

The Navigator

RBC WEALTH MANAGEMENT SERVICES

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Prescribed Rate Loans for Family Income Splitting

CRA's prescribed interest rate is still only 1% – A rare opportunity to lock in your prescribed rate loan at the lowest rate in years!

This article explains how prescribed rate loans can be used for income splitting with family members. Any reference to “spouse” also applies to common-law partners of either the same or opposite sex as they are treated the same as married spouses for Canadian tax purposes.

You should obtain professional advice from a qualified tax advisor before acting on any of the information in this article. This will ensure that your own circumstances have been considered and that action is taken on the most recent information available.

Using a formal loan at the Canada Revenue Agency (CRA)'s prescribed rate of interest is an excellent way to legally split income with your adult children, your spouse or your minor children (if loaned through a trust). A formal loan that meets certain requirements enables all income earned on the loaned capital to be taxed in the hands of your adult children, your spouse or your minor children.

The CRA's prescribed rate of interest for family loans will remain at 1% until at least March 31st, 2013. This represents a rare opportunity to lock in a prescribed rate loan arrangement at a very low rate. For this reason, you may want to consider lending funds to family members in lower tax brackets, who may in turn invest the proceeds of the loan at a rate of return that is sufficient to cover the interest on the loan. The net income earned (after deducting the interest expense paid to the lender) will be taxed in the hands of your family member at their lower income tax rate.



RBC Wealth Management

The Spousal Loan Strategy is a form of income splitting between spouses using a loan at the CRA's prescribed rate of interest.

What is family income splitting?

The Spousal Loan Strategy is a form of income splitting between spouses using a loan at the CRA's prescribed rate of interest. This strategy consists of shifting income from the spouse in the higher tax bracket to the spouse in the lower tax bracket. When taxed in the lower income spouse's hands, the investment income is taxed at a lower rate than if it were taxed in the higher income spouse's hands. This results in more after-tax income for the family and a larger total family asset base. The same tax savings strategy applies to income splitting using a prescribed rate loan between parents and adult children or minor children through the use of a trust.

To maximize the benefits of family income splitting, you cannot simply transfer funds to your lower income spouse or minor children by way of an outright gift, or by changing the name on your investment account to your lower income family member's name. A parent can make an outright gift to an adult child to maximize the benefits of family income splitting but if the parent feels more comfortable loaning funds to their adult children, the loan must be at least at the CRA's prescribed rate of interest in order to benefit from income splitting. The requirement to make loans at the CRA's prescribed interest rate for family income splitting is due to the CRA's enforcement of the "income attribution rules" discussed later in greater detail.

Loans at prescribed rates — Will the CRA allow this method of income splitting?

Yes, the CRA permits loans at prescribed rates to family members as a way to avoid the income attribution rules, provided that:

- A formal loan arrangement exists between the parties;
- The rate of interest is at least the CRA's prescribed interest rate at the time the loan is established (the CRA sets and publishes these rates quarterly); and
- The interest is paid by the borrower to the lender annually no later than 30 days after December 31st of the year.

Example of a prescribed rate loan to an adult child

Judy Smith believes she has accumulated more than enough wealth to live comfortably and she dislikes paying income taxes at the highest marginal tax rate. Her adult child, however, has no taxable income. If Judy could utilize a method of income splitting, the family unit could reduce their total tax liability.

Judy approaches her advisor at RBC, who understands her present situation and overall objectives. As her son is still a young adult, Judy is not comfortable making an outright gift to him to achieve family income splitting. To be able to maximize the benefits of family income splitting with her adult son, her RBC advisor recommends that she consider approaching her tax advisor to discuss the merits of income splitting with her adult son through the use of a loan at the CRA's prescribed rate.

To illustrate the benefits of family income splitting, let's assume that Judy was considering investing \$100,000 in a bond yielding 4% (paid annually). Through discussions with her RBC advisor and her tax accountant, she decided to lend the \$100,000 to her 19-year-old son, Jimmy, to enable him to purchase the bond.

