the husband by the wife, assuming the return generated is greater than 1%, you will have effectively saved over 25% in tax for an Ontario resident on the additional net investment income (46.4% highest rate vs. 21.05% lowest rate).

In the situation described above, the wife would report \$1,000 of interest income ($\$100,000 \times 1\%$) on her tax return in the year(s) the interest is received. The husband would get a deduction of \$1,000 for the interest paid to earn investment income. Assuming the loan remains outside (the interest is actually paid), the attribution rules would not apply and any income earned on the \$100,000 will be reported on the husband's personal income tax return in the year(s) it is earned.

Existing Arrangements

It may also be possible for individuals with existing prescribed rate loans/income splitting arrangements in place to take advantage of the lower prescribed rate. However, this requires proper structuring to not fall afoul of CRA's rules. Income Tax Act Subsection 74.1(3) prevents the straight substitution of a new low rate loan for an existing loan. The restructuring would need to ensure that there is a legal repayment of the existing loan and the issuance of a new and distinctly different loan otherwise CRA may “look through” the restructuring of the lending arrangement by taking the position that the new loan is really just a continuation of the existing loan at a lower interest rate.

Of course, the best way to ensure the restructuring is done properly is a repayment of the existing loan in cash, a separation of time and then a new cash loan, perhaps even for a different amount. This may not always be practical as it may require liquidation of the investment portfolio by

the borrower to provide the cash for the repayment. To avoid this problem, there could be a partial repayment of the existing loan followed by the issuance of a new loan (preferably after a separation of time and for a different amount as discussed above). Until the balance of the existing loan is repaid in full there would be two loans outstanding at different interest rates.

The use of a prescribed rate interest loan, especially at the historically low rate currently in effect, provides a great tool for couples or families looking to effectively split income. It is an avenue that is obviously more beneficial when there is a greater difference in the marginal tax rates of the individuals involved.

Capital Loss Transfers

In addition to the use of prescribed rate loans, there are other tax saving/income splitting possibilities dictated by the current economic conditions. One such possibility is the transfer of capital losses. The current economic “downturn” has many Canadians sitting with large losses in their portfolios. Realizing these losses now is of little tax value unless you have realized capital gains in the past three years. With the exception of the year of death, capital losses can only be used to offset income from capital gains. Any losses realized in the current year (net of any capital gains) can be carried back to offset capital gains reported in the previous three taxation years or carried forward indefinitely to offset future capital gains.

If you have not realized capital gains in the past three years, you might want to transfer the loss to your spouse if they can use it now, rather than hanging on to an asset which has decreased in value. By relying on the definition of an affiliated person (which includes your spouse) and the superficial tax loss rules, in a few simple steps you can transfer your losses to your spouse for use now rather than waiting for the market to turn around.

Income Tax Act Subsection 40(2)(g) deems a taxpayer’s loss, to the extent that it is a superficial loss, to be nil. A superficial loss occurs where during the period that begins 30 days before and ends 30 days after the disposition of the investment, the taxpayer or a person “affiliated” with the taxpayer buys, or has a right to buy, the same or identical property (called “substituted property”) and the taxpayer or a person “affiliated” with the taxpayer still owns or has a right to buy the substituted property 30 days after the sale. While the loss is deemed to be nil for the spouse transferring the investment, generally, the loss can be added to the adjusted cost base of the substituted property acquired by the affiliated person.

An “affiliated” person includes your spouse (or common-law partner). It can also include a corporation that is controlled by you or your spouse/common-law partner. The affiliated rules can also include partnerships and trusts.

To execute a capital loss transfer transaction, one spouse

would sell their investment and within 30 days either before or after the sale, the other spouse would purchase the identical investment. The acquiring spouse must hold the investment for at least 30 days after the sale by the original owner, and thereafter can sell it, if desired. The acquiring spouse’s adjusted cost base for the investment is their cost to acquire the investment increased by the amount of the superficial loss.

The following example illustrates how a capital loss transfer transaction as described above would take place between spouses.

Mr. Scharf is a hard luck investor who just cannot seem to pick a winner. Mrs. Scharf on the other hand is a shrewd investor who is always picking winners. In January, Mr. Scharf acquired shares of Profitco at \$100 which are now only worth \$40. If Mr. Scharf were to sell his shares he would incur a capital loss. Assuming he did not have any capital gains to offset the loss this year or in any of the three previous taxation years, Mr. and Mrs. Scharf may want to take advantage of the capital loss transfer provisions.

