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I S S U E S

A Message From the President

By P. Lee Fisher, *President and CEO*

For our Summer 2009 issue of insight, we have continued to focus on home and family. The first article deals with the Spousal Loan. With interest rates at an all-time low, the opportunity to build assets in the hands of the lower income spouse is more appealing than at any other time in history. It also makes a case for repaying existing loans and reborrowing at the lower rates. Janice Sloan addresses the issues to be resolved to ensure compliance with CRA's rules.

Then we have an article on the benefits of starting a home renovation this summer or fall. The federal and provincial governments will reward you for getting that DIY job done or for engaging professionals to carry out your plans to spruce up your home. Lindsay Hagen has written the article for us on the Home Renovation Tax Credit and has included several links where you can get more information.

Lastly, our book review this month is on "The Automatic Millionaire Homeowner", written by David Bach. Although the book was written 5 years ago, it continues to have relevance today. It shows renters how to buy a first home, even with lousy credit and tiny savings. Leave your copy on the cottage coffee table for your children to browse. It's a powerful read, especially for young people.

I hope you're having a wonderful summer!

Lee.

Spousal Loans

By Janice Sloan, *Senior Tax Manager*

With the 2008 downturn in the stock market and the drop in the prescribed interest rate, more focus is being put on spousal loans and questions are being asked. Articles are appearing in newspapers, given that on April 1, 2009, the prescribed interest rate dropped to 1%, the lowest prescribed rate in history. How can taxpayers with existing loans take advantage of the lower rate?

This article discusses the income-splitting arrangement using a spousal loan, the rules themselves and the implications if the rules are "broken".

There are a number of "attribution rules" in the Income Tax Act (Canada) that prevent income splitting amongst family members, i.e. shifting income to family members who are in lower tax brackets, thereby reducing the over all taxes payable. These attribution rules are both comprehensive and complex. Where one spouse earns interest income from property received as a gift from the other spouse, the attribution rules would require the income be included in the taxable income of the transferor spouse (i.e. attributed back).

BASICS OF A SPOUSAL LOAN

An exception to the attribution rules is made where funds are loaned to a spouse and, under the terms of the loan, interest is required to be paid at the prescribed interest rate in effect at the time the loan is made. The loan should be documented and interest payable on the loan must be paid each year no later than January 30 of the following year.

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The Home Renovation Tax Credit

By Lindsay Hagen, Executive Assistant, CPA

THE ARRIVAL OF THE SUMMER MONTHS INEVITABLY MEANS AN ENDLESS LIST OF PROJECTS TO COMPLETE AROUND YOUR HOME OR COTTAGE. WITH THE CURRENT STATE OF OUR ECONOMY, FIXING UP THE OLD HOMESTEAD MAY NOT BE AT THE TOP OF YOUR PRIORITY LIST. BUT SINCE THE FEDERAL GOVERNMENT REVEALED THE HOME RENOVATION TAX CREDIT (HRTC) IN ITS BUDGET ON JANUARY 27, 2009, YOU MAY WANT TO RECONSIDER. AFTER ALL, WITH A RENOVATION BUDGET OF \$10,000 YOU CAN EXPECT TO GET BACK \$1,350 FROM THE GOVERNMENT – A SAVING OF 13.5 PER CENT.

WHAT IS THE HOME RENOVATION TAX CREDIT (HRTC)?

The HRTC is, “a non-refundable tax credit for work performed or goods acquired in respect of an eligible dwelling.” Any dwelling that you own and use personally could qualify, including your home, cottage or condominium unit. The credit is based on eligible expenditures for work or goods acquired after January 27, 2009 and before February 1, 2010. Homeowners can claim a tax credit for 15 per cent of renovation expenses between \$1,000 and \$10,000 for the 2009 taxation year. The maximum tax credit is worth \$1,350. If you own and use your home and cottage personally, eligible expenditures incurred for both properties will normally qualify for the HRTC.

The federal government hopes the Home Renovation Tax Credit will get Canadians spending now to help create jobs in industries typically hurt by an economic downturn.

