

THE GLOBE AND MAIL

• CANADA'S NATIONAL NEWSPAPER

• FOUNDED 1844

• March 12, 2009



CESTNICK

TAX MATTERS

Low interest rates a boon to tax on investment income

I'm an optimist by nature, as are most of my friends. For example, take my friend Jeremy. He's a musician who plays the saw. That's right, give him a violin bow and a wood saw, and he'll play you Ode to Joy – and get this, he carries a pager (he can't afford a BlackBerry).

Now that's optimistic.

Then there's Don. I don't know all that he sells, but rubber chickens are among the list of items. Don says his business is a leading indicator, and he likes what he sees for the rest of 2009.

I'm optimistic about 2009 as well – from a tax point of view. The Bank of Canada lowered its overnight lending rate to just 0.5 per cent on March 3. You can't get much lower than this. And this spells good news for taxpayers: a fantastic opportunity to shift investment income from one family member to another to save tax.

If you're the higher-income earner in your family, you could save significant tax dollars by arranging your affairs so that your lower-income spouse, common-law partner or child pays the tax on some of the investment income earned in the family, rather than you. The amount of tax that can be saved varies by province and the difference in your level of income and that of your family members, but as much as \$15,990 in taxes could be saved annually (a Canada-wide average).

Consider Don and Michelle. They are married and live in Ontario. Don earns \$125,000 annually from his employment, and Michelle earns \$20,000. Don's marginal tax rate is 46.41 per cent, while Michelle's is 21.05 per cent. If we were to add \$10,000 of taxable investment income to Don's income, he'd pay additional taxes of \$4,641. Michelle, on the other hand, would pay taxes of just \$2,105. The couple would save \$2,536 in taxes every year if Michelle pays the tax instead of Don.

Here's the problem: The “attribution rules” in our tax law are designed to prevent you from simply giving your spouse, common-law partner or related minors money to invest with the hope of having them pay the tax instead. Those rules will cause any income earned by your family member to be taxed in your hands. In the case of minors, any interest or dividend income will be taxed in your hands (capital gains will be taxed in the hands of the kids).

But there's good news. You can avoid the attribution rules by charging interest at the prescribed rate set under our tax law, or commercial lending rates if they are less. Now get this: That prescribed rate will be just 1 per cent starting April 1. It's never been lower.

Consider Don and Michelle again. Don has \$100,000 that he wants to invest. Rather than investing in his own name, he wants to give the money to Michelle to invest so that she'll pay the tax on any investment income instead.

Don will accomplish this by lending the money to Michelle by way of a promissory note on April 1 (or any time in the second quarter of 2009). The note will be interest-bearing at the prescribed rate of just 1 per cent, with the principal due on demand.

As long as Michelle actually pays any interest owing to Don by Jan. 30 of each year (for the prior year's interest charge), the attribution rules won't apply, and Michelle will pay the tax as planned. Now, Don will have to report the interest paid to him as income, but the couple will effectively save tax to the extent Michelle earns a return greater than the 1-per-cent interest rate on the note.

There's another point to note here. The 1-per-cent rate can remain in effect for the full duration of the loan; that's right, the rate can effectively be locked-in forever. And if you've set up loans to family members in the past, consider repaying those loans (perhaps by selling sufficient investments to do this; count the tax cost of this first, but with accrued losses there shouldn't be a tax hit), and then advancing a new loan to the same borrower, taking advantage of the new lower prescribed rate effective April 1.

Sorry, I can't suggest that you simply re-paper that loan

without an actual repayment; it's important for the taxman to be able to trace the flow of funds to a new loan.

Tim Cestnick, FCA, CPA, CFP, TEP is Managing Director of The WaterStreet Group Inc., and author of The Tax Freedom Zone and 101 Tax Secrets for Canadians 2009, among other titles.
tcestnick@waterstreet.ca