At the beginning of the year, Judy loans \$100,000 to Jimmy at the 1% CRA prescribed rate of interest. Jimmy earns interest income of \$4,000 annually on his investment in the bond and reports it on his income tax return. He has no other sources of income. He is required to pay Judy \$1,000 a year in interest but he can deduct this expense on his tax return. The resulting \$3,000 of net taxable income does not attract any income tax since this amount is less than Jimmy's basic personal tax exemption.

Judy is now only paying tax on the 1% of interest income she receives from the loan to Jimmy and Jimmy is earning 3% tax-free (4% net of 1% interest expense) while only using \$3,000 of his basic personal tax exemption. Jimmy must pay the interest for the current year to Judy no later than January 30th of the following year and Judy must include the interest on the loan on her income tax return in the year she receives it from Jimmy. If this was a low or no interest loan, all the interest income Jimmy earned on the bond would be attributed to Judy and family income splitting would not be successful.

Example of a prescribed rate loan to your spouse (the Spousal Loan Strategy)

Walter has excess cash and wants to utilize a loan at the 1% prescribed rate to split income with his spouse, Jane. Jane signs a simple promissory note to Walter for \$200,000, which is payable upon demand at the prescribed rate of 1%, with interest paid annually.

Jane invests her \$200,000 such that she is able to generate an annual return of 7%, or \$14,000. If the loan is outstanding for a full year and there is no need to prorate, Walter will receive \$2,000 of interest income from Jane, while Jane will have \$14,000 of investment income with a deduction of \$2,000 for the interest she paid to Walter.

Annual tax impact of the Spousal Loan Strategy

	Walter	Jane
Income	\$2,000	\$14,000
Interest expense	--	(\$ 2,000)
Net income from loan	\$2,000	\$12,000

Walter, who is in the top tax bracket, is able to shift \$12,000 of taxable income to Jane, who is in a lower tax bracket. If there is a 20% difference between their tax brackets (e.g. 45% versus 25%), then the family will save \$2,400 on their total tax bill ($\$12,000 \times 20\%$) in the first full year that the loan is established. If Walter simply transfers the funds to Jane or makes a low or no interest loan to her, family income splitting will not be successful since all the income will be attributed back to him.

In order to take advantage of the current lower prescribed interest rate, it may be advantageous for you to repay an existing loan and arrange for a brand new loan at the lower rate.

Important factors to keep in mind

It is important to ensure that your spouse, adult children or the trust, in the case of minor children, have sufficient funds to make interest payments on the loan. Not only should the invested funds generate a return at least equal to the interest expense in order to make the loan mechanism worthwhile, but the family member to whom you make the loan must also be able to pay the interest to you each year. In the first year of the loan, the amount of interest payable has to be prorated based on the number of days in the year during which the loan is outstanding.

If the required interest payments are not made to you within 30 days after the end of the year, the attribution rules will apply. Not only will attribution apply for the year the loan interest payment is missed, it will also apply for all subsequent years, regardless of whether or not the missed interest payment is subsequently made up. Simply put, once a loan interest payment is missed for a given year, the attribution rules will permanently apply to the entire capital amount that was loaned for the remaining lifetime of the loan.

The prescribed rate is set quarterly by the CRA based on the average 90-day T-bill rates of the first month of the previous quarter. Therefore, confirm the prescribed interest rate in effect each time prior to formalizing a new prescribed rate loan.

In order to take advantage of the current lower prescribed interest rate, it may be advantageous for you to repay an existing loan and arrange for a brand new loan at the lower rate. However, the process of refinancing an existing spousal loan requires careful consideration since the income attribution rules could be triggered if the refinancing is not executed

correctly. For more information, ask your advisor for a copy of the article titled, “Modifying a Prescribed Rate Loan.”

Once you formally establish a prescribed rate loan, the rate applies for the life span of the loan, even if prescribed rates subsequently increase or decline. There is no maximum or minimum amount restriction on these loans. You can create the loan for any length of time and a simple demand loan is sufficient to lock in the prescribed rate. To keep the demand feature of the loan in effect, however, you’ll need to renew your promissory note as required.

