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The clock is ticking on the low one per cent prescribed rate, so act now and lock in

Rare opportunity

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Last year, I wrote an article for *The TaxLetter* about the prescribed loan strategy. It's been a popular, and relatively simple, income-splitting tax strategy over the last few years while the prescribed rate of interest was at a low one per cent.

In that article, I suggested that the one per cent rate was likely to increase to two per cent in the last quarter of 2012. As it turns out, I was just 12 months too early in my pronouncement – it's been confirmed that the rate will rise to two per cent effective October 1, 2013.

What does this mean for you? Well, if you are one of the many taxpayers who would like to take advantage of the few income tax-splitting strategies out there, and have been procrastinating, now is the time to do it, or forever hold your peace.

The beauty of taking advantage of the one per cent rate now is that you get to lock into this low rate for the lifetime of the loan. So don't delay: read on to get familiar with the strategy before it's too late.

The general rule when it comes to income splitting is to avoid the "attribution rules." These rules will prevent you from sprinkling income to the low-income members of your family.

Specifically, if you simply give money or an investment to a lower-income spouse or minor child (or lend money on a tax-free basis for them to invest), any income earned from such investments in their hands will be attributed back to you.

However, the "prescribed loan" strategy is an exception to the attribution rules. The Income Tax Act allows a spouse or minor child (or family trust of which such persons are beneficiaries) to pay tax on income if the investment is funded by a loan from you, provided that the debtor (i.e., spouse, child or trust) pays you interest at the "prescribed rate" at the time the loan is made.

How does it work?

You, as the lender, can loan after-tax money to a spouse, minor child, or a family trust for their benefit at the prescribed rate in place at the time of the loan.

These funds would then be invested, and any income gained can be taxed in the hands of those family members, and assuming they are in lower tax-brackets, tax savings would result.

Alternatively, you can transfer property-in-kind instead of cash, and take back a promissory note bearing the prescribed rate of interest. Note, however, that this kind of transfer could potentially trigger any accrued capital gains in your hands.

In order to qualify for this tax break, 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.

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

Historically, the prescribed interest rate has varied between three per cent to as high as seven per cent. As I noted above, however, this rate was at the very low rate of one per cent since April 1, 2009 – not long after the economy plummeted. Hence, the rise in popularity for

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this strategy as the interest to be paid 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. You, as the lender, would have to pay tax on the receipt of such interest, in addition to your family member having to cough up the money to pay such interest.

Therefore, you would really need a lucrative investment if you wanted to pursue this loan manoeuvre.

One obvious example would be a stock which you expect to appreciate (that is, if you're lucky enough to find one in the current market).

The flip side 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.

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And what if your investment turns out to be a loser? Then you might want to purposely trigger the attribution rules by missing an interest payment. That way, for tax purposes, the loss will probably be treated as your own. So you can actually take advantage of the attribution rules by turning them in your favour.

It may be the case that you have already put in place the prescribed loan strategy before 2009, when the prescribed rate was higher.

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

You may want to consider restarting the clock now by having the prescribed loan repaid in full by your spouse, child or trust. You can then put in place a new loan and lock into the low one per cent 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 rate were to increase in the future.

Using a family trust

If you are looking to income split with your minor children, the prescribed loan strategy should be done through the use of a family trust. A discretionary family trust is set up for the benefit of a spouse and minor children, with the high-income spouse loaning funds to the trust at the prescribed rate for investment purposes.

The trust, in turn, invests the funds. Income earned on the investments is then allocated and distributed out to the beneficiaries, to be taxed in their hands.

If you are thinking of using a family trust, or already have one in place, it is important that you are aware of certain compliance matters for family trusts in case CanRev decides to knock on your door.

In particular, you should be aware of certain issues that may be looked at in detail by the CRA:

- Distributions out of trusts that are not properly documented;
- Diversion of cash for the trustees' own use instead of to the beneficiaries;
- 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.

And 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?

First, make sure that the trust is properly settled and that each party knows their responsibilities.

This would mean ensuring that the person forming the trust (commonly referred to as 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.

Next, trustees should meet at least annually and minutes or meeting notes should be prepared, even if no actions were taken by the trustees. Any resolutions made by the trustees should be prepared where income is to be distributed to beneficiaries.

And ensure that income allocated to beneficiaries is evidenced by promissory notes if not paid before the year-end. Also, 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 account.

Finally, file a tax return for the family trust each year, ensuring all steps of the prescribed loan strategy are carefully executed and documented.

Remember: the clock is ticking on the low one per cent rate. If you haven't called your tax advisor yet, pick up the phone before it's too late. October 1, 2013 is just around the corner. ❑