TD Wealth

Income Splitting with a Prescribed Rate Loan

Introduction

Canada and most of its provinces (except Alberta) and territories impose a progressive rate of tax on the income of an individual. This progressive tax system is an incentive for individuals to look for ways to split income with other taxpayers, particularly family members.

The prescribed rate has been 1% since April 1, 2009. On October 1, 2013, the prescribed rate will increase to 2%.

Income splitting is achieved when income otherwise taxable to one taxpayer (and at a higher rate) is shifted to and is taxed in the hands of another taxpayer who is taxed at a lower rate. When income splitting can be achieved, it provides tax savings and leaves more money that can be used for investment purposes or to pay living expenses.

While income splitting sounds like a wonderful idea, Canada has 'attribution rules' designed to thwart taxpayers attempting to income split. Generally speaking, these attribution rules operate by attributing investment income back to the higher rate taxpayer from:

- money loaned, and
- property that is loaned or transferred to a lower rate taxpayer, where the taxpayers are related (e.g., spouses or common-law partners and minor children).

If the attribution rules apply, all investment income is attributed back to the higher rate taxpayer if the income splitting involves spouses or common-law partners. Where the income splitting involves minor children, all investment income (but not capital gains) is attributed back.

One exception to the attribution rules is where the parties use a Prescribed Rate Loan (PRL) for the money loaned or property that is loaned or transferred.

A PRL uses the prescribed rate of interest that is determined by a formula in the Regulations under Canada's *Income Tax Act*. This prescribed rate of interest is calculated quarterly and a PRL is an effective and often used strategy to successfully achieve income splitting (e.g., not have the attribution rules apply). The prescribed rate has been 1% since April 1, 2009. On October 1, 2013, the prescribed rate will increase to 2%.

To be an effective PRL, the following criteria should be met:

- there is a written loan agreement
- at the time the loan is made, the rate of interest charged is at least equal to the lesser of:
  - the prescribed rate, or
  - an arm's length rate (e.g., a commercial rate), and
- the loan interest (for the prior year) must be paid on or before January 30th of the following year.

If the interest payments on the PRL are not made when required, the attribution rules will apply for the current and all future years. In this case, the original PRL should be repaid and a new PRL entered into so that the attribution rules do not apply.

The interest paid must be included in income and is therefore taxable to the lending party. If the PRL proceeds are used for investment purposes, the borrowing party may be able claim a tax deduction for the interest paid.

It should be noted that if property is transferred to a spouse or common-law partner ("spouse"), there is an automatic spousal rollover rule under the *Income Tax Act* that applies. Under this rollover rule, no gain or loss is triggered on the transfer of property between spouses, however, all of the income or loss (and any capital gain or loss) from the transferred property will be attributed back to the transferring spouse.

Accordingly, where property is transferred between spouses for income splitting purposes, the transferring spouse should elect out of the automatic rollover. This results in any accrued capital gain being taxable in the year of transfer to the transferring spouse.

PRL Example

Skyler Doe lends his common-law partner Tyler $100,000 at a time when the prescribed rate is 2%. Assume that Skyler is in a 40% marginal tax bracket, and Tyler is in a 25% marginal tax bracket.

Skyler	Income for Skyler	Income for Tyler	Tyler
Lends Tyler $100,000			Invests the $100,000
Earns 2% interest (from Tyler)	$2,000	$5,000	Earns 5% interest from his investment
Skyler's Taxable Income	$2,000	$3,000	Tyler's taxable Income
Tax @ 40%	$800	$750	Tax @ 25%
After tax income	$1200	$2,250	After tax income
Total Income (After Tax)	**$3,450**		

If Skyler had kept and invested his $100,000 for himself, the full $5,000 of interest income would have been taxed in his hands, yielding an after tax income of just $3,000.

Additional Information:

- The CRA announces the prescribed interest rate on a quarterly basis. This rate generally follows the interest rate on 90 day Government of Canada Treasury Bills (T-Bills) sold in the first 30 days of the previous quarter. For example, the prescribed rate for October 1 to December 31, 2013 is based upon the 90 day T-Bills that were sold in July 2013.
- The prescribed rate can be locked in under a PRL. For example, if the current prescribed rate is 2%, this rate can be locked in for as long as the loan is in existence, regardless of whether the prescribed rate rises. However, if the prescribed rate declines, the PRL can be renegotiated to lock in the lower prescribed rate.
- There is no limit on the PRL amount or the length of time the PRL is in place.

Generally speaking, a PRL agreement would:

- Provide the names of the borrower and lender
- Stipulate the amount loaned (principal)
- Stipulate the interest rate charged (prescribed rate or higher)
- Be signed, dated and witnessed, and
- Stipulate that interest for the year is due and payable on or before the 30th of January of the following year.

As with any tax related planning, it is important to consult with a tax professional prior to implementing this strategy. Legal advice may also be required in the drafting of the PRL Agreement.

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