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KNV INCOME SPLITTING LOANS MEMO

CANADA REVENUE AGENCY PRESCRIBED RATE 1% FOR THE SECOND QUARTER OF 2009

On March 4, 2009 the Canada Revenue Agency (CRA) announced that the prescribed interest rate used to calculate taxable benefits on low interest loans will be reduced from 2% to 1%, effective from April 1 to June 30, 2009. This announcement makes tax planning using income splitting loans an increasingly attractive opportunity.

TAX PLANNING USING AN 'INCOME SPLITTING LOAN'

Income splitting opportunities exist when one family member is taxable at a lower marginal income tax rate than another. The goal of income splitting is to allocate income that would be taxed in the hands of the higher rate taxpayer to the lower rate taxpayer resulting in the family paying less tax on an overall basis.

The Income Tax Act has provisions that discourage income splitting. If an income producing asset is gifted from the higher rate taxpayer to the lower rate taxpayer then the income earned from this asset may be 'attributed' back to the higher rate taxpayer, and no income splitting will occur.

Rather than gifting the income producing asset, if the higher rate taxpayer were to loan the lower rate taxpayer the money to purchase the asset with interest payable at the prescribed rate then the income earned on the investment will not be subject to the attribution rules.

The interest on the prescribed rate loan can be paid during the year and must be paid in full within 30 days of the end of the calendar year. The interest received on the loan will be taxed in the hands of the higher rate taxpayer and the interest paid is generally tax deductible to the lower rate taxpayer.

TIME IS OF THE ESSENCE

The CRA prescribed rate is based on the 90 day treasury bill rate rounded up to the nearest whole percentage. Treasury bill rates cannot be negative, so 1% is the lowest prescribed rate possible. For a loan advanced from April 1 to June 30, 2009 the prescribed rate will be 1% for the life of the loan.

If you have an existing income splitting loan then you should consider re-financing the loan between April 1 and June 30, 2009.

INFLATIONARY RISK

Given the current financial uncertainty, if your plan is to invest the proceeds from the income splitting loan in a long term monetary asset (e.g. five-year GIC) then you should consider the risk of high levels of inflation exceeding your return on investment.

EXAMPLE – LOW INCOME SPOUSE

Mark has the opportunity to earn 5% interest by investing in a mortgage, he has \$100,000 to invest, and he earns over \$126,265 per year from his job as an Engineer. Mark's wife Stephanie works part time as a teacher and earns \$25,000 per year.

Option 1 – Mark invests in the mortgage

	Mark
Investment income (\$100,000 x 5%)	\$5,000
Income tax @ 43.7%	(2,185)
After-tax proceeds	\$2,815

Option 2 – Mark lends Stephanie the money to invest at the prescribed rate

	Mark	Stephanie
Investment income (\$100,000 x 5%)	\$ NIL	\$5,000
Interest at the prescribed rate	1,000	(1,000)
Net investment income	1,000	4,000
Income tax (Mark 43.7%; Stephanie 20.1%)	(437)	(804)
After-tax proceeds	\$ 563	\$3,196

The income splitting loan will save Mark and Stephanie **\$944** in tax expense per year.

EXAMPLE – FAMILY TRUST

Mr. and Mrs. Jones have a similar opportunity to earn 5% by investing in an arm's-length mortgage. They have \$300,000 to invest, and both Mr. and Mrs. Jones have individual incomes over \$126,265 per year from working at the family business Jones Plumbing Ltd. The Jones' have three children living at home, Lisa, Michelle and Aaron. The Jones' children have no income and are beneficiaries of the Jones Family Trust.

Option 1 – Mr. and Mrs. Jones invest in the mortgage

	Mr. and Mrs. Jones
Investment income (\$300,000 x 5%)	\$15,000
Income tax @ 43.7%	(6,555)
After-tax proceeds	\$ 8,445

Option 2 – Mr. and Mrs. Jones lend the money to the Jones Family Trust, and the Jones Family Trust allocates the income to the child beneficiaries.

	Mr. and Mrs. Jones	Family Trust	Lisa	Michelle	Aaron
Investment income	\$ NIL	\$15,000	\$ NIL	\$ NIL	\$ NIL
Interest at the prescribed rate	3,000	(3,000)	-	-	-
Net investment income	3,000	\$12,000	-	-	-
Income allocation		(12,000)	4,000	4,000	4,000
Income tax (Parents 43.7%; Children 20.1%)	(1,311)	NIL	(804)	(804)	(804)
Basic Personal Exemption	NIL	NIL	804	804	804
After-tax proceeds	\$1,689	NIL	\$4,000	\$4,000	\$4,000

The income splitting loan will save the Jones' family **\$5,244** in tax expense per year. The "Kiddie Tax" will not apply in this situation since the mortgage is arm's length.

Implementation of income splitting strategies such as the ones outlined above should be carefully documented and administered. Please contact your KNV advisor if you feel this planning opportunity may be right for you.

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