

TaxBreaks

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Take care when refinancing prescribed rate loans



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In our April – May 2009¹ issue, we discussed a number of inter-spousal tax planning arrangements. The first article, “Taking advantage of the prescribed rate,” specifically addressed loans between spouses that bear interest at the prescribed rate. We invite you to read the article for a full explanation, but basically, the idea is that the higher-income spouse lends money to the lower-income spouse, who invests the funds and takes advantage of a lower personal tax rate. While there are several attribution rules that operate to prevent income splitting, a loan between spouses is not subject to these attribution rules provided that it is a bona fide loan and that the interest rate is no less than the prescribed rate in effect at the time the loan is made. The prescribed interest rate is adjusted quarterly and is currently at an all-time low of 1% per year.² The prescribed rate in effect at the time the loan is advanced remains in effect for the duration of the loan, even if the prescribed rate increases afterwards.

In this article, we’ll look at two situations that occur with this kind of arrangement. First, we will consider the issues that can arise when individuals with high interest rate spousal loans wish to refinance to take advantage of a lower prescribed interest rate. Then, we will examine what can happen if the investments acquired with the proceeds of the loan have declined in value, making repayment of the full principal amount of the loan difficult or impossible.

Be careful when refinancing a loan between spouses

If a loan between spouses has already been made and the prescribed rate that applies is higher than 1%, it may be worthwhile to renew the loan to take advantage of the lower prescribed rate. If you are considering refinancing, be sure that the first loan is actually paid off and the second is a new loan separate from the first.

There are a number of factors that determine whether the new loan is indeed a new loan. In particular, there has to be an actual transfer of funds between spouses and not just, for instance, an exchange of notes. This may be difficult when the spouse doesn’t want to dispose of the investments acquired with the proceeds of the first loan.

In addition, keep in mind that the Canada Revenue Agency takes the position that when a second loan is used to repay the first, there is no income, gain or loss from the amount loaned. The attribution rules could then apply and any tax benefit would be lost.



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¹ TaxBreaks 09-2, April – May 2009.

² The prescribed interest rate has been 1% since April 1, 2009 and is revised quarterly. The Canada Revenue Agency has announced that the prescribed rate for the period from July 1 to September 30, 2009 is again set at 1%.

When the investments have declined in value, the debtor spouse may not have sufficient funds to repay the first loan in full. If a portion of the principal of the loan is forgiven, the debt forgiveness rules will apply (see below).

This means that it may be better not to forgive the first loan immediately, but rather settle it later. For example: Marc loaned his wife, Marie, \$500,000 when the prescribed rate was 3%. Marie used the money to purchase an investment which then declined in value and is now worth only \$450,000. Marie does not have the extra \$50,000 she would need to repay the loan in full. In these circumstances, Marie could repay \$450,000 on the first loan by disposing of her investment, incurring a \$50,000 capital loss that she could later apply against capital gains in any future year or in any of the three previous years. She could then take out a new loan from Marc for \$450,000 at the new prescribed rate of 1%. The balance of \$50,000 would remain outstanding and this portion of the first loan would continue to bear interest at the prescribed rate of 3%. Note that Marie must continue paying interest at 3% on the \$50,000 outstanding.

Often, a spouse may not wish to dispose of his investments even though they have declined in value. If this were the case for Marie, she could repay her loan by transferring the investment to Marc at its fair market value of \$450,000, and elect not to use the spousal rollover rules (unless this election is made, the investment will be deemed to have been disposed of for a consideration equal to its tax cost). Marie would incur a \$50,000 capital loss on disposition of her investment. In this case, though, the loss would be denied because it would be considered a "superficial loss," as the investment was transferred to her husband. The amount of the denied loss would be added to the adjusted cost base of the investment now held by Marc.

Marc could later take advantage of the capital loss on the investment when he in turn disposes of it in favour of a third party (only, however, if he waits more than 30 days to dispose of it in favour of a non-affiliated person). Assuming that the market value of the investment has not changed after more than 30 days, Marc would dispose of the investment for \$450,000 but nonetheless incur a \$50,000 capital loss since the adjusted cost base of the investment for him would be \$500,000.

In this last scenario, Marc incurs a capital loss on his loan and possibly another capital loss on disposition of the investment, whereas Marie incurs no loss. This may cause a problem for her, as discussed below, if she ends up with no tax loss balance and the unpaid balance of the first loan is forgiven. In this case, she may have an income inclusion of one half the forgiven amount of the debt.

Investment losses and debt settlement

If the debtor spouse does not have enough money to repay the first loan in full and part of the principal has to be forgiven, the debt settlement rules are likely to apply.

Again using our previous example, Marie sells her investment for \$450,000 and incurs a \$50,000 capital loss. She can then repay \$450,000 on the loan; however, if the \$50,000 balance is forgiven, there could be adverse tax consequences for Marie.

A debt will be deemed to be forgiven if the lender no longer has any legal recourse for repayment, which can include expiry of the applicable limitations period under provincial law. So, if our couple leaves the loan unpaid, the mere lapse of time may give rise to a debt forgiveness for tax purposes.

Under the Income Tax Act (the Act), when a commercial debt is settled, the forgiven amount is applied against certain tax attributes of the debtor or 50% of it may even be included in the debtor's income. A loan made at the prescribed rate is usually considered a commercial obligation, within the meaning assigned to this expression in the Act, since the interest is payable by the debtor in satisfaction of a legal obligation and this interest is deductible.