If you are disposing of securities to fund the loan, any capital gains or losses accrued at the time you sold the securities will be recognized on your tax return in the year of the sale.

Attribution rules

As we discussed earlier, a simple transfer of funds to your spouse or minor children, or a low or no-interest loan to your adult children or minor children through a trust, does not achieve maximum family income splitting due to CRA’s enforcement of the income attribution rules. The following sections explain how the income attribution rules could render these strategies ineffective.

Spousal attribution

If you gift any capital to your spouse (or if you lend it without charging at least the CRA’s prescribed rate of interest), your gifted capital will be transferred at your adjusted cost base (ACB) and any future investment income and capital gain/loss on the eventual sale of the investments will be taxable in your hands. This is why you cannot simply change the name on an investment account to that of your lower income spouse in the hope of having the income taxed in your spouse’s hands. However, you can avoid the income attribution rules by implementing the Spousal Loan Strategy in accordance with the CRA’s terms and conditions, as described earlier.

Attribution and minor children

If you gift an amount to your minor child to invest, typically through a trust arrangement, any interest and dividends earned on the gifted investment, that is paid out or allocated to that beneficiary, will attribute back to you and be taxed in your hands. Capital gains earned on the gifted amount are not subject to the attribution rules in this case and will be taxed in your minor child’s hands.

If you are the settlor and trustee of a trust and the transfer to the trust is revocable (i.e. you can retrieve the assets that were transferred to the

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trust), the validity of the trust structure may be challenged by the CRA and there will be a risk that capital gains could be attributed back to you.

Attribution and adult children

The income earned on funds transferred as a gift to an adult child is not attributed back to the parent; therefore, any outright gift will achieve family income splitting.

When a gift is made it is generally not revocable and consequently, the parent making the gift loses control of the funds. As a parent, you may not be comfortable with that for a number of reasons. In order to retain control, you may want to loan funds to your adult child, instead of making a gift, as you can always recall a loan. However, when a low or no interest loan is made to adult children, the income attribution rules may apply. Interest and dividend income, but not capital gains/losses, that is earned on the loaned funds, will attribute to the parent who made the loan, for tax purposes. You can avoid the income attribution rules by charging interest on the loan at least at the CRA's prescribed rate.

In order to retain control, you may want to loan funds to your adult child, instead of making a gift, as you can always recall a loan.

Example: Cash gift to adult child to fund education

Ed has a 19-year-old daughter, named Sandy, who has just completed her first year of university. Ed set aside \$300,000 in a separate investment account and used the investment income earned on these funds to help finance Sandy's education expenses. He is currently earning 5% on these investments, or \$15,000 per year. However, he is also paying tax on this amount at the top marginal rate of about 45%. The after-tax amount of \$8,250 is just about enough to cover a year of Sandy's education expenses.

If Ed gifts \$165,000 to Sandy instead, the family's tax bill could be significantly reduced. Sandy could invest this amount to generate a 5% return and earn the required \$8,250. As Sandy has her basic personal tax exemption as well as her tuition credits and no other sources of income, she may not pay any tax on the investment income. Furthermore, Ed still has \$135,000 invested at 5%, which is earning \$6,750. After paying 45% tax on this investment income, he will have \$3,713 in additional income.

In summary, instead of using all of the investment income earned on the \$300,000 for Sandy's education, Ed now has an excess of \$3,713 and Sandy's education is fully funded.

If you do not want to gift an amount to your adult child, either because you do not want to ultimately give up the funds or because you feel that your adult child is not mature enough to take full control, a demand loan, which allows you to take back the loan amount at any time, may be

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loan arrangement and to draft a new loan agreement at the lower rate. (Ask your advisor for a copy of “Modifying a Prescribed Rate Loan.”)

- Prior to implementing this strategy, we recommend that you consult your own professional tax and/or legal advisors to determine its appropriateness, as well as ensuring that your loan agreement contains all the necessary criteria to satisfy the CRA.

› Please contact us for more information.

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