IN FACT AND IN LAW

Taxation

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Act Quickly to Split Income

By Philip Nolan

The Bank of Canada's dramatic cut in interest rates over the last year which was aimed at spurring economic activity and fighting the onset of a recession has also opened the door to some interesting tax planning opportunities. As interest rates in Canada have fallen to their lowest point in over 40 years, so have the rates paid on Government of Canada Treasury Bills.

This is important because the interest rate set at the Bank of Canada 90-day Treasury Bill auctions is used to establish the prescribed rate of interest for the purpose of the *Income Tax Act* (Canada), which in turn, is used for many purposes, including the setting of the minimum interest rate that must be charged in order to avoid the attribution rules.

Attribution Rules

When money is lent or property is transferred to a minor or a spouse, the attribution rules may apply such that the person who loaned the money or transferred the property, rather than the minor or the spouse, will be taxed on the income derived from the money loaned or the property transferred. In the case of spouses, the attribution rules apply not only to income (i.e. interest, dividends, etc.) but also to capital gains.

There is a notable exception to the application of the attribution rules when property is transferred at its fair market value. Where the consideration received for the transfer includes indebtedness, interest must be charged at a rate no less than the prescribed rate of interest at the time the indebtedness arises. All the interest that was payable in respect of the indebtedness must be paid no later than 30 days after the end of the calendar year in which it became payable.

The current prescribed rate of interest is 2%. Consequently, income splitting opportunities and tax planning opportunities abound. It is not required that loans made by individuals be repaid within any given time period. As such, if the transaction is properly documented, the 2% rate can be frozen indefinitely. However, the rate for loans made during the July 1st, 2002 to September 31st, 2002 period will rise to 3%;

Income Splitting

During the second quarter of 2002, property generating income in the hands of a parent, spouse or grandparent can be transferred to another individual at very low interest rates, thereby allowing a family to potentially shift taxable income from the high income earners to those who pay little or no tax and, in so doing, improving the family's overall financial situation.

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Certain specific types of investments would have to be acquired in order to avoid the income splitting tax or “kiddie tax”.

The prescribed rate of interest for the third quarter of 2002 has been set at 3% on the basis of the Treasury Bill auctions held in April of 2002. We will know by the end of July 2002 whether or not this window of opportunity will be extended beyond September 30, 2002.

Whether it is at 2% or 3%, loaning money at these historically low interest rates should be considered by everyone before interest rates rise to their more historic higher levels.

The foregoing rules are but a brief summary of a highly complex aspect of income tax legislation. Any planning in this regard should be carried out in consultation with your tax adviser.

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