

# Tax Memo

## 1% Taxable Benefit Rate: Action Required Before January 1, 2010

The federal prescribed interest rate for taxable benefits is 1% until December 31, 2009, the lowest in at least two decades. A low rate can provide tax saving opportunities for you or your family, if you will be:

- participating in or refinancing a family income-splitting loan arrangement; or
- taking out or replacing an employee home purchase loan.

To lock in the 1% rate, you must act before January 1, 2010. The rate is subject to change every quarter, so after December 31, 2009, it could be higher or the same.

### Family income-splitting loan arrangements

The 1% prescribed rate means that this is a good time to make a loan bearing interest at 1% to a low-income spouse and/or other adult family member who will invest the funds. This splits income, because income earned on the investment exceeding the 1% interest charge can be taxable to the low-income family member at his or her lower tax rate. Normally, this income (including interest, dividends and certain other types of investment income, and capital gains in the case of a spousal loan) would be "attributed" to the lender and included in his or her income, rather than the borrower's income, for tax purposes.

For this strategy to work:

- the loan must, among other requirements:
  - be entered into before January 1, 2010; and
  - bear interest at 1%, which must be paid by January 30 of the following year (and by January 30 following the end of every subsequent year during which the arrangement continues); and
- the borrower's return on the investment must exceed 1%.

For example, if \$300,000 is invested at 2.5% for the year, \$4,500 of income (i.e.,  $\$300,000 \times [2.5\% - 1\%]$ ) will be taxable to the borrower at his or her low marginal tax rate. Because the 1% rate on the family loan is locked in, significant tax savings can arise in future years, if market rates increase and investment returns improve.

Careful adherence to the interest payment requirements is essential, because if a payment is even one day late for any year, the exemption from the attribution rules will be lost for that year and all subsequent years until the family member no longer holds the invested funds or any "substituted property" (property for which the original loan proceeds have been exchanged in one or more transactions).

### Using a family trust

A discretionary family trust can also be used to implement this family income-splitting loan arrangement. The same loan and interest payment requirements described above must be met. Any income or capital gains the trust earns exceeding the 1% interest the trust pays the lender can be allocated and made payable to, and therefore be taxable to, beneficiaries of the trust, who could include any of the lender's lower-income family members, including minors. This strategy allows the

lender to determine the allocation to each family member, optimizing the use of personal tax credits and marginal tax rates. Further, it involves only one loan.

## Refinancing a family loan

If you have already lent funds to a family member at a higher interest rate, you can still benefit from the 1% prescribed rate. However, you cannot simply change the interest rate on the loan to 1%, because the attribution rules would begin to apply and any income (and capital gains on loans to a spouse) subsequently earned on the funds would be taxable to you. Similarly, making a new loan at 1% that is used to repay the existing loan might also trigger the attribution rules. Taking into account Canada Revenue Agency (CRA) pronouncements, the attribution rules should not apply if the existing loan is repaid and a new loan is advanced in separate transactions. This could be achieved, for example, if:

1. the borrower sells the investments and uses the proceeds to repay the existing loan;
2. you extend a new loan using funds other than funds received from the repaid loan;
3. the amount and terms of the new loan differ from those of the former loan; and
4. all transactions are supported by appropriate documentation.

Current market conditions may make it undesirable to sell investments. Instead of point 1, it appears from comments made by the CRA that the debtor may be able to borrow from an arm's length party, such as a bank, to repay the existing loan (but you must not guarantee, or otherwise allow your property to be used as security for, the bank loan). You would then make a new loan to the low-income family member who would use the loan proceeds to repay the bank. Points 2, 3 and 4 would still apply.

Although the above refinancing approaches appear supportable based on CRA commentary, the CRA has not addressed them specifically. The rules that apply to these situations are not clear, so professional advice should be obtained before implementing any refinancing of a family loan.

## Employee home purchase loans

Employees can take advantage of the low prescribed interest rate by taking out or replacing an employee home purchase loan before January 1, 2010. This will ensure that the employee's interest rate benefit will be calculated using a rate of 1% for the next five years.

A home purchase loan must be used to acquire (or repay or replace a loan used to acquire) a home for the employee or a relative of the employee. Unlike other employer-provided loans, the interest rate used to calculate the employment benefit will not exceed the rate in effect when the loan was made. Therefore, increases in the prescribed interest rate after the loan is made will not affect the calculation of the benefit. A home purchase loan is considered a new loan on each fifth anniversary and the prescribed rate at that time applies for the next five years.

## For help

Before structuring these loan arrangements, please contact your local PricewaterhouseCoopers High Net Worth Tax Services professional at [www.pwc.com/ca/hnwtaxcontacts](http://www.pwc.com/ca/hnwtaxcontacts) or:

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