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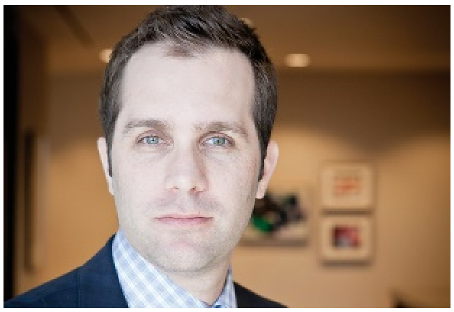
Income Splitting Isn't Dead:

Prescribed Rate Loan Planning



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With all of the recent proposed changes to the taxation of private corporations in Canada, it's hard for many to believe that there are still strategies available in 2018 to split income amongst family members. But there are. And the best time to implement one of these strategies – prescribed rate loan planning - is now, as the benefit to this type of planning will be reduced as of April 1, 2018.

Prescribed rate loan planning is a simple and effective strategy that allows high-income earners to split income with their family members who earn no, little or even less income, including spouses, children, grandchildren, more remote issue, parents and even minor nephews and nieces. The strategy involves a loan of money or assets by the high-income earning individual directly to one or more family members facing lower tax rates or, more commonly, to a trust established for the benefit of such family members. Where in-kind property is transferred, consideration must be given to the taxes that may arise on the transfer. To avoid the application of the attribution rules (which would cause all of the income earned by the loaned property to be taxed in the high-income earner's hands), the loan must bear interest of at least the "prescribed rate," a rate set by the government every three months determined with reference to short-term government of Canada T-bill rates. **With the prescribed interest rate at a historically low rate of 1% and an increase to 2% coming into effect as of April 1, 2018, now is the ideal time to implement (or top up) a prescribed rate loan if you haven't already done so.**

Once the loan is made, the borrower – whether the family member(s) or a trust on behalf of such family members - can invest the funds, and any income earned in excess of the prescribed rate can be taxed in the hands of such family members. The tax-saving opportunity lies in the spread between the prescribed rate and the rate at which the invested funds earn income. In fact, once the loan is made, it can bear interest at the prescribed rate, *at the time of the loan*, forever and, as a result, as interest rates rise (and with it, the prescribed rate), so too should the spread and, accordingly, the tax savings.

The tax impact of this strategy can be best explained through an example.

A couple, both paying taxes at the top marginal tax rate, has three young children (with no other income), each of whom attends private school, summer camp, and participates in a number of extra-curricular activities. The annual expenses for each child in this regard totals $10,000 and the parents have been funding these expenses with income they earn on their investments, the fair market value of which is assumed to be $1 million.

If the couple is earning 5% on its $1 million investments annually, they will be paying ~$26,765 of tax on their $50,000 of investment income (assuming such income is interest, dividends, etc., and not capital gains). If this income was used to pay for their children's expenses, they would have to dip into their other income to come up with the ~$6,765 shortfall for their children's expenses.

If prescribed rate planning is used instead, $10,000 (1% of $1 million) of income would be taxed in the couple's hands, resulting in taxes in the range of $5,353, while $40,000 of income could be divided equally and taxed in the children's hands, resulting in an aggregate of ~$1,100 of taxes (so long as the "kiddie tax" does not apply to any of the children while they are minors - which will depend on the nature of the investments). As a family unit, they will enjoy annual savings in excess of $20,000!

All of the income taxed in the children's hands must be paid to, or applied for the benefit of, the children. Since children's costs don't typically start and end with private school, summer camp, and extra-curricular activities, the excess (i.e., $10,000) could be used pay for other expenses like the children's portion of family trips, clothing and even groceries. (Strict record keeping is highly advisable in this regard.) Alternatively, the couple doesn't have to allocate all of the income in each year to the children; a portion of the income could be allocated to the parents or even taxed in the trust.

And you don't need $1 million of investible assets to take advantage of the planning. It can be done a smaller scale and still result in annual tax savings for the family. The planning also isn't limited to just children. For example, grandparents who wish to pay for their grandchildren's education, take their grandchildren on family trips, etc. can use this planning to fund these expenses using their grandchildren's marginal tax rates instead of their own.

In order for the strategy to work, it is imperative that the prescribed rate of interest *actually be paid* in each year to the lender by January 30th of the following year. If that interest payment is missed even once, the benefits of the planning will be undermined forever. Conversely, there may be instances where attribution is *desired* (i.e., if the investments go bad), in which case missing an interest payment could cause one to purposely fall into the attribution rules. In addition, there will be some ongoing administration where a trust is used, including, among other things, the filing of tax returns and resolutions documenting the allocation and payment of income to the trust's beneficiaries in each year.

Any future loans can only be made at the prescribed rate *at the time of the loan* so proper record keeping is critical in order to ensure that the appropriate amount of interest is being paid to the lender in each year.

Finally, it is critical that US tax consequences be considered when implementing a prescribed rate plan where one or more of the borrowers or the beneficiaries of a trust are US citizens, US residents or US green card holders. The tax implications in this regard may be far-reaching and the importance of considering them cannot be understated.