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CRA SET TO INCREASE THE PRESCRIBED INTEREST RATE – IS NOW THE TIME TO IMPLEMENT A FAMILY INCOME SPLITTING STRATEGY?

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On July 1, 2022, the Canada Revenue Agency will be doubling the "prescribed rate" from one to two percent for the first time since 2020. As a result, now may be the time to consider whether a prescribed rate loan is an appropriate income splitting strategy for your situation.

Overview

The purpose of prescribed rate loan planning is to shift investment income from a family member in a high tax bracket to a spouse and/or child in a lower tax bracket. With proper planning and execution, this can be done without triggering the family attribution rules in the *Income Tax Act*.

The strategy itself is fairly straightforward. A high-income family member loans money to a family trust or directly to a low-income family member, such as a spouse, at the prescribed interest rate. The trust or the low-income family member then invests in securities and pays interest to the high-income family member. Interest on the loan must be actually paid to the high-income family member by January 30 of each year. All investment income in excess of prescribed rate (currently 1%) is taxed in the hands of the low-income family member, with the net result being a lower effective tax rate for the family as a whole.

Let's consider an example of a high-income family member, Susan, who has a marginal tax rate of 53% and $1M in investable capital which will generate an annual return of 6%. The table below demonstrates the tax benefit of loaning funds at 1% to her spouse, John, who has a marginal tax rate of only 20%.

	Investments directly by Susan	Funds Loaned to John to Invest
Taxable Investment Income	$60,000	$60,000
Tax payable by Susan	$31,800	$5300 (on interest income)
Tax payable by John	-	$12,000
Total Family Tax	**$31,800**	**$17,300**

The total annual tax savings in the above scenario are $14,500. This strategy can also be used to split income with children, in which case a family trust is generally established to make the investments and distribute any income to the low-income spouse and/or children.

Why now?

The benefit from this strategy relies on there being a healthy spread between the prescribed interest rate (currently 1%) and the investment income generated by the loaned capital. When the prescribed rate is higher, the potential benefit from this strategy is diminished. The good news is that structures established prior to July 1, 2022, can "lock-in" loans at the current lower rate.

The Bottom Line

Although the concept appears to be relatively simple, all prescribed rate loans must be carefully structured to prevent inadvertently triggering the income attribution or "tax-on-split income" (TOSI) rules. We would be pleased to provide additional information and discuss whether this strategy is right for you and your family.

The material contained herein is necessarily of a general nature and cannot be regarded as legal advice. The members of our firm would be pleased to provide additional information. You may reach us at (514) 849-1188 or by e-mail as follows:

Sydney Sweibel
ssweibel@sweibelnovek.com

Barbara L. Novek
bnovek@sweibelnovek.com

Carol Rabbat
crabbat@sweibelnovek.com

Denis A. Lapierre
dlapierre@sweibelnovek.com

Ryan Rotchin
rrotchin@sweibelnovek.com

Slava Sinigerska
ssinigerska@sweibelnovek.com

Amaya Olivo Espinal
aolivo@sweibelnovek.com

Steven Patterson
spatterson@sweibelnovek.com