Unprecedented Tax Opportunity – When will the sale end?

By Tracy Broeze, CFP

If spouses earning unequal incomes are looking to save on taxes, (and really, who isn't?), there is an unprecedented tax opportunity available at the moment in the form of income splitting. As with anything to do with CRA and taxes, we have to be very careful that we understand all the rules, but once we do, there are many legitimate, CRA-approved strategies that can save us money.

Canada's system of graduated taxation often leaves one spouse in a higher tax bracket, and therefore paying more tax than the other. Ideally, we would like equal distribution of income which gives lower overall household tax. This was the thinking behind the new pension splitting legislation last year that is now saving thousands of dollars in taxes for Canada's retirees. With pension splitting, we assign a lower income spouse some of the total pension income, up to 50%, actually causing them to pay *more* tax. This leaves the higher income spouse with *less* taxable income and a combined lower tax bill. With the graduated rates, getting into a lower tax bracket is a real savings for the household. Simply imagine the possibility of paying 35% tax instead of 46%. Who would say no to that?

With the economic downturn came an incredible silver lining. The prescribed interest rate, set quarterly by the government, is at the lowest it has ever been and, in fact, at the lowest it can ever go. Historically, this rate averages about 5-6% but it's now down to a record low of 1%. So what is this rate good for?

Here's how it works. The prescribed interest rate is used to set interest rates on loans between spouses. If you lend money to your spouse without interest, any money your spouse earns with the loan will be taxed in your hands. So there's no tax savings in giving your spouse money or investments, CRA will charge it back to you anyway. The only exception to this attribution rule is if the loan is invested in an active business venture.

However, if you lend to your spouse, charging interest at least annually at the prescribed rate at the time of the loan, your spouse can deduct the interest paid and any money earned will be taxed in the hands of your spouse. The interest received from your spouse is still taxable to you as the lender, but with the current rate at 1%, a net tax savings is much easier to achieve. The greater the difference in income between spouses, the better this strategy works. If there is a spouse with no income at all, this is an excellent, not to mention easy, way to save on your tax bill.

Sounds great, right? So where's the catch? In this case, the catch is in the documentation and reporting. The loan must be formally documented and the interest must be paid each year within 30 days after the end of the year. Get help from your advisor in drafting the promissory note, a witness signature will also add credibility to the transaction. The interest payments must be fully supported, (think cancelled cheques). If this deadline is missed for any reason, CRA will attribute all income for that year and every year thereafter back to the lender, so be ready to prove that interest was paid and paid on time.

If you already have a spousal loan in place with a higher interest rate, be warned! You can't cross out the old interest rate and write in 1%. The old loan must be formally paid off, ideally selling the investments bought with the old loan, and a new loan agreement must be drafted. Here again, get professional advice; there are superficial loss rules that have to be addressed but given the low rate, it's still very worthwhile to replace the old loan. Once the new agreement is in place, the interest rate can remain at 1% indefinitely.

Since this opportunity hinges on the low prescribed tax rate, we have to keep in mind that the rate changes. The next rate will be announced on October 20th. In the most recent rate announcement on September 10th, the Bank of Canada projected 1.3% economic growth for the third quarter and 3% growth for the fourth quarter. This may indicate a rate hike in the future. To get the lowest prescribed rate CRA will ever allow, call us. It's our job to make it easy for you!