COMMENT

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INCOME SPLITTING OPPORTUNITY

Over the years, opportunities for income splitting within a family have been curtailed. In general terms, if capital is gifted or loaned at zero interest, then the investment income is attributed back to the originator of the capital. The rules catch direct as well as indirect transfers (such as those interposing a trust).

If a parent transfers capital to a child under the age of 18, then the interest and dividend income is attributed back to the parent and taxed in his or her hands. However, capital gains realized by the child are not attributed back to the parent, but are taxed in the child's hands. (In more general terms, this attribution rule applies to a transfer to a person under the age of 18 (as at Dec. 31) who does not deal with the originator at arm's length, or who is a niece or nephew.)

If one spouse transfers property to the other spouse, the interest and dividend income, as well as any capital gains or losses, are attributed back to the originating spouse.

An important exception to attribution is allowed for loans of value. If the transfer is a bona fide loan, then there will be no attribution of income (i.e., interest and dividends) or capital gains (in the case of spouses) to the originating party. A bona fide loan is one that bears interest at least equal to the lesser of the prescribed rate at the time the loan was incurred, and an open-market interest rate that would have been agreed to by arm's-length parties. In addition, the interest must be paid at least annually and within 30 days of year-end, every year. Failure to meet either of these two criteria voids this exception to the attribution rules.

The prescribed interest rate is established each calendar quarter. It is the average rate on 90-day Government of Canada treasury bills issued during the first month of the preceding quarter (rounded up to a whole percentage). Therefore, the prescribed rate applicable to any given loan will be based on interest rates that were in effect between two and five months before the date of the loan.

	1st Q	2nd Q	3rd Q	4th Q
2000	5%	6%	6%	6%
2001	6%	6%	5%	5%
2002	3%	2%		

The opportunity

The income splitting opportunity arises from the recent low prescribed interest rates. Money can be loaned to a spouse or children at the current prescribed rate, and the borrower can earn some net investment income. Provided the interest on the loan

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is paid within 30 days of the calendar year-end, there will be no attribution of the resulting investment income. For example, if the borrowed funds can be invested at five per cent and the loan interest rate is set at two per cent, then three per cent has been effectively moved from one taxpayer to another. It should be noted that the two per cent interest on the loan would have to be reported as income to the originating person. The borrower will report gross income of five per cent, and should be eligible for an interest expense deduction of two per cent, resulting in a net three per cent income.

Example of a $100,000 loan

Borrower

Interest income	
5% of $100,000	5,000
Interest expense	
2% of $100,000	2,000
Net income	3,000

Lender

Interest income	
2% of $100,000	2,000

The $5,000 of investment income on the $100,000 of capital has been split; $3,000 to the lower income taxpayer, and only $2,000 to the higher income taxpayer.

While the Income Tax Act contains many rules to curtail income splitting, there is an opportunity today to get some value from the exercise. Documentation and following the procedures is the key to realizing the tax savings from income splitting.

I/R 7401.00

GIFTS TO EMPLOYEES

Employees are generally taxed on the value of all benefits they receive by virtue of their employment. The Income Tax Act requires an income inclusion for the value of a benefit "of any kind whatever" that is received or enjoyed in the year. But what happens when an employer gives a gift to an employee? Is the value included in income? Are there different types of "gifts"? How much is included in income? Are there exceptions? Are there limits?

As noted above, the value of every benefit, of any kind, must be included in an employee's income. However, the CCRA's administrative policy includes the value of non-cash gifts only if they exceed a specified threshold. The CCRA will allow up to two gifts per year, totalling no more than $500. This means that the employer is entitled to deduct the cost of the gift, and the employee does not have to recognize the value of the gift(s) as a taxable benefit. If any single gift exceeds $500 in any one year, the full amount is included in the employee's income with no allowance for the threshold amount. If several gifts are made, and their aggregate value exceeds the $500 limit, then the employer can select which gift(s) will be treated as non-taxable. One or more of the gifts will be taxable.

The CCRA also allows another $500 threshold for up to two non-cash awards. Awards can be described as mementos marking special occasions, such as length of service or the achievement of safety targets. The CCRA has stated that it does not expect the same employees to receive $500 awards on a consistent, annual basis.

In such a case, the rewards will be recharacterized as disguised compensation.

It is important to note that gift certificates, items readily convertible to cash, and cash itself do not qualify for these exceptions and would be fully taxable to the employee.

Gifts and awards are to be valued at the cost to the employer, including all taxes and ancillary expenses, in determining if the $500 threshold is crossed. However, where a gift fails the threshold test, it is the fair market value that must be reported in the employee's taxable income. Note that if the gift or award is marked with the employer's name or logo, the fair market value of the gift can be reduced accordingly.

Lastly, an employer may host up to six parties and social events per year for employees without triggering a taxable benefit, provided the cost is contained to a maximum of $100 per employee for each event. Such social events must be available to all employees in the particular location.

There is great joy in giving, but sometimes there may be a cost in receiving. Every employee should be happy to receive a gift, an award, or an invitation to a social event. However, if such a gift, award, or invitation causes a tax liability, the joy may be short-lived.

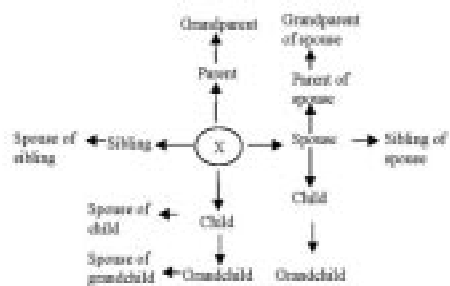
I/R 2400.00

NON-ARM'S LENGTH

Throughout the Income Tax Act (the "Act"), the phrases *armís length* and *non-armís length* are used to differentiate the tax treatment of certain transactions. An example where the tax treatment differs is the valuation under a buy-sell arrangement in a shareholders' agreement. The sale of property between siblings, or between a parent and a child, are other examples where the term "non-arm's length" arises.

In non-arm's-length situations, the CCRA reserves the right to determine the value at which a transaction takes place, notwithstanding a fixed price set out in a signed agreement between the parties. This differs from an arm's-length situation, where the CCRA will generally accept the negotiated price.

Generally speaking, arm's-length individuals are not related by blood, adoption, marriage or common-law partnership. The following chart illustrates those individuals who are considered non-arm's length to another individual (named "x"). All relationships radiate from x.



The term *common-law partner* is interchangeable with the term *spouse* in this chart. Adopted children are treated the same as natural children.

It is also possible for unrelated persons to be deemed to be non-arm's length for the purposes of the Act. This depends on the facts of their relationship and interactions. For example, two individuals who act together for a common purpose may be deemed to be acting at non-arm's length.

Essentially, the Act assumes that non-arm's-length individuals are not dealing in a normal, commercial manner, and may complete a transaction in such a way that income tax is artificially minimized. While the Supreme Court has said that individuals can arrange their affairs to minimize tax, they cannot improperly do tax planning using non-arm's-length transactions.

In essence, the only variation in tax treatment is that the CCRA reserves the right to review the transaction to ensure that it is taxed similarly to an arm's-length situation. Where the parties are not dealing at arm's-length, they must ensure that any transaction is reasonable and well documented.

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