



Prescribed Rate Loans for Family Income-Splitting

June 2017

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Income splitting is the transferring of income from a high-income spouse to a lower-income spouse to reduce the overall tax burden of the family. Since our tax system has graduated tax brackets, by having the income taxed in the lower-income earner's hands, the overall tax burden of the couple can be reduced.

Unfortunately, the "attribution rules" in the Income Tax Act (the Act) make this difficult by generally attributing any income or gains earned on money transferred or gifted to a spouse back to the original transferor spouse.

Fortunately, however, the Act does provide an exception to this rule if funds are loaned, rather than gifted, from one spouse to the other at the prescribed rate in effect at the time the loan was originated.

The prescribed rate is set by the Canada Revenue Agency quarterly and is tied directly to the yield on Government of Canada 90-day Treasury Bills, albeit with a lag. The calculation is based on a formula in the Income Tax Act regulations, which takes the simple average of three-month Treasury bills for the first month of the preceding quarter rounded up to the next highest whole percentage point.¹

How it Works

In a typical income splitting loan strategy, a high-income spouse loans funds at the prescribed rate to their lower-income spouse. The loan should be supported by a properly drafted loan agreement and interest on the loan must be paid within thirty days of the end of the calendar year. The investment returns net of the tax-deductible interest on the spousal loan can then be taxed in the lower-income spouse's hands.

The Benefit

The net effect of implementing a prescribed rate loan will be to have only interest income at the prescribed rate taxed in the hands of the higher-income spouse, while any investment return generated above the prescribed rate is taxed in the hands of the lower-income spouse.

Prescribed rate loans can also be used to help fund minor children's expenses, such as paying for private school and extracurricular activities, by making a prescribed rate loan to a family trust.

You should obtain tax and legal advice before implementing a prescribed rate loan, to determine the best way to structure and operate this type of arrangement and the implications in your particular circumstances.

¹ T-bill rates that are used in the calculation of the prescribed rate can be found on the Department of Finance website at <http://www.fin.gc.ca/admin/len/rcr-trc-eng.asp>. Prescribed interest rates can be found on the Canada Revenue Agency website at <http://www.cra-arc.gc.ca/interestrates/>.

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As with all planning strategies, you should seek the advice of a qualified tax advisor.

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