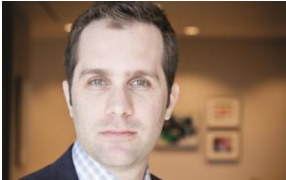




**MINDEN GROSS LLP**  
**BARRISTERS & SOLICITORS**  
145 KING STREET WEST, SUITE 2200  
TORONTO, ON, CANADA M5H 4G2  
Tel 416.362.3711 Fax 416.864.9223  
www.mindengross.com

## **Income Splitting 101: Prescribed Rate Loan Planning<sup>1</sup>**



**Matthew Getzler**  
Associate, Minden Gross LLP  
Tel. 416.369.4318  
mgetzler@mindengross.com

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With tax rates as high as they are in Canada, it's no wonder that people continue to search for ways to reduce their tax bill. Prescribed rate loan planning is a simple and effective strategy that allows high-income earners to split income with their family members who earn little or no income, including spouses, children, grandchildren, 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 (that 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.

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, set at the time of the loan, forever and as interest rates rise (and with it, the prescribed rate), so too should the spread and, the tax savings.

The tax impact of this strategy is 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

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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 anywhere from roughly \$12,500 to \$25,000 of tax on their \$50,000 of investment income, depending on the type of income they are earning (e.g., capital gains, dividends, interest, rent, etc.). If this income was used to pay for their children's expenses, they could be left with as much as \$7,500 after-tax for other purposes or they might have to dip into their other income to come up with the \$5,000 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 \$2,500 to \$5,000, while \$40,000 of income would be taxed in the children's hands, resulting in anywhere from no taxes to roughly \$1,500 in 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 the range of \$10,000 to \$18,500.

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., extra \$10,000 taxed in the children's hands) could be used to pay for other expenses like the children's portion of family trips, clothing and even groceries. (Strict record keeping is highly advisable.) Alternatively, the couple doesn't have to loan the entire \$1 million; however, any income earned on the portion that is not loaned will, of course, be subject to tax in the couples' hands at the highest marginal tax rates.

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.

With the prescribed interest rate at a historically low rate of 1%, now is the ideal time to implement a prescribed rate loan if you haven't already done so. And even if you have, consideration should be given to repaying any prescribed rate loans in full and putting a new loan into place at the 1% prescribed rate, taking into account the taxes that may be owing upon the liquidation of the assets required to repay the loan.

For more information on Income Splitting, Succession Planning or Personal or Corporate Tax Planning, please contact [Matthew Getzler](mailto:mgetzler@mindengross.com) at [mgetzler@mindengross.com](mailto:mgetzler@mindengross.com).