Family Income Splitting: Using a Prescribed Rate Loan

Canada has a progressive tax rate system which means that the marginal rate of tax increases as an individual's income surpasses various brackets. To mitigate the effect of being in a higher tax bracket, individuals may look for ways to split income with family members such as spouses/common-law partners, adult and minor children/grandchildren.

Income splitting between family members typically involves shifting taxable income to a high-income earner to a lower-income earner, with the objective of having the income taxed at a lower rate in the hands of the lower-income taxpayer. This may provide a family with more money for purposes such as investing.

While income splitting is appealing, Canada has "attribution rules" aimed at curtailing the ability of taxpayers to income split with related taxpayers. These rules operate by attributing income/losses (or, in some cases, capital gains/losses) back to the higher income taxpayer earned on property that is directly or indirectly loaned or transferred to the lower income taxpayer.

A Prescribed Rate Loan (PRL) arrangement enables income splitting without application of the attribution rules. This arrangement involves transferring funds, using a formal loan agreement, to a lower income family member for investment.

In order for the attribution rules not to apply, the following criteria should be met:

- there is a written loan agreement;
- at the time the loan is made, the rate of interest charged is at least equal to the lesser of:
  – the federal prescribed rate of interest, and
  – an arm's length rate (e.g., a commercial rate); and

- the loan interest for the current calendar year must be paid on or before January 30th of the following year. If the interest payments are not made when required, the attribution rules will apply for the current and all future years.

As the funds are used for investment purposes, the lower income family member may be able claim a tax deduction for the interest paid on the loan. Any income earned on the investments, which is in excess of the interest paid, would be taxable in the hands of the lower income earner. The interest paid is considered to be income to, and taxable to, the higher income earner.

When considering a PRL arrangement, individuals should consider:

- the tax rates of the borrower and lender;
- the rate of interest tied to the PRL; and
- the anticipated rate of return generated from the borrowed funds.

PRL Example

Alex lends to his common-law partner Tyler $100,000 at a time when the prescribed rate is 3%. Assume that Alex is in a 40% marginal tax bracket, and Tyler is in a 25% marginal tax bracket.

Alex	Income for Alex	Income for Tyler	Tyler
Lends to Tyler $100,000			Invests the $100,000
Earns 3% Interest (from Tyler)	$3,000	$5,000	Earns 5% interest (from his investment)
Alex's Taxable Income	$3,000	$2,000	Tyler's Taxable Income (net of $3,000 interest paid to Alex)
Tax @ 40%	$1,200	$500	Tax @ 25%
After-Tax Income	$1,800	$1,500	After-Tax Income
Total Income (After-Tax)	$3,300		

If Alex had kept and invested $100,000 for himself and earned interest at 5%, the full $5,000 of interest income would have been taxed in his hands, yielding an after-tax income of $3,000 which is lower than the $3,300 generated where a PRL is implemented.

> The invested funds would need to generate a return that is greater than the interest on the loan.

Generally speaking, in order for a PRL arrangement to be worthwhile, the borrower (e.g., Tyler) would typically need to remain in a lower tax bracket than the lender (e.g., Alex) and be able to make the corresponding interest payments. In addition, the invested funds would need to generate a return that is greater than the interest on the loan and any associated administrative costs.

PRLs and estate planning issues

As previously discussed, with a PRL, a written loan agreement would be in place, often in the form of a promissory note, outlining the terms of the loan agreement. One of the important issues to address when entering into a PRL arrangement is the possibility that either the borrowing or lending partner passes away before the loan is repaid.

Upon the *death of the borrower*, a PRL arrangement would typically be treated like any other outstanding debt, unless the lender forgives the debt. When this occurs, the debt forgiveness rules within the *Income Tax Act (ITA)* may apply. If the debt is not forgiven, the borrower's estate would be required to repay the outstanding loan amount.

If the *lender's death* occurs before the loan is repaid, his or her executor will need to work with the borrower to ensure the loan is repaid, unless there is documentation summarizing that the lender forgives the loan on death. The *ITA* debt forgiveness rules do not apply to loans forgiven by way of bequest or inheritance.

Forgiving a loan can be complex and may impact the distribution of an estate. Therefore a discussion with an estate lawyer, as part of the PRL process, and overall estate planning is recommended.

Additional Information

- The Canada Revenue Agency (CRA) announces the prescribed interest rate on a quarterly basis.
- The prescribed interest rate is locked in under a PRL. For example, if the current prescribed interest rate is 2%, this rate is locked in for as long as the loan is in existence, regardless of any subsequent changes in the prescribed interest rate.
- In some instances, individuals may use a family trust as part of their PRL arrangement. The family trust would act as the borrower and would be required to pay interest to the lender based on the criteria previously outlined above.
- There will be legal costs associated with having a loan document properly prepared outlining the terms of the PRL. In addition, where a family trust is used as part of a PRL arrangement, there may be costs associated with establishing and maintaining the family trust structure, such as legal fees and annual accounting and tax filing fees for the family trust.
- There is no limit on the PRL amount, or the length of time for which the PRL remains in place.
- The Department of Finance released draft legislation on December 13, 2017 dealing with the Tax on Split Income (TOSI) to further restrict income splitting opportunities. The proposed measures broaden the TOSI from minor to adult individuals resident in Canada and expand the scope of split income to include, among others, income from indebtedness. These rules, generally effective from January 1, 2018, are complex and may have an unanticipated impact on existing income splitting arrangements. Individuals who have, or plan, to put into place a PRL, should consult with a qualified tax advisor to make sure that there is no negative effect arising from these proposals on their arrangement.

Prior to the implementation of a PRL arrangement, individuals should seek the advice of a tax advisor and lawyer to ensure that the planning opportunity is appropriate in their particular circumstances.

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