Income Splitting Opportunities for Families Using Prescribed Loans

Sometimes an individual wishes to shift income to lower income family members in order to reduce the family's tax liability. While there are "attribution rules" in the *Income Tax Act* (Canada) to prevent this, it is still possible to do legally with the right planning techniques. One such plan is the "Prescribed Loan Plan".

Since the prescribed rate on income splitting loans was reduced to a mere 1% for loans made between April 1st and June 30th of this year, the Prescribed Loan Plan is now a simple and cost effective means of reducing a family's tax liability.

What is the Prescribed Loan Plan?

The easiest way to illustrate how the Prescribed Loan Plan operates is through an example:

> Mr. Smith pays tax at the highest marginal tax rate in Ontario of 46.41%. His wife, Mrs. Smith, is in the lowest tax bracket and pays tax at the rate of 21.05%. Mr. Smith loans Mrs. Smith $500,000, and she earns a return of 4% per year.

If the income attribution rules apply, the $20,000 earned by Mrs. Smith will be included in Mr. Smith's income for tax purposes and subject to $9,282 of tax.

Under the Prescribed Loan Plan, the income attribution rules will not apply provided interest at the prescribed rate when the loan is made is paid on the loan. As a result, any income and capital gains realized by Mrs. Smith on investments acquired with the loan will be included in Mrs. Smith's income and not attributed to Mr. Smith.

Based on the 1% prescribed rate loan and the 4% annual return on the investments, Mrs. Smith will be taxed on income of $15,000 (i.e., $20,000 of investment income less the $5,000 of interest paid to Mr. Smith) and Mr. Smith will be taxed on $5,000 (i.e., the interest received from Mrs. Smith). As a result, the total tax paid on the $20,000 of income will be $5,478 (i.e., $3,157.50 on Mrs. Smith's income of $15,000 and $2,320.50 on Mr. Smith's $5,000 of interest income). This is approximately $3,800 (or 41%) less tax than the $9,282 that Mr. Smith would have paid on the income. Over a period of 10 years, this simple planning amounts to tax savings of approximately $38,000 (plus compounding)! If the loan between Mr. and Mrs. Smith is larger or if Mrs. Smith earns an average return that is greater than 4%, the tax savings will be greater.

The same planning can be implemented with children, and if the children have little or no other income, the tax savings can be even larger.

Conditions and Recommendations under the Prescribed Loan Plan

The conditions that must be met so that the attribution rules do not apply are not onerous.

First, the rate of interest on the loan must be equal to the prescribed rate at the time the loan is made. The current prescribed rate of 1% is in effect until June 30th (the rate for the next quarter will be set in late June).

Second, the interest payable on the loan each year must be paid by January 30th of the following year. If even one year's interest payment is missed or paid after January 30th, all income earned by the borrower will be attributed to the lender for that year and all years following that year. Attribution of income for the future years can only be corrected if the loan is repaid and a new loan at the prescribed rate at that time is made.

It is also recommended that:

1. The loan at the prescribed rate is properly documented. This can be done with a relatively simple loan agreement or a promissory note;
2. The borrower and lender each have their own accounts so that it is clear which person is making the loan, receiving the loan, paying the interest, receiving the

interest and making the investments. None of these accounts should be joint accounts;

3. There should be a "paper trail" that shows the borrowed money being transferred to the borrower from the lender, the investment being made by the borrower and interest being paid by the borrower to the lender; and
4. A family trust is created to obtain the loan and make the investments for Prescribed Loan Plans made with children who have not attained the age of 18 years.

Estate Planning Considerations under the Prescribed Loan Plan

If the Prescribed Loan Plan is implemented, the estate plans of the borrower and lender may need to be updated. Since the loan represents an asset of the lender:

1. The lender may want to specifically deal with the loan in his or her will; and
2. Planning should be considered to avoid probate tax on the loan (see our publication – *Some Estate Planning Opportunities*).

The borrower also needs to consider what will happen when he or she dies. As a debt, the loan will need to be repaid even if the lender dies. This may require the sale of some or all of the investments acquired with the loan. If the loan is forgiven by the lender when the borrower dies, there may be adverse tax consequences for the borrower or the borrower's estate.

Are there other opportunities to income split with family members?

Depending upon your circumstances, there may be additional opportunities to income split with family members. For example, if you own your own company, there are a numbers of ways your family's tax may be minimized.

If you would like to discuss the Prescribed Loan Plan or any other income splitting opportunities, please contact our Tax Practice.

Bryan McNulty heads up Pallett Valo's new Tax Practice.

Pallett Valo LLP Tax Practice Area

Tax Law is complex and requires highly specialized practitioners to navigate and interpret its intricacies. Our Tax Practice provides income tax advice to businesses and their owners to achieve tax efficient results that are consistent with our clients' non-tax objectives.

We assist our clients by assessing and minimizing the tax payable on their business transactions including the purchases and sales of businesses, advise on ownership structures, and implement on-going income tax reduction strategies. We also provide U.S. Estate Tax planning advice for individuals who are U.S. citizens, own significant U.S. property or have family members who are U.S. citizens or residents.

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