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FINANCIAL ADVISORY SUPPORT

Prescribed Rate Loans for Family Income Splitting

CRA's prescribed 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.

Using a formal loan at the Canada Revenue Agency (CRA) 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 31, 2010 — the lowest rate in 25 years! 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 at least 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.

What is family income splitting?

The Spousal Loan Strategy is a form of income splitting between spouses using a loan at 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.

Prescribed Rate Loans for Family Income Splitting

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. However, if the parent feels more comfortable with 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 clearly permits loans at prescribed rates to family members as a method to avoid the income attribution rules, provided that:

- A formal loan exists between the parties
- The rate of interest is at least the CRA prescribed rate at the time the loan is established (the CRA sets and publishes these rates quarterly)
- The interest is paid by the borrower to the lender (i.e. spouse or parent) annually no later than 30 days after December 31 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 she were able to 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 with 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 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), but through discussions with her RBC advisor and her tax accountant, she instead decided to lend the $100,000 to her 19-year-old son, Jimmy, and he will purchase the bond.

In January 2010, 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. Since he must pay Judy $1,000 a year in interest, he may deduct this expense on his tax return. The remaining $3,000 of net taxable income does not attract any income tax since this amount is less than his basic personal tax exemption.

Judy is now only paying tax on the 1% of interest income 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 30 of the following year, and Judy must include the interest on her income tax return in the year it is received from Jimmy. If this is a low or no interest loan, all of the interest income will be attributed to Judy, and family income splitting will not be successful.

In the first year these amounts have to be prorated based on the number of days the loan is outstanding in the year.

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 expense 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 x 20%) in just the first full year. If instead 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.

Important factors to keep in mind

Ensure that your spouse, adult children or the trust for minor children has sufficient funds to pay the interest due to you on your 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 your family member must also be able to pay the interest to you each year.

If the required interest payments are not made to you within 30 days after the end of the year, the attribution rules will apply, and you, the higher income lender, will have to report all the investment income with the exception of capital gains/losses if the borrower is an adult child or a trust for minor children. 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.

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 you formalize 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 "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 rise or decline. There is no maximum 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.

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 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 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 hopes of having the income taxed in your lower income spouse's hands. However, you can avoid income attribution rules by implementing the Spousal Loan Strategy in accordance with CRA's terms and conditions 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 will be attributed back to you and taxed in your hands. Capital gains, however, are taxed in your minor child's hands, not yours.

If you're the settlor of a trust and also the trustee and/or the transfer to the in-trust account is revocable (i.e. you can get back the assets transferred to the in-trust account), the validity of the trust structure may be challenged by the CRA, and you will take the risk that capital gains may also 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. Note that if you are disposing of securities to fund the loan, any capital gains or losses accrued at the time the securities are sold will be recognized on your tax return in the year of the sale.

When a gift is made it is generally not revocable; therefore, a parent loses control of the funds. As a parent, you may not be comfortable with that for a number of reasons. Therefore, in order to retain control, you may want to loan funds to your adult child instead since you can always recall the loan. When a low or no interest loan is made to adult children, the income attribution rules may apply. Any interest and dividend income, but not capital gains/losses, are attributed to the parent. To avoid the income attribution rules, you must charge interest on the loan at least at the CRA's prescribed rate.

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 used the investment income earned on $300,000 that he set aside in a separate investment account to help her fund her education expenses. He is currently earning 5% on his investments, or $15,000 per year. However, he is also paying tax on this amount at the top marginal rate of about 45%, and the after tax amount of $8,250 is just about the right amount for one year's educational costs for Sandy.

If, instead, Ed gifts $165,000 to Sandy today, the family's tax bill could be lowered significantly. Sandy could invest this amount to earn the required $8,250. With her basic personal tax exemption as well as her tuition credits, Sandy may not pay any tax on the income earned. Furthermore, Ed still has $135,000 invested at 5%, earning $6,750. And after paying 45% tax, he has $3,713 in additional income.

In summary, instead of using all of his investment income earned on the $300,000 for Sandy's education, Ed now has an excess $3,713, and Sandy's education is still 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 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 more appropriate. See "Example of a Prescribed Loan to an Adult Child" above.

Summary of how to implement the prescribed rate loan strategy

- Meet with your tax advisor to ensure they agree that this income-splitting strategy is appropriate for your circumstances. Beware, if you are selling appreciated securities to fund the loan, you will trigger an unrealized capital gain and the corresponding income tax.

- Have your tax and/or legal advisor draft a promissory note for you and renew it as required to ensure that the demand feature is kept in effect. It could be a simple demand note that does not specify a fixed period for the loan, which implies that your demand loan can remain outstanding for life. Alternatively, if you wish to specify a term for the loan, remember that there are no maximum or minimum time constraints. Your note must specify the interest rate, which must be at least the prescribed rate of interest in effect at the time the loan was established. For further guidance, ask your advisor for the Loan Agreement and Demand Promissory Note package.

- Once your note is in place, you must draw a cheque on your account or conduct a transfer in accordance with your loan arrangement.

Prescribed Rate Loans for Family Income Splitting

- If you are implementing the Spousal Loan Strategy, it is recommended that you establish a separate investment account for the funds loaned. This will help you keep track of the investment income generated since separate tax reporting slips (e.g. T3 and T5 slips) will be produced for the account in your spouse's name. This will also assist you in dealing with the CRA should they ever request documentation relating to the loan arrangement. It is also possible to add your spouse to this account for estate planning purposes as the secondary account holder.

- Interest must be paid annually, no later than 30 days after year-end, or attribution will apply. This deadline is critical because once the loan is "offside" and the attribution rules apply, there is no way to get that loan back "onside." Make sure that your borrowing spouse, adult child or trust in the case of a minor child who will be making the interest payments actually cuts a cheque payable from their account to yours. This will allow you to substantiate the payment with a cashed cheque.

- We also recommend that you keep track of the prescribed interest rates. If the rate falls, it could be to your advantage to repay your current loan arrangement and to draft a new one 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 tax and/or legal advisors to assess its appropriateness, as well as to ensure that your loan agreement contains all of the necessary criteria to satisfy the CRA.