The TaxLetter®

Vol. 28, No. 3 | Your Guide to Tax-Saving Strategies | Single Copy: $10.00 March 2010

***INCOME*SPLITTING**

Don't miss out on a tax planning opportunity

Prescribed rate break

Samantha Prasad LL.B.

Income splitting with family members has been a long standing tradition.

Of course, that's assuming you are able to jump over the hurdles commonly known as the "attribution rules" which will prevent you from sprinkling income to the low-income members of your family.

More specifically, the attribution rules prevent you from income splitting simply by putting an investment in the name of a lower-income spouse or minor child (even if you are giving or lending your spouse or child the money to buy the investment). The result is that any income earned from such investments will be attributed back to you.

Samantha Prasad, LL.B., is a tax partner with the Toronto-based law firm Minden Gross LLP, a member of Meritas Law Firms Worldwide, and a Contributing Editor of The TaxLetter, published by MPL Communications. *sprasad@mindengross.com*

There are, however, some exceptions to the attribution rules. The most popular exception would be the "prescribed loan" strategy.

The Income Tax Act allows a spouse or minor child (or family trust of which such persons are beneficiaries) to report and pay tax on this income if the investment is funded by a loan from you. That's provided that the debtor (i.e. spouse, child or trust) pays you interest at the "prescribed rate" in effect at the time the loan is made.

Over the past years, the prescribed interest rate has varied – the lowest being three per cent and the highest seven per cent.

However, as a result of the depressed economy over the past 18 months, the prescribed interest rate has been at a historical low for the last few quarters: one per cent. Yes, one per cent. Which means that the benefits of the prescribed loan strategy are even more enhanced since the interest paid out will not break the bank.

In earlier years, when the prescribed interest rate was in the higher range, the ability to take advantage of this manoeuvre was limited since you, as the lender, would have to pay tax on the receipt of such interest.

Therefore, you would really need a lucrative investment in order to pursue this loan manoeuvre. One obvious example would be a stock which you expect to appreciate, if you can find a solid one in these up and down markets.

The flip side of this is that if the loan is made for the purpose of earning income (i.e. your spouse, child or trust were to borrow the money to make an investment), then the interest paid to you will normally be deductible by the payor.

In order to qualify for this tax exemption, the interest on the loan for each year must be paid no later than January 30 after the year end. Otherwise, the attribution rules will apply and the profits will be taxable in your hands.

Furthermore, if you miss even one deadline, the attribution rules will apply on the particular investment forevermore.

Conversely, if your investment turns out to be a loser, which could be the case if the markets slump, you might want to purposely trigger the attribution rules by missing an interest

payment. In this manner, for tax purposes, the loss will probably be treated as yours. That way you can actually take advantage of the attribution rules and turn them in your favour.

It may be the case that you have already put in place the prescribed loan strategy, but at a time when the prescribed rate was much higher.

Unfortunately, you are locked in at that higher rate because the income tax rules state that the prescribed rate must be the one in place at the time the initial loan was made.

Accordingly, you may want to consider restarting the clock by having the prescribed loan repaid in full by your spouse, child or trust.

Then you can put in place a new loan and lock in the current one per cent prescribed rate.

And the good news is that you will be locked into this low rate for as long as the loan is in place, even if the prescribed rate increases in the future.

Case law & CRA Initiatives

In light of the low one per cent prescribed rate, which was recently announced as being in place until the end of June 2010, the prescribed loan strategy has become quite popular, especially through the use of a family trust.

A discretionary family trust can be set up for the benefit of a spouse and minor children. The high-income spouse then loans funds to the trust at the one per cent prescribed rate for investment purposes.

However, recent case law and CRA scrutiny have made tax practitioners sit up and take note.

The cases of *Garron* and *Antle*, both released in the fall of 2009, have changed how we look at the residency of a trust and when a trust will be properly settled.

Garron held that a trust will be resident where the central management and control of the trust lies (and no longer where the majority of the trustees are resident). *Antle* in turn held that the settlement of the trust will be defective where there is a lack of intention to create a trust and no certainty of subject matter or property.

To add complications to these new trust law principles, it has been discovered that the CRA was auditing domestic trusts in a number of tax offices (notably, in the "Golden Horseshoe" area in Ontario). Apparently, the CRA was reviewing certain transactions as they pertain to family trusts, notably:

- distributions out of a trust to family members paid with promissory notes that may be unenforceable under limitation rules.
- diversion of cash for the trustees' own use.
- the absence of proper accounting records or trustees' minutes and the inability to locate the original settlement property for the trust.
- monitoring of compliance with the deemed disposition upon the 21st anniversary of the family trust.

So what does this mean for you if you have a prescribed loan with a family trust, or are thinking of putting this strategy in place?

- Make sure that the trust is properly settled and that each party knows their responsibilities.

This would mean ensuring that the settlor understands his or her role in formally establishing the trust and the trustees have an understanding of the assets held by the trust and their role as a trustee with respect to same.

- Trustees should meet at least annually and minutes or meeting notes should be prepared, even if no actions were taken by the trustees.
- Trustee resolutions should be prepared where income is to be distributed to beneficiaries.
- Ensure that income allocated to beneficiaries is evidenced by promissory notes if not paid before the year-end.
- Distributions to the beneficiaries should be for the beneficiaries' own use. It is also recommended that bank accounts be opened for each beneficiary and any distributions of income be distributed to their respective accounts.
- File a tax return for the family trust each year.
- Ensure all steps of the plan are carefully executed and documented.

The prescribed loan strategy is still worthwhile, what with the low prescribed rate of interest in place. However, ensure that the proper documentation and compliance is done with respect to this manoeuvre just in case the tax man comes knocking on your door. ❐

© Copyright 2010 by MPL Communications Inc., Reproduced by permission of *The TaxLetter*, 133 Richmond St. W., Toronto, ON M5H 3M8