



COMMENT

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LOANS TO EMPLOYEES

In providing employee benefits, an employer may offer loans to help an employee purchase a home, a car, or shares of the employer corporation. Sometimes the employer will offer these loans at a discounted interest rate in order to encourage or support certain activities or actions. The general principle is that if the employee pays less than market interest rates, a taxable benefit will arise.

The taxable benefit to the employee is the difference between the amount of interest that would have been charged on the loan at the “prescribed rate” (as determined under the Income Tax Regulations), and the amount actually paid by the employee. The following points are important in terms of calculating the benefit:

- In order to reduce the taxable benefit, any interest stipulated in the loan agreement must be paid by the employee before the 30th day following the end of the taxation year (i.e., no allowance is made for accrued or payable interest).
- Generally, the quarterly prescribed interest rate is used in the calculation. This means that each quarter must be analyzed separately.

Consider an example where an employee was granted an interest-free loan of \$10,000 on January 1st to buy shares of his employer. The prescribed rates for each quarter during the year were two, three, four, and five per cent respectively. The taxable benefit would be determined as follows:

Quarter	Calculation	Taxable benefit
1 st	$3/12 \times 2\% \times \$10,000$	\$ 50
2 nd	$3/12 \times 3\% \times \$10,000$	75
3 rd	$3/12 \times 4\% \times \$10,000$	100
4 th	$3/12 \times 5\% \times \$10,000$	<u>125</u>
TOTAL		\$350

In the above example, \$350 would be included in the employee’s income as a taxable benefit in respect of the taxation year (assuming the employee paid no interest on the loan). Remember that, to the extent that the employee is charged a taxable benefit, he or she is deemed to have paid the interest. Therefore, the employee may be entitled to an interest expense deduction to the extent that the borrowed money is used to earn income from the property (as in the case of a share purchase). Interest on a loan used to purchase a vehicle for employment purposes may also be deductible in certain circumstances.

Special rules apply to the interest calculation on loans used to fund home purchases or home relocations. In these cases, the prescribed rate in effect at the time the loan was made is the maximum rate in measuring the taxable benefit. In other words, the formula uses the lesser of the current quarterly prescribed rate and the prescribed rate in effect at the time the loan was granted. The maximum prescribed rate is reset on every fifth anniversary of the loan.

In addition, an employee who realizes a benefit on a home relocation loan may be entitled to a special deduction. In essence, the interest benefit on the first \$25,000 of the loan is deductible in arriving at taxable income. This deduction is only available for the first five years of the loan.

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For employees who own 10 per cent or more of their company shares, separate rules apply. The full amount of the loan will be included in the individual's income in the year the loan is made, unless:

- the loan was granted to the individual because of the employment relationship (rather than because of the shareholding);
- the loan is for the purpose of buying a home, unissued shares, or a work-related car; and
- the loan contains bona fide arrangements for repayment within a reasonable time.

If all of these requirements are met, the taxable benefit will be calculated as it is for other employees.

The prescribed rate on employee and shareholder loans is three per cent for the third quarter of 2002. While this is an increase over the two per cent rate applicable in the second quarter, the prescribed rate is lower than it has been for many years. Many types of plans and arrangements are available to individuals who want to take advantage of this opportunity.

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RISK MANAGEMENT FOLLOWING A RELATIONSHIP BREAKDOWN

The emotional and financial bond that grows within a family unit is fractured with the onset of separation and divorce. Dealing with the emotional outcome of a relationship breakdown creates tremendous stress, which is compounded when the need to separate the financial interdependencies is added into the equation. It is easy to see how relationship breakdowns can become fraught with distrust.

Risk management should be an important consideration in the agreement arising out of a relationship breakdown. If the agreement requires ongoing spousal or child support, the death or disability of the supporting spouse (or common-law partner) could have a direct financial impact on the former spouse, a new spouse, children from the former relationship, and children from a current relationship.

Consider the following example:

- Wilson pays \$1,700 in child support and \$700 in spousal support per month to his former spouse, Michelle. Wilson is now married to Barbara and together they have two young children.
- Although Michelle works, payments provided by Wilson are an integral part of her family's financial plan. The combination of child and spousal support represents \$28,800 (\$20,400 + \$8,400) in annual income for Michelle. Because the child support falls under an agreement made after April 30, 1997, \$20,400 is non-taxable and \$8,400 is taxable when received by Michelle.

Wilson, Michelle, and Barbara each have to consider the financial impact of the risks that they face.