If there is a debt settlement, the forgiven amount calculated under the Act must first be applied against certain tax attributes, if available, in a predetermined order. If the provided tax attributes are insufficient to absorb the forgiven amount, half of the unused portion of the forgiven amount will be included in the debtor spouse's income. As a rule, the tax attributes that will be reduced are, in order:

- losses other than capital losses, excluding business investment losses
- farm losses
- restricted farm losses
- losses other than capital losses, if they are allowable business investment losses, for previous years
- capital losses for previous taxation years.

Application of the forgiven amount is mandatory against certain tax accounts but not all. Other tax attributes against which the forgiven amount may be applied are also provided. For example, the forgiven amount can be applied to reduce the adjusted cost base of certain capital property. The unused portion of the forgiven amount may also be applied against the net capital loss incurred during the year (based on a special mechanism). If an unapplied balance remains, one half must be included in the debtor's income and will be taxable.

Marie can dispose of her investment on the market and repay \$450,000 on the loan using the proceeds. As for the \$50,000 balance, she can keep this loan if she is able to pay the interest. If the balance cannot be repaid, the debt forgiveness rules may eventually be triggered, in which case the forgiven amount will have to be applied against various tax balances. If the debt is settled after the year in which Marie disposed of her investment, the forgiven amount of \$50,000 could, in the absence of a tax balance, reduce the amount of the capital loss she incurred at the time of disposition. In the end, Marie would not have an income inclusion or a capital loss.

Marc, however, will have incurred a \$50,000 capital loss on the loan he granted his wife. Note that nothing in the Act

will result in the husband's loss on the loan being denied even if it is a loan made to his spouse, provided that the obligation was acquired in order to earn income from a property or business.

Caution!

Although our example is fairly simple, the debt forgiveness rules are extremely complex and can result in unintended consequences. While the current prescribed rates are tantalizingly low, refinancing a loan may be more complicated than it seems, particularly where the underlying investments have declined in value. This kind of planning should be used with caution and in consultation with a tax professional.

Canada provides waiver relief in transfer pricing reassessments – A good news/bad news proposition

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Canada recently amended its Income Tax Act to allow taxpayers to file a waiver beyond the normal reassessment period.

Under the Income Tax Act, the Minister of National Revenue may reassess a taxpayer's income at any time during the normal reassessment period, which is three years from the first assessment date for Canadian-controlled private corporations, and four years for other corporations. In certain situations – including if the reassessment involves an adjustment to transactions between the taxpayer and a non-resident with whom the taxpayer was not dealing at arm's length (in other words, in the case of transfer pricing adjustments) – the Minister is permitted to reassess for an additional three years beyond the normal reassessment period (resulting in a total of six or seven years).

Taxpayers can extend the statute period by filing a waiver. If a valid waiver is filed, the Minister can reassess at any time until the day that is six months after the waiver is revoked, for any matter specified in the waiver. The ability to file a waiver may be beneficial to taxpayers in the event of an audit, when the deadline is approaching and the auditor would otherwise reassess before properly

finishing the audit, necessitating collection action, the need to file notices of objection, etc. However, until the recent amendment, a waiver was valid only if it was filed within the three- (or four-) year normal reassessment period. So, because of what was generally considered a drafting anomaly, it was common for taxpayers in transfer pricing audits (when the period for reassessments was extended by three years) to be in a position where the Canada Revenue Agency (CRA) had the ability to make a reassessment, but the taxpayer did not have the ability to file a valid waiver to extend the statute. This was particularly problematic because the CRA often would not commence a transfer pricing audit until after the period in which a waiver might have been provided had expired.

The amendment passed into law on March 12, 2009, allows taxpayers to file a waiver during the extended assessment period, not just during the normal reassessment period. Although the number of taxpayers affected by this situation may be limited, we believe it will benefit taxpayers in the following situations:

- Taxpayers in transfer pricing audits when the end of the extended reassessment period is approaching. Before the amendment, the taxpayer would not have been able to file a valid waiver to allow the auditor to finish the audit before reassessment.

- Taxpayers that have filed a request for an advance pricing arrangement (APA) with a rollback to all open years. Administratively, the Canadian Competent Authority has required waivers to consider an APA rollback. Historically, the taxpayer was not able to file a valid waiver for any open years beyond the normal reassessment period. Taxpayers should now have greater flexibility to request a rollback.
- Taxpayers requesting a downward adjustment for open years under the extended reassessment period, but not the normal reassessment period. Historically, taxpayers were not able to file a valid waiver to keep open the years that were beyond the normal reassessment period, if required to allow the downward adjustment to be processed.

There currently is no legislative provision for a waiver filed during the three-year extended reassessment period to be revoked. The legislative provision that allows for revocation of waivers applies only to waivers that are filed in the normal reassessment period. It is understood that this is a technical anomaly that will eventually be corrected; however, please note that it has taken over 10 years to correct the initial anomaly.

It remains to be seen if CRA auditors may use the extended waiver period to pressure taxpayers into providing waivers when the audit was not commenced in a timely manner or not carried out expeditiously. Therefore, while it is generally a welcome change, taxpayers should proceed with caution before issuing a waiver beyond the normal reassessment period, given the above concerns.

While the amendment to subsection 152(4) of the Income Tax Act is generally good news for taxpayers, there are potential drawbacks to the extension in the waiver deadline.

Canadian tax rates

The federal government and all provinces and territories have now tabled their 2009-10 budgets; Deloitte has prepared **highlights of the budgets** and has posted them on our website. In addition, we compile and update a series of tax rate tables for individuals and corporations, taking into account current federal, provincial and territorial tax legislation. To access these tables online or to download a PDF file, please consult our **Tax rate tables** web page.

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