WHO IS ELIGIBLE?

About 4.6 million families in Canada are expected to benefit from the credit. For the purpose of the credit, a family will generally be considered to consist of an individual, and where applicable, the individual's spouse or common-law partner and children under 18. If two or more families share the ownership of an eligible dwelling, each family will be eligible for their own separate credit that will be calculated on their respective eligible expenditures.

WHAT ARE ELIGIBLE EXPENDITURES?

Almost any job that improves your home or cottage will be eligible for the credit, with a few exceptions. The purchase of furniture, appliances or tools will not be eligible. Also not eligible for the credit are routine maintenance expenses such as furnace cleaning, snow removal, lawn care, pool cleaning and carpet cleaning. The HRTC can also be coupled with other government programs that put money back in your pocket when you renovate your home. For instance, making your home more energy-efficient can qualify you for grants of up to \$5,000 under the ecoENERGY Retrofit Program. You will still be able to claim the Home Renovation Tax

Credit. Eligible expenditures must be supported by receipts, which will not have to be submitted with the tax return, but must be available if requested by Canada Revenue Agency (CRA).

Examples of HRTC – Eligible and Ineligible Expenditures:

ELIGIBLE

- Renovating a kitchen, bathroom, or basement
- New carpet or hardwood floors
- Building an addition, garage, deck, garden/storage shed, or fence
- Re-shingling a roof
- A new furnace, woodstove, boiler, fireplace, water softener, or water heater
- A new driveway or resurfacing a driveway
- Painting the interior or exterior of a house
- Window coverings directly attached to the window frame and whose removal would alter the nature of the dwelling
- Laying new sod
- Swimming pools (permanent – in ground and above ground)
- Fixtures (e.g., lights, fans, etc.)
- Associated costs such as permits, professional services, equipment rentals, and incidental expenses

INELIGIBLE

- Purchase of furniture and appliances and visual electronics
- Purchase of tools
- Carpet cleaning
- House cleaning
- Maintenance contracts (e.g. furnace cleaning, snow removal, lawn care, and pool cleaning)
- Financing costs

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Spousal Loans

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For the purposes of illustration, assume that the husband lends money to his stay-at-home spouse. Although the interest income payable under the loan/note is taxed in the husband's hands, the investment income earned by the wife will be taxed in her hands and the interest she pays on the loan will be deductible by her in the year paid. Provided the investments earn more than the interest payable under the loan, there is an overall tax savings.

If interest is not paid 'on time', then the loan becomes "tainted". The attribution rules will apply for the year the interest payment is missed and every year thereafter. If the attribution rules apply, then the investment income earned on the loaned property, i.e. interest, dividends etc., (and capital gains and losses, in the case of loans between spouses) is attributable to the husband, in which case the income splitting benefits are eliminated.

There must be evidence that the interest has been paid. The interest must be paid by the wife from her funds – the husband cannot give the money to the wife to pay the interest. In a Technical Interpretation (9213685), CRA stated:

***“It is a question of fact as to whether or not a particular amount is paid and the Department is prepared to look beyond one particular piece of evidence to determine whether the borrower has effectively transferred an amount to the lender on account of the interest due. In our view a promissory note would not constitute the payment of interest in the situation you describe but rather would represent a deferral of the payment so required.*”**

***We would also like to point out that if the lender further advances to the borrower the funds to pay the interest on the original loan in a separate transaction, attribution of income earned in respect of the property acquired with the first loan may be applicable by reason of the second loan in accordance with either subsection 56(4.3) or 74.1(3) of the Act.*”**

ALTERING THE INTEREST RATE

There is no mechanism for changing the interest rate on a spousal loan when the prescribed interest rate drops. To benefit from a reduction in the prescribed rate, an existing spousal loan would need to be repaid and a new loan entered into. It cannot simply be a rewrite of the original note. To adjust the rate or refinance may "taint" the loan and the attribution rules may apply. CRA has stated that a loan will be deemed to be the same loan if the only change in the loan is the interest rate.

