

Opportunity for Increased Tax Savings from Income Splitting with a 1% Prescribed Rate Loan

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In this blog we will explain how you may be able to benefit from a 1% prescribed-rate loan to split income with certain family members who are taxed at a lower marginal rate.

This issue has gained renewed interest because the Canada Revenue Agency announced that starting 1 July 2020, the prescribed interest rate is reduced from 2% to 1%. This drop will improve the potential income splitting tax savings through the use of a prescribed-rate loan. In general, Canadian income tax laws limit the ability of a taxpayer to shift income into the hands of a family member who is taxed at a lower personal tax bracket. Accordingly, where a high-income taxpayer gifts or loans capital interest-free to a spouse or minor child for the purpose of having the investment income generated on that capital taxed in the spouse or minor's hands, income attribution rules will tax the investment income in the hands of the high-income taxpayer, at the taxpayer's higher marginal personal tax rate.

This attribution rule can be avoided if interest is charged on the loan to the spouse or minor child (or to a trust the beneficiaries of which include the spouse and or minor) provided that the interest rate charged is equal to or greater than the interest rate prescribed in the Income Tax Regulations at the time the loan is made. The prescribed rate is published by the Canada Revenue Agency and updated quarterly. While the prescribed rate has been 2% since 1 April 2018, as of 1 July 2020, the prescribed rate has dropped to just 1%.

When this loan arrangement is properly implemented, investment income from the loaned capital may be taxed in the hands of the low-income family members. The low-income family members (or a trust established for their benefit) will pay the 1% interest charged by the high-income taxpayer, and deduct the interest from income earned. The high-income taxpayer will include the 1% interest income in his or her taxable income. This interest must be paid within 30 days of the end of each year the loan is outstanding. If the interest is not paid, the investment income will be attributed to the high-income taxpayer, defeating the planning.

The 1% prescribed interest rate makes this loan arrangement a very attractive income splitting opportunity. And because the minimum interest rate required is fixed at the time the loan is made, the 1% rate is grandfathered, even if the prescribed rate rises in the future.

To illustrate how tax savings can be achieved by a family, consider the following example:

(A) with no income splitting:

- Mrs. A is taxed at the highest personal tax bracket.
- Mrs. A has a husband, Mr. A, and 2 minor children, none of whom earn any income.
- Mrs. A has \$600,000 of investment capital.
- If Mrs. A invests her investment capital personally and earns an 8% return (\$48,000), **she will have to pay \$25,694 of income tax on the investment income.**

(B) with a 1% prescribed rate loan arrangement:

- Mrs. A loans \$200,000 to Mr. A and \$400,000 to a trust for the 2 minor children.
- Mr. A and the trust for the 2 children earn the same 8% investment return (\$48,000 in total).

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- Mr. A and the trust for the 2 children pay 1% in interest to Mrs. A (\$2,000 by Mr. A and \$4,000 by the trust).
- The net investment income earned by Mr. A is \$14,000, and by the trust for the 2 children is \$28,000.
- The trust for the 2 minor children can allocate the income to the children equally (provided the trust is drafted appropriately, the income can be used to pay for the children's expenses such as private school fees, summer camp, sports activities, travel expenses, etc.)
- The income tax payable by Mr. A and the 2 children on the net investment income is approximately \$278 each (\$834 total).
- Mrs. A receives interest income from the prescribed rate loan of \$6,000 in total, on which Mrs. A pays tax of \$3,212.
- **The total income tax paid by Mrs. A, Mr. A, and the 2 children is \$4,046**

Compared to the first scenario where there is no income splitting contemplated, **the income tax saved using a prescribed rate loan to split income is approximately \$21,648 per year.** Over a period of 5 years, this amounts to a tax savings of approximately **\$108,240.**

The loan can be called at any time should the income splitting structure no longer be of any advantage, for example, if Mr. A begins earning significant income and or the minor children are grown and start earning their own significant income.

Even if the children in our example are adults, it is recommended that a trust be established for the benefit of the children, in order to provide greater control and flexibility over the arrangement and the use of the income by the children. The low income spouse can also be a discretionary beneficiary of the trust if this is considered advisable.

If the taxpayer already has an existing prescribed rate loan arrangement that was carried out when the prescribed rate was higher, and wishes to benefit from the current lower rate, they must ensure that the new loan is not considered to be a continuation of the existing loan. Otherwise, the arrangement will fail and attribution will result.

If you think a similar arrangement may be suitable for you or one of your clients, please contact one of our tax and trusts professionals who will be happy to speak with you and provide a more detailed and customized analysis.

If you require assistance, please contact **Lindsay Histrop** at 416.865.6697.

(This blog is provided for educational purposes only, and does not necessarily reflect the views of Gardiner Roberts LLP).

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