



Income Splitting: Prescribed Rate to Increase

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“Income splitting” refers to tax-planning strategies whereby an individual in a high tax bracket shifts some of his or her tax burden to individuals in a lower tax bracket – for example, the individual’s spouse or minor children. Canada’s *Income Tax Act*, however, contains “attribution rules” that eliminate income splitting opportunities when an individual gratuitously transfers, or loans funds at no interest, directly to his or her spouse or minor children or indirectly, for instance, to a trust for their benefit. In such cases, income derived from the property that was transferred or loaned (or from substituted property) will be attributed back to the spouse or parent who transferred or loaned the property.

The application of these attribution rules can be avoided where property is transferred for fair market value consideration or through the use of loans that meet certain requirements, namely, (1) the loan bears interest at Canada Revenue Agency’s prescribed interest rate at the time the loan is made, and (2) interest for a particular year is paid to the lender by January 30 of the following year (“Prescribed Rate Loans”). Prescribed Rate Loans can be used between spouses whereby an individual in a higher tax bracket lends funds at the prescribed rate to his or her spouse who is in a lower tax bracket. The spouse would invest the loaned funds and, after paying the interest on the loan for the year by January 30 of the following year, would report the net income arising in respect of the loaned funds on his or her own tax return.

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Prescribed Rate Loans can also be used to shift the tax burden to minor children through discretionary family trusts established for the children's benefit. The parent would loan funds to the trust at the prescribed rate. The trustees of the trust would invest the loaned funds and pay the interest on the loan to the parent for each year by January 30 of the following year. The trustees can then allocate the net income derived from the loaned funds to the children. Provided the children are Canadian residents, income that is allocated and paid or made payable in the year to the children would be taxed in the children's hands, and the trust would then have a corresponding deduction for the allocation of such income to the children.

Although the individual lending funds at the prescribed rate to his or her spouse or to a family trust will include the interest income arising in respect of the loan in his or her income for tax purposes, Prescribed Rate Loans shift some of the tax burden to the spouse or the beneficiaries of the family trust because the net investment income arising in respect of the loaned funds would be taxed in their hands.

The prescribed rate of interest at the time the loan is entered into applies for the period the loan remains outstanding. Currently, the prescribed rate is 1% but is expected to increase to 2% on July 1, 2022. Individuals who wish to consider Prescribed Rate Loans as part of their tax planning may wish to consider this strategy before the new rate comes into effect.

For strategic advice regarding all of your tax planning, **please contact our firm.**

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