Act now for income splitting loans: CRA’s prescribed rate set to double

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Using a prescribed rate loan to split investment income with a spouse, common-law partner or even your kids is one of the most recommended tax planning strategies available to families. Yet the window for locking-in an income splitting loan at the lowest possible historical prescribed rate of 1% is quickly coming to an end as the prescribed rate is set to double to 2% on July 1, 2022.

Prescribed rate doubling to 2% as of July 1, 2022

Recent increases in interest rates in Canada will cause the prescribed rate set by the Canada Revenue Agency (CRA) to double to 2% from 1% effective July 1, 2022. The prescribed rates are set by the CRA quarterly and are tied directly to the yield on Government of Canada three-month Treasury Bills, albeit with a lag. The calculation is based on a formula in the *Income Tax 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 (if not already a whole number).

To calculate the rate for the upcoming quarter (July through September 2022), we look at the first month of the current quarter (April) and take the average of the three-month T-Bill yields, which were 1.02% (April 12, 2022) and 1.38% (April 26, 2022).[1] That average is 1.20% but when rounded up to the nearest whole percentage point, we get 2% for the new prescribed rate for the second quarter of 2022.

This upcoming increase marks the first time the prescribed rate has gone up since it dropped to the current historic low of 1% in July 2020.

Set up income splitting strategies before July 1, 2022

If you act now, by June 30, 2022, you can take advantage of the all-time historic low prescribed rate of 1% to split income for the duration of the loan, even once the rate increases to 2% (or higher) in the future.

Here's how the income splitting strategy works, using an example of Jack, who is in the highest tax bracket, and Dianne, who is in the lowest bracket. Jack loans Dianne $500,000 at the current prescribed rate of 1% secured by a written promissory note. Dianne invests the money in a portfolio of Canadian dividend paying stocks with a current yield of 4%.

Each year, Diane takes $5,000 of the $20,000 in dividends she receives to pay the 1% interest on the loan to Jack. She makes sure to do this by January 30 of each year following the year after the loan was made, as required under the *Income* Tax Act.

The net tax savings to the couple would be having the dividends taxed in Dianne's hands at the lowest rate instead of in Jack's hands at the highest rate. The savings are offset slightly by having the $5,000 of interest on the promissory note taxable to Jack at the highest rate for interest income. This interest paid, however, is tax deductible to Dianne at her low tax rate as the interest was paid for the purpose of earning income, namely the dividends.

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[1] Source: Bank of Canada, Selected Treasury Bill Yields, available online at bankofcanada.ca/rates/interest-rates/t-bill-yields/.

The rush to beat the June 30th deadline is that in order to avoid the attribution rules from applying to a spousal loan such as this one, you need only pay interest at the prescribed rate in effect at the time the loan was originally extended. In other words, if you establish the loan during a quarter in which the prescribed rate is 1%, as it currently is, you can use that rate for the duration of the loan, even if the prescribed rate rises in the future. Note that there need not be an end date to the loan, which could be simply repayable upon demand.

So for loans granted as of July 1, Dianne would have to pay $10,000 back to Jack to be taxed at the highest rate, instead of $5,000.

This strategy can be expanded to help fund children's expenses, such as private school and extracurricular activities, by making a prescribed rate loan to a family trust. The trust then invests the money and pays the net investment income, after the interest on the loan, to the kids either directly or indirectly by paying their expenses. If the kids have zero or little other income, this investment income can be received perhaps entirely tax-free.

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