Mr. Scharf would sell his shares on the open market for the fair market value (\$40). Within 30 days either before or after the sale, Mrs. Scharf would buy the same number of shares on the open market for fair market value (assumed to still be \$40). The superficial loss rules deem Mr. Scharf’s loss to be nil. The adjusted cost base of Mrs. Scharf’s shares would be \$100 (the \$40 she paid plus the \$60 superficial loss on Mr. Scharf’s disposition) the same as Mr. Scharf’s cost base prior to selling his shares. Provided she holds the shares for at least 30 days after Mr. Scharf’s sale, Mrs. Scharf would realize a capital loss when she subsequently sold the shares on the open market on the assumption that the fair market value did not exceed \$100 at that time. If the fair market value at the time of Mrs. Scharf’s sale remained at \$40 she would realize the same \$60 loss that Mr. Scharf would have realized if not for the superficial loss rules. Provided the transactions took place as described with the mandatory 30 day limits being met, Mrs. Scharf would have a \$60 loss (\$30 net capital loss) that she could use to offset her other capital gains realized in the year (or carry them back up to three years). This provides immediate tax savings to the Scharfs as opposed to waiting for Mr. Scharf to eventually realize capital gains in the future.

The use of capital loss transfers can be quite beneficial in these tough economic times. The transfer can result in immediate tax savings instead of waiting for the market to rebound.

The use of a prescribed rate loan or a capital loss transfer is particularly relevant given the current economic conditions. With the prescribed interest rate at an all-time low and the market slumping, these are strategies that can benefit a wide spectrum of investors and taxpayers. For the business owner/manager there are many other income splitting opportunities and they are not necessarily tied to the current economic climate.

Other Income Splitting Ideas - Business Owners

It is a common question of many business owners: How can I pay less tax and is there any way I can get my spouse/family involved in the business? There are several options to address these concerns. Family members could be paid a salary, can be shareholders and receive dividends or be beneficiaries of a family trust which owns shares of the company. Each of these options provides their own respective benefits and drawbacks.

An owner/manager can employ his/her spouse and or family member and pay him/her a reasonable salary. Not only does this additional salary provide for a deduction to the business it also allows the salary to be taxed in the hands of the spouse/family member who is presumably taxed at a lower rate. In addition, it generates earned income for the spouse/family member which creates RRSP room for this individual and provides for the opportunity for further tax savings. Furthermore, the spouse/family member would be subject to CPP premiums which, while an outlay now, provides for future benefits on retirement and further income splitting. It should be noted that the spouse or family member must actually work for the business and the salary paid must be reasonable. Section 67 of the Income Tax Act states that an expense will not be deductible unless that amount is reasonable in the circumstances. If the amount is deemed unreasonable, the business would lose the salary deduction while the amount paid to the spouse/family member would remain taxable to them.

Another alternative would be to have the spouse and or children who are not minors become shareholders of the company. They could then receive taxable dividends from the private corporation. The spouse and or children should pay for the shares out of their own funds to avoid the application of the attribution rules. If the corporate dividends are the only source of income for the low income spouse/child there are significant tax savings. For example in 2009, a low income spouse/child could receive \$37,500 of non-eligible dividends tax free. The acquisition of shares also provides another opportunity for a prescribed rate loan to be used. The higher income spouse/owner/manager could loan the funds used to acquire the shares to the lower income individual at the prescribed interest rate thus alleviating the need for cash to acquire the shares.

A third alternative would be to create a family trust, have the trust acquire shares of the corporation and have the spouse and other family members as beneficiaries of the trust. This is very similar in nature to having the individuals subscribe for shares directly in that the trust would receive dividends from the company and subsequently distribute them to the beneficiaries subject to the terms of the trust.

The acquisition of shares and the use of family trusts are effective income splitting tools. They are also an integral part of many estate planning and corporate

reorganization strategies. These will be discussed in greater detail in an upcoming Finer Focus.

If you are interested in setting up a prescribed rate loan, restructuring your existing loan or if you would like to evaluate other income splitting possibilities given your personal circumstances, please contact a Welch LLP professional or visit us at: www.welchllp.com

By Rob Meers, CA

Welch LLP is a full service firm of Chartered Accountants with offices in eastern Ontario and western Quebec. For more information about the firm and to locate an office near you, visit our website at www.welchllp.com. A Finer Focus is produced by Welch LLP as an information service with the understanding that it does not render accounting, legal or other professional advice. The commentary contained herein is not intended, nor should it be relied upon, to replace specific professional advice. It is recommended that readers consult their professional advisors regarding any matter addressed in this publication.