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## Income Splitting Loans

*A tax planning opportunity*

BY VANCE LECOCQ, CA

In the past several years in an effort to stimulate the economy, the government has followed a policy of significant interest rate reductions. This has created an opportunity for individuals interested in income splitting strategies to reduce their household tax situation.

One of the key elements to consider when evaluating income splitting opportunities is the Prescribed Rate. The base federally prescribed quarterly interest rate is calculated by taking the average equivalent yield of Government of Canada 90-day treasury bills (rounded to the next highest whole percentage point) sold during the first month of the immediately preceding quarter. This base rate applies to taxable benefits for employees and shareholders, low-interest loans, and other related party transactions. It has recently been announced that for the fourth consecutive quarter, the prescribed rate will be 1%. This is the lowest the rate has ever been, and assuming the T-Bill rate can't go negative, the lowest it will ever be.

There are obvious tax planning opportunities that flow from this reduction in the prescribed rate, the most notable being the use of

income splitting loans. The current economic climate may present a once in a lifetime planning opportunity that may never arise again. However, in order to benefit from this opportunity, the loan must be incurred between January 1, 2010 and March 31, 2010 (and potentially after this date, but only if the quarterly prescribed rate remains at 1%). The key benefit is that the interest rate on the loan will remain at 1% for as long as the loan is outstanding, regardless of how high interest rates increase in the future. In situations where spouses or children will be in different marginal tax brackets for the foreseeable future, the cumulative tax savings can be significant.

In this regard, the following planning strategies should be considered:

THE KEY BENEFIT IS THAT THE INTEREST RATE ON THE LOAN WILL REMAIN AT 1% FOR AS LONG AS THE LOAN IS OUTSTANDING, REGARDLESS OF HOW HIGH INTEREST RATES INCREASE IN THE FUTURE.

1. One spouse can loan funds to the other spouse to make an investment. For attribution to be avoided, the borrowing spouse must pay interest to the lending spouse at the prescribed interest rate in effect at the time the loan is made. The loan should be made pursuant to a written agreement and interest payable on the loan for each year must be paid no later than January 30th after the year-end; otherwise, the attribution rules will apply. Attribution means that the spouse who loans the funds will have to report any income/gains or losses from the investment of the funds, thereby defeating the income splitting opportunity.
2. Owner-managers with a significant credit balance in their shareholder loan account and who have a spouse (or adult child) with little or no income can use a similar strategy—with a twist. If the original shareholder loan is payable on demand, the company can repay the loan. The amount repaid will be loaned to the spouse (or adult child), who will re-loan it to the company on an interest-bearing basis (prime plus a certain percentage). If the loan is made between January 1, 2010 and March 31, 2010, the spouse will only have to pay 1% interest on the loan for as long as it remains outstanding.
3. Existing income splitting loans can be repaid and a new loan can be set up to benefit from the 1% rate. However, the features of the new loan should be differentiated somewhat from the old

loan. Otherwise the CRA could view them to be the same loan in which case this planning strategy could be set offside

As a simple example, assume Mr. X loans \$2 million dollars to his spouse and follows all of the steps needed to avoid the attribution rules. Mrs. X invests in a balanced portfolio of dividend paying stocks, bonds, and preferred shares which produce a 3% income yield, and growth potential. Mrs. X must pay \$20,000 each year to Mr. X, who will have to report the amount as income. Mrs. X's net income (after deducting the interest) will be \$40,000 (\$60,000 - \$20,000). Assume the diversified portfolio grows at 6% annually over the next five years, and continues to deliver a 3% income yield. The portfolio will be worth \$2,676,451 and will be producing \$80,000 a year in income.

Mrs. X will still only have to pay \$20,000 each year to Mr. X, but her net income after deducting the interest will increase to \$60,000. In addition, the \$676,451 of growth will be taxed in her hands.

If Mrs. X has either no other sources of income or only earns a small amount of other income, and Mr. X is already subject to the highest marginal rate of tax, the tax savings for this couple by implementing this planning strategy could be significant.

To maintain interest deductibility and avoid attribution, certain rules must be followed. Contact your tax specialist to discuss if a spousal loan would be appropriate for you.

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