The Navigator

The Spousal Loan Strategy

Implementing a spousal loan can reward you with substantial tax savings when the strategy is properly executed and managed. When you consider the Spousal Loan Strategy, it is important for you to understand the responsibilities associated with establishing a spousal loan and carefully consider all recommendations provided to ensure that the strategy remains successful in the long-term.

The content in this article is for information purposes only and does not provide tax or legal advice. It is imperative that you 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 are properly considered and that action is taken based on the most current legislation.

The Strategy

The spousal loan strategy aims to shift future investment income from the higher income spouse to the lower income spouse in order to take advantage of the lower income spouse's lower marginal tax rate. This involves the higher income spouse loaning funds to the lower income spouse. The lower income spouse will then use the loaned funds for investing purposes to generate investment income. Shifting the investment income to the lower income spouse results in annual tax savings for the family and helps the lower income spouse accumulate funds for retirement or help them achieve their other financial goals.

Why can't the higher income spouse just gift funds to the lower income spouse instead of going through all the trouble of loaning funds from one spouse to the other? If the lower income spouse doesn't pay adequate consideration to the higher income spouse for the use of the higher income spouse's funds, any investment income generated on the funds will be attributed back to the higher income spouse. In order to avoid income from being attributed back to the higher income spouse, the lower income spouse should pay annual interest on the loan to the lending spouse. The interest charged must be at least equal to the Canada Revenue Agency (CRA) prescribed interest rate that is in effect when the loan is made. Further, this interest must be paid annually no later than 30 days after year-end. Otherwise, all current and future income will be attributed back to the lending spouse and this income-splitting strategy will not work.

To implement this strategy, the higher income spouse makes a demand loan to their lower income spouse. This demand loan is backed by a promissory note signed by both spouses. The promissory note can specify a specific period for the loan or it can remain outstanding for life. Loans outstanding for life need to be renewed as required in order to maintain the demand feature of the loan. For further guidance, ask your advisor about the Loan Agreement and Demand Promissory Note package. It is important that you consult your own legal advisor to review these legal documents.

Basic Steps to Implementing the Spousal Loan Strategy

Step 1 – Identify potential non-registered assets.

Determine which assets exposed to the higher marginal tax rate of the higher income earning spouse can benefit from this strategy. These may be funds that have accumulated over time in a taxable non-registered account, a sudden cash windfall, such as an

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inheritance, or proceeds from selling a business. Convert the non-registered assets chosen for this strategy into cash if the assets are not already in cash form. This may trigger capital gains or losses. You may wish to consider consolidating your non-registered assets from other institutions with your advisor to fund the demand loan.

Step 2 – Loan cash to your spouse.

To implement this strategy, the higher income spouse makes a demand loan to the lower-income spouse. The loan is backed by a demand promissory note and a loan agreement which sets the terms of the loan. It is essential that you consult a qualified legal advisor in drafting these documents. The loan is a private arrangement between you and your spouse and any legal documentation should be retained by your lawyer or safely filed at home.

It is recommended that the loan is made from and received by sole accounts. That is, the higher income spouse should lend money from an account solely in their name to an account solely in the name of the lower income spouse. Joint accounts should not be used. This is so that the loan and investment income earned can be tracked for tax reporting purposes. This may require new, separate, non-registered accounts to be opened in the sole name of higher income spouse and lower income spouse.

Step 3 – The lower income spouse builds a portfolio.

The lower income spouse invests the entire loan amount in a portfolio in their own name. To benefit from the strategy, design the portfolio to produce an annual income exceeding the CRA's prescribed interest rate on the loan.

Step 4 – Make annual interest payments.

The lower income spouse must pay the higher income spouse annual interest, as set out in the loan agreement, no later than 30 days after year-end. The full interest due must be paid to keep the strategy in effect. Failure to do so may result in any investment income earned to be attributed to the higher income spouse for tax reporting purposes. The interest must be paid at the rate indicated in the loan agreement, which can be a minimum of the CRA's prescribed rate at the time the loan was made. Should the CRA's prescribed rate change in the future, the interest rate for the spousal loan will not change. In order for the borrowing spouse to deduct the interest paid in the same year as they owe tax on their investment earnings, the interest should be paid by December 31.

Step 5 – Calculate your annual tax savings.

Ensure that the strategy remains effective by reviewing your tax savings with your accountant or tax advisor every year. The end goal of the Spousal Loan Strategy is to shift investment income earned on non-registered assets to the spouse with the lower marginal tax bracket and maximize your family's tax savings. The required payment of the interest on the loan must be accounted for when determining the borrowing spouse's investment return.

Step 6 – Renew your promissory note.

Ensure that the demand feature of the loan is kept in effect by renewing your promissory note as required. As a best practice, you may wish to renew the note on an annual basis to ensure it remains a legally binding document. You should consult your legal advisor when renewing the promissory note.

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Maximize Your Family's After Tax Investment Income

The following illustration shows how a portfolio could be increased by approximately $25,000 over five years and approximately $70,000 over 10 years with a loan of $500,000 where the lower-income spouse has a 25% marginal tax rate and the higher income spouse has a 45% marginal tax rate. We also assume an annualized 7% rate of return comprised of 3% interest and 4% realized capital gains.

Tax Considerations

The higher income spouse is taxed on the interest income received each year from the lower income spouse. This applies to the original capital borrowed (less any repayments) only and is not affected by any investment income generated and reinvested.

The interest paid by the lower income spouse is generally tax-deductible if the proceeds from the loan are used to purchase income producing assets.

This strategy may not result in lower overall family taxes if the family has a very tax-effective portfolio (i.e. deferred capital gains, return of capital, etc.). The taxes payable by the higher income spouse on the loan interest received may exceed any tax savings from shifting the investment income to the lower income spouse. Therefore, it is important to consult with your advisor prior to implementing this strategy.

Conclusion

If you are interested in learning more about the Spousal Loan Strategy and want to increase your total family after-tax income, please contact your advisor. Ask your advisor to help you perform an assessment using our Spousal Loan Calculator to demonstrate how much you can benefit from the Spousal Loan Strategy and to determine if the strategy makes sense given your personal financial situation.

	Without Spousal Loan Strategy	With Spousal Loan Strategy	
	High-income spouse	High-income spouse	Low-income Spouse
Initial asset value	$500,000	$0	$500,000
Income generated	$35,000	$0	$35,000
Interest received (paid)	n/a	$5,000	($5,000)
Pre-tax income	$35,000	$5,000	$30,000 w
Taxes payable	($11,250)	($2,250)	($5,000)
Income after tax	$23,750	$2,750	$25,000
Total after-tax income	$23,750	$27,750	
Tax Savings:			
1-year difference	**$4,000**		
5-year difference	**$25,070**		
10-year difference	**$66,238**		

Notes:
- Assumes 1% interest payment on spousal loan (the CRA's prescribed rate when the article was published). Future rates may vary. Check with your advisor.
- Assumes all savings are reinvested.

Please contact us for more information about the topics discussed in this article.

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