CESTNICK

TAX MATTERS

Higher interest rates may mean taking some time to rethink

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Perhaps you've heard about the guy who visited his doctor and was diagnosed with low blood pressure. The doctor prescribed one IKEA self-assembly bedroom furniture set and two wall-mount shelf units. That will fix the problem. And if that doesn't work, just keep an eye on the Bank of Canada and the inevitable further increase in interest rates – likely on June 1 at the bank's next meeting.

While this might concern a lot of Canadians – because we're a country of borrowers – there's no need to panic. Let's take a look at a few tax and financial planning ideas you should be considering right now in light of more increases to rates.

Budget for higher debt payments.

Your bank's prime rate is likely to increase from the current 3.2 per cent to between 4 per cent and 5 per cent over the next year or so. According to Royal Bank of Canada economists, the average Canadian household can expect debt payments to increase by about $2,000 next year when this happens, but you'd be wise to figure out more accurately how your own monthly debt payments will change if rates do increase by, say, 1.5 percentage points over the next year. It's reasonable to expect monthly payments to increase by 15 per cent to 30 per cent. Will you need to cut back spending on other things? Start planning for that now.

Make interest deductible.

If your interest costs are going to increase, why not make them deductible for tax purposes? This could cut your borrowing costs by as much as half. Consider selling any investments, or taking savings you might have, and paying down some debt. Then, reborrow to replace your investments or savings. When you borrow for the purpose of earning income, you can generally deduct your interest costs.

Don't give up on home ownership.

Higher interest rates are already having an impact on housing prices and will continue to cause some softening of prices in the short term – which is good for home buyers. Given the shortage of supply in the housing market, however, there's some debate about whether a

crash in real estate prices is even possible. But if you're concerned about a dramatic decline in real estate values, rising interest rates could create more of a "soft landing" in prices.

Revisit retirement income planning.

With an increase in rates, you can expect improved returns on your fixed-income investments. More recently, the value of fixed-income investments has been hit hard with the increase in rates we've seen in the past two months – particularly those investments of longer duration. The FTSE Canada Universe Bond Index was down 10.3 per cent year-to-date as of May 4. That index has an average duration of 7.5 years. The longer the duration of a bond, indicated in years, the greater the loss with each rate increase (and vice versa when rates decline). By choosing much shorter-duration investments you'll protect your capital more as rates rise, allowing you to take advantage of new higher rates on your fixed-income investments in the short term.

Anticipate reduced inflation.

Inflation reached 6.7 per cent in March. There are various factors contributing to this – including the conflict in Ukraine, an increase in demand coming out of the pandemic, and continuing supply chain issues – but while the inflation we're experiencing is more than just transitory, it won't be permanent. The Bank of Canada aims to keep inflation at about 2 per cent and increasing interest rates is expected to return inflation to 2.5 per cent by the end of 2023 and to its 2-per-cent target by 2024. So, there may be light at the end of the inflation tunnel.

Reconsider your pension options.

Many people in recent years, when they have had the choice, have left their company pension plans in favour of taking a lump-sum amount – called the commuted value – from the plan. The thinking? Many have believed that they can invest the money better themselves, even though they've had to pay some tax on part of the commuted value in the process. As interest rates rise, pension plans will become healthier and your other investment options may not look as good in comparison. It could then make sense to remain in your pension plan, and to even buy back pensionable service if you have that option.

Watch the prescribed rate.

You can save tax by splitting income with your spouse. This is the idea of moving investment income to the hands of your spouse if he or she is in a lower tax bracket. This is most commonly done by lending money to your spouse and charging the prescribed rate, which is currently just 1 per cent. This rate can be locked in indefinitely. But the prescribed rate is likely to rise to 2 per cent on July 1. The Canada Revenue Agency will announce the rate to take effect July 1 likely in mid-June. Set up a loan to your spouse before July to take advantage of today's lower rate.

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