Disability

If any of the adults becomes disabled, the ability to earn an income could disappear or be substantially impaired. From a planning perspective, it is important to review the financial impact that the disability of one individual could have on the others:

- If Wilson becomes disabled, his ability to pay support to Michelle could become restricted and his ability to support his current family could also become strained.
- If Michelle becomes disabled, her financial contribution to her family would be severely impaired. She may turn to Wilson for additional support. Perhaps a downgrade in Michelle's lifestyle, due to financial limitations, could cause Wilson to be emotionally drawn into a new level of financial support which neither he nor his current family anticipated.
- If Barbara becomes disabled, her contribution to her family could become restricted, which in turn could impact Wilson's ability to pay support to Michelle.

The purchase of an individual disability income policy will not eliminate the financial risks associated with a disability, but it can help manage them.

Death

Planning for the death of a spouse or former spouse has to address a similar combination of risk factors:

- Wilson's premature death would result in the loss of his income contribution to his second family, along with the loss of support payments to Michelle and the children from his first family. Michelle may have to make a claim against Wilson's estate to secure her family's financial position. Parents have a legal responsibility to provide financial support for their children regardless of whether the parents live together, are separated, or are divorced. Planning for Wilson's estate should consider the long-term financial situation of Barbara and Wilson's second family, as well as Wilson's financial obligations for his first family.
- The premature death of Michelle would likely result in Wilson assuming full financial responsibility for his children. Under the current arrangements, the children live with Michelle and, although Wilson provides child support payments, Michelle makes a significant contribution to the family's financial support. The loss of Michelle's contribution and the potential shift in custody to Wilson has significant financial implications.

- Barbara's premature death will impact Wilson in terms of the financial security of his second family, and could well impact Wilson's ability to maintain support payments to Michelle.

Life insurance is a critical tool that can eliminate the risk element for the individuals involved in such a situation. To ensure that no one is caught by surprise, it is generally beneficial for each spouse to own a life insurance policy on the life of the other spouse. This gives the former spouses control and security. At the time of separation, Wilson and Michelle could each purchase a life insurance policy on the life of the other. While the owner of the policy assumes financial responsibility for the policy premiums, the owner also retains control of the beneficiary designation and decisions concerning the policy, thereby managing the long-term financial risk associated with a relationship breakdown.

Careful planning should be a primary consideration as individuals move through the stages toward financial independence following a relationship breakdown. Not only must the immediate financial issues be addressed, but also the management of any potential risk to the long-term plans.

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SMALL BUSINESS DEDUCTION

A Canadian-controlled private corporation ("CCPC") is entitled to a deduction known as the *small business deduction*. The deduction from the company's federal tax otherwise payable results in a low rate of tax on a company's first \$200,000 of profit.

The small business deduction is equal to 16 per cent of the least of the following amounts:

1. the company's net income from an active business carried on in Canada;
2. the company's taxable income (in excess of certain deductions for foreign taxes paid); and
3. the company's business limit.

The calculation takes into account the company's active business income as well as its taxable income. In this fashion, the deduction is limited to the active business income portion of the company's taxable income.

For federal income tax purposes, a company's business limit is \$200,000. However, a company must share its business limit with any

"associated" companies, as defined in the Income Tax Act. In very general terms, two companies are associated if one controls the other, or if both companies are controlled by the same individual or group of individuals.

A key piece of the small business deduction is determining the company's active business income carried on in Canada:

- "Carried on in Canada" indicates that any active income from foreign operations will not count in the calculation.
- "Active business income" has been defined to mean income other than investment income or personal services income.

Personal services income is colloquially referred to as the income earned by an incorporated employee. The exclusion of personal services income is intended to prevent highly paid executives from rerouting their income through a corporation in order to have a portion of their income subject to the low corporate tax rate. The primary exceptions to the rule are situations

where there are more than five full-time employees, or where income passes between associated companies.

Some provinces now permit professionals such as lawyers, accountants, and physicians to incorporate. Unless the professional is already an employee of an organization, the active income from the incorporated professional practice would qualify for the small business deduction. This result is not unexpected because a professional practice is similar to a business carried on by a sole proprietor or partnership, which could incorporate.

The factors in the calculation of the small business deduction would seem to indicate that every business operating in Canada has the advantage of a low rate of tax on the first \$200,000 of its income. To prevent large corporations from accessing this deduction, the business limit of \$200,000 is reduced by a formula that takes into account a tax on the capital of large corporations. In this fashion, large corporations are denied access to the small business deduction.

The small business deduction offers a tremendous advantage for small businesses operating in Canada. The government's policy objective is to encourage investment in Canada, and by allowing some business income to be taxed at a low rate, the business can retain more of its earnings to finance expansion.

Small CCPCs also benefit from an acceleration of the seven per cent general corporate rate reduction that is being phased in from 2001 to 2004. The full seven per cent reduction now applies to active business income of between \$200,000 and \$300,000.

Finally, note that most provinces also offer a lower tax rate on the first \$200,000 (or more) of the active business income of a CCPC, thus compounding the benefits of the federal small business deduction.

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