A tempting opportunity from the CRA

BY JAMIE GOLOMBEK, TAX EXPERT, FINANCIAL POST SEPTEMBER 25, 2009

Adam and Eve as portrayed in the painting "The Fall of Man" by Titian 1570. If you're married or living common law, you may well be tempted by one of the best income-splitting opportunities of all time.

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If you're married or living common law, you've just been given an extra three months to take advantage of the best income-splitting opportunity of all time.

The Canada Revenue Agency recently confirmed that its prescribed interest rate for loans will remain at its all-time low of 1% until at least Dec. 31. The prescribed interest rate is calculated based on the average yield of 90-day T-bills sold during the first month of the previous quarter.

Lending funds to a spouse at the prescribed rate for the purpose of investing takes advantage of the exception to the attribution rules in the Income Tax Act. The Act generally blocks most attempts at income splitting.

Income splitting is the practice of transferring income from a high-income spouse to a lower-income spouse to reduce the overall tax burden of the family.

Under the attribution rules, any income or gains earned on money transferred or gifted to a spouse is attributed back to the original spouse.

If, however, the funds are loaned rather than gifted at the prescribed rate and the interest paid annually by Jan. 30 of the following year, the resultant income or gains may be taxed in the recipient's hands and won't be attributed back.

To illustrate, if Adam is in a tax bracket of 45% and purchased a $200,000 GIC that pays 2.5% interest annually, he will earn $5,000 of interest income and pay tax of about $2,250. If Adam loaned the funds to his wife, Eve, at 1%, Eve would buy the GIC and earn $5,000 in interest income. She would then pay Adam $2,000 of deductible interest expense on the 1% loan and net $3,000.

If Eve was in the lowest tax bracket of about 20%, she would pay tax of $600. Of course, Adam would have to pay tax on the $2,000 of interest income received from Eve, which amounts to $900 at his 45% rate. But the total tax burden for this couple has been reduced to $1,500 from $2,250 — an annual savings of $750.

The beauty of acting now, of course, is that even though the prescribed rate is recalculated quarterly, you need only use the rate in effect at the time the loan was originally extended. That rate holds up for the duration of the entire loan, which could be 10, 20 years, even indefinitely.

While not a technical requirement under the Act, it's probably a good idea to get a lawyer to draft a promissory note or loan agreement between spouses to evidence both the terms of the loan and the fact that the loan was properly extended and dated during a 1% prescribed rate calendar quarter.

Finally, while you can also use this strategy to income split with children, it's wise to use a formal family trust to hold such investments. This will avoid myriad legal issues associated with minors signing potentially voidable contracts.

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Adam and Eve as portrayed in the painting "The Fall of Man" by Titian 1570. Jamie Golombek says the CRA has just given couples a very tempting income-splitting opportunity