

INCOME SPLITTING: TAKE ADVANTAGE OF THE 1% PRESCRIBED RATE

The Canada Revenue Agency reduced the prescribed rate on income splitting to 1% for the period April 1st 2009 to September 30, 2009. Historically, the prescribed interest rate has never been so low.

The prescribed interest rate is the rate that applies to loans made pursuant to an agreement to split income. As a result, we have an **exceptional opportunity** to establish a **long term income splitting** strategy with one's spouse, adult children, or minor children (by using a trust).

How should one proceed to income split?

It is usually profitable for a high net worth individual to transfer some of his income to a related person who is in a lower tax bracket. As a result, the attribution rules in the Income Tax Act are generally designed to prevent this type of income splitting strategy. The application of these rules has the effect of attributing the income earned by the lower income earner back to the transferor, thereby reducing the opportunity to income split.

However, the tax laws provide the following exception to the attribution rules: that is, where a taxpayer makes a loan to a relative (e.g.: a spouse, an adult child, or a trust created for the benefit of minor children) and the loan bears interest at a rate equal to (or greater than) the prescribed rate at the time the loan is issued then the attribution rules will generally not apply. Please note that in order for this type of strategy to work, the related person must pay the lender the interest owing in respect of the year no later than 30 days after the end of calendar year.

Consider the following illustration:

- Mr. X has an annual income of \$200,000
- His spouse, Mrs. X, has an annual income of \$25,000

In order to take advantage of the low prescribed rates, on May 1, 2009, Mr. X makes a \$1 million loan to his wife. The loan bears interest at a rate of 1%.

Because the interest rate is equal to the prescribed rate of 1% that was in force at the time of the loan, the attribution rules will not apply, provided that Mrs. X pays the interest expense within the period prescribed by the Income Tax Act. To meet this condition, Mrs. X must pay the interest owing in respect of each year on or before January 30th of the following year. Failure to make an interest payment on time will result in the application of the attribution rules.

While Mr. X will have to include the interest in his income, Mrs. X will pay tax on the net investment income generated on the \$1 million loan. Assuming a return on investment of 4%, in 2009 Mrs. X would pay tax on approximately \$ 27,000 ($\$1,000,000 \times 4\% \times 8/12$) of income less the interest paid on the borrowing. Therefore, in this example, Mr. X will have successfully transferred approximately \$20,000 of net investment income to Mrs. X in calendar 2009.

Planning that will work in the long term

A 1% loan to a relative made before the end of September 2009 will help avoid the application of the attribution rules during the entire existence of the borrowing (e.g.: for a period of 3, 5, or 10 years, etc.). That is, the 1% interest rate on the loan will remain fixed until the loan matures, even if the prescribed rate increases thereafter.

Please contact a member of our tax department to obtain more information regarding this type of planning.