Cidel
Asset Management

July 1, 2020: Income Splitting

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An expected drop in the CRA's "prescribed interest rate" on July 1 presents Canadians with an historic opportunity to implement one of the most accessible tax-saving strategies: "income splitting".

Income splitting diverts income from a higher-income earner to a lower-income earner; the diverted income is then taxed in the hands of the lower earner, at their lower marginal tax rate. The benefit of income splitting is the tax saved from having the diverted income taxed at the lower earner's marginal tax rate compared to that of the higher earner. Income splitting usually occurs between spouses, between parents and children, or between grandparents and grandchildren. The income that is split with a spouse or child can be used to pay for a variety of living expenses that would otherwise be borne by the higher earner, including private school tuition, summer camp fees, vacations, and investment opportunities.

Although recent changes to the tax rules have limited the ways in which taxpayers can split their income, the rules still permit families to split income using their investment portfolios. This is accomplished by the higher earner transferring the investment portfolio directly to the lower earner or, more commonly, to a trust for which the lower earner is a beneficiary. The income earned on the investment portfolio is allocated to the lower earners, thereby reducing the overall tax burden on the investment income for each year that the structure is in place.

On the transfer of the portfolio, the trust (or lower earner) will usually issue an interest bearing promissory note to the higher earner. The interest paid on the promissory note must be included in the higher earner's taxable income each year and, as such, is a "cost" of implementing an income-splitting plan.

To avoid adverse tax consequences, the interest rate on the note must be at least equal to the CRA's "prescribed interest rate" at the time the promissory note is issued. It is important to note that the interest rate on the promissory note is "locked-in" and should not fluctuate as and when interest rates rise.

The prescribed interest rate is expected to drop to 1% as of July 1st. Note that the prescribed interest rate cannot be less than 1%.

The drop in the prescribed interest rate to 1% provides a unique opportunity for Canadians to split income with their families at historically low costs. If you think you may benefit from splitting income with your spouse, children or grandchildren, please contact us to learn more about how Cidel can assist.