To repay the loan, the wife may need to sell her investments (incurring broker fees etc.) or borrow the funds from a third party to repay the loan. It is important the terms of any new loan be as different as possible for the original loan. If CRA considers them to be the same loan, the attribution rules may apply.

INVESTMENT VALUE LESS THAN LOAN

With the current market conditions, there are cases where the market value of the wife's investments are less than the loan amount. In these circumstances, if she sells her investments and uses the funds to repay the loan, the forgiveness of debt rules may apply to the outstanding loan amount. These rules are extremely complex and can raise additional issues.

If the wife sells her investments and incurs capital losses, how will she generate future gains to offset the losses? If the husband takes back the assets and basically picks up the wife's cost basis, he will need to sell the assets to recognize the losses (and wait 30 days if he wants to reacquire the same investments). Again he will incur the broker fees, etc.

Is there any basis for the husband loaning funds back to her at the lower interest rate when a portion of the first loan is outstanding? What happens to the original outstanding loan amount? Is there any basis for the husband to claim a loss on the original loan, particularly if the wife owns any other assets that could be liquidated to repay the outstanding portion of the loan or if he reloans funds to her?

Unfortunately these questions deal with gray areas of tax and are not easy to answer. The ability to income split with a spouse by using the interest-bearing loan provides tax savings advantages. This is the exception to the attribution rules. Recent articles that discuss spousal loans have stopped short of discussing potential options when a spousal loan is no longer covered by the underlying investments, in part, due to the uncertainty of the tax implications on a general basis. The current market conditions are unprecedented and no one is stepping forward with viable suggestions from a tax standpoint.

An option some are suggesting is to let the loan become tainted by not paying the annual interest. As noted above, this would result in the attribution rules applying and all income would attribute to the husband on a going forward basis. However, there remains the issue of selling the investments and reloaning the funds to benefit from the lower prescribed interest rate.

For a complete, up to date list of quarterly prescribed rates, please visit: <http://www.cra-arc.gc.ca/tx/fq/ntrst-rts/menu-eng.html>

Book Review:

The Automatic Millionaire Homeowner, Canadian Edition:

A Powerful Plan To Finish Rich In Real Estate

Written by David Bach.

“RENTERS STAY POOR, HOMEOWNERS GET RICH, AND SMART LANDLORDS LAUGH ALL THE WAY TO THE BANK!”
— DAVID BACH.

In his best-selling book, tailored for Canadian readership, David Bach outlines an “automatic plan” for owning your own home and becoming a millionaire. Bach, a well-known strategist for gaining wealth, presents his ideas which center upon the principles that we all have to live somewhere and over the long term, real estate prices go up, so why not use our homes as an investment vehicle? The author contends that renting will not make anyone rich, down payments do not require large sums of money, and a home can be purchased even if the buyer has credit-card debt. The author’s action steps include determining what price of home you can afford and employing strict financial discipline in spending

money and consistently adding to a “home” savings account for use in accelerating mortgage payments and ultimately retiring the mortgage ahead of schedule.

This book is a good choice for first time homebuyers as it provides a general overview of the buying process; from finding a real estate agent, to finding the right loan, to finding the right home. The Automatic Millionaire Homeowner is simple, easy to read, and highly motivational. We think this would be great book for your kids, or young people you care about, who are interested in buying their first home.

The Home Renovation Tax Credit

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HOW CAN I GET MORE INFORMATION ON THE HRTC?

For further information, call CRA’s individual income tax enquiries service at **1-800-959-8281 (1-800-959-7383 for French)**.

Or visit one of the following websites:

<http://www.cra-arc.gc.ca/hrtc>

<http://www.budget.gc.ca>

<http://www.plandaction.gc.ca>

TIP:

RONA, the largest Canadian distributor and retailer of hardware, home renovation and gardening supplies, is offering consumers up to \$1,000 back in gift cards on materials or installation services purchased at RONA for use in projects eligible for the federal government’s Home Renovation Tax Credit. Customers making purchases of over \$1,000 at RONA will be offered gift cards worth 10% of their expenses before taxes. More information is available at www.rona.ca.

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