Change is coming: Understanding your opportunity for income splitting

May 25, 2022

With the increase in prescribed interest rates set for July 2022, one of the last remaining opportunities to income split amongst family members is about to increase in cost. This opportunity is available to families who are interested in earning investment income.

What you need to know

- Currently, a family with one or more members earning less than $220,000 per year can save tax by putting in place a prescribed rate inter-family loan. This typically occurs by having a parent make a loan to a family trust (of which their spouse or minor children may be beneficiaries) at 1 per cent.
- The recipient of the loan (spouse, children and/or trust) then invests it in publicly traded securities and pays the lender 1 per cent.
- Any income earned on the investments (less the 1 per cent paid to lender) is subject to tax in the hands of the recipients at their lower effective rate. This provides overall tax savings for the family.

To illustrate this example…

To illustrate the application of this planning, consider the following family unit, which consists of Mr. and Dr. X and their two children:

- Dr. X is a high-income earner, who pays tax at the highest marginal rate;
- Mr. X does not have any source of income;
- Child A and Child B are in full-time studies and do not have any source of income; and
- Mr. X, Child A and Child B are beneficiaries of a family trust.

Given that Dr. X is in the highest marginal tax bracket, Dr. X will pay tax of approximately 40 per cent on dividend income earned from portfolio investments in publicly traded shares. Therefore, on an investment of $3,000,000, which yields a 5 per cent return, would be approximately $60,000 of tax payable.

Dr. X could make a prescribed rate interest-bearing loan to the family trust, which would use this money to invest and earn the same 5 per cent return. On this return, a portion will be paid to Dr. X as interest income and the remaining dividend income will be allocated proportionately to Mr. X, Child A and Child B to potentially eliminate the overall tax on this dividend income.

How BLG can put this plan into action

This plan works well given the low prescribed rate currently in effect of 1 per cent. However, the prescribed rate is set to increase to 2 per cent in June 2022. Consequently, implementing this plan after June 2022 will reduce its efficiency.

BLG is prepared to help you implement this plan, where appropriate, before the prescribed rate increases from 1 per cent to 2 per cent. For more questions, or to get started, please reach out to any of the authors or key contacts listed below.

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