Split Your Income - Save Tax!

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

"Prescribed Rate Loan"

You don't have to be Albert Einstein to know that Canada's marginal tax rate system makes it 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. The Canada Revenue Agency ("CRA") prescribed interest rate is set at 1% - an all-time low!

The prescribed rate is the base rate used in the calculation of 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 sets the interest rate that must be used for income splitting arrangement between spouses or minor children.

The income attribution rules apply if you gift or lend 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, with a proper "prescribed rate loan" the attribution rules do not apply and you can effectively split income with a lower income family member. A proper loan requires interest to 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 onside, 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 is set at the time the loan is made and will not change even if the prescribed rate increases in the future. 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 x 1%); the husband would get a deduction of $1,000 for the interest paid. The attribution rules would not apply and income earned on the $100,000 of investments will be reported on the husband's personal income tax return annually.

Existing Arrangements

It is 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. The Income Tax Act prevents the straight substitution of a new low rate loan for an existing loan. The restructuring must ensure that there is a repayment of the existing loan and the issuance of a new and 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 old loan at a lower interest rate.

The best way to ensure the restructuring is done properly is a repayment of the old loan, a separation of time and then a new 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 to split income. It is an avenue that is more beneficial when there is a greater difference in the marginal tax rates of the individuals involved. Children with no income can provide a valuable planning opportunity.

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 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 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 and the superficial tax loss rules, you can transfer unrealized losses to your spouse for use now rather than waiting to use in the future.

The Act 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 owns the same or identical property. 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. 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 realize a capital loss. If he did not have 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 opportunity.

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 back the loss 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 a prescribed rate loan or a capital loss transfer is particularly relevant given the current lower interest rate environment. With the prescribed interest rate at an all-time low and market declines, these are strategies that can benefit a wide spectrum of investors and taxpayers. For business owners, there are 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 or children 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.

A business owner can employ his or her spouse and family member and pay the person 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 family member who is presumably taxed at a lower rate. In addition, it generates earned income for the family member which creates RRSP contribution room for this individual and provides for the opportunity for further tax savings. Furthermore, the family member would be subject to CPP premiums which, while an outlay now, provides for future benefits on retirement. It should be noted that the spouse or family member must actually work for the business and the salary paid must be reasonable. The Income Tax Act provides 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 family member would remain taxable.

An alternative would be to have the spouse and or children who are not minors become shareholders of the company. They could then receive dividends from the corporation. The spouse 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 spouse or child there are significant tax savings. For example in 2014, a spouse or child could receive $40,000 of dividends tax free.

A final alternative would be to create a family trust, have the trust acquire shares of the corporation and have the spouse and other family members be 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 allocate the income to the beneficiaries 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

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