The Navigator

RBC WEALTH MANAGEMENT SERVICES

Using a Family Trust for Prescribed Rate Loan Arrangements

A low prescribed rate can provide tax saving opportunities for you and your family.

With the Canada Revenue Agency (CRA) prescribed rate at a historical low, now is an excellent time to consider tax saving opportunities for you and your family. A family trust structure can be used to implement a prescribed rate loan income-splitting strategy to help you reduce your family's tax burden.

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 properly and that action is taken on the latest information available.

Using a family trust

If structured properly, a family trust is a trust structure that allows a parent or grandparent to split income with their low-income family members. The strategy is to shift investment income and capital gains that would otherwise be taxed in your hands at a high marginal tax rate to the hands of your low-income spouse, children, nieces/nephews and/or grandchildren.

In order to ensure income-splitting arrangements are implemented appropriately, the Income Tax Act has income "attribution" rules. These rules will attribute taxable income back to the tax return of the related family member that actually supplied the capital for investment, thus achieving no tax savings. The potential for application of the attribution rules in a family trust strategy depends on the structure of the trust, how the capital is funded to the trust and

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the type of investment income that is distributed from the trust to the related beneficiary.

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Prescribed rate loan

A prescribed rate loan is created when investment capital is loaned by a high-income family member (the lender) to a low-income family member or family trust (the borrower) using a formal written loan agreement. In order for this loan strategy to work, the interest rate on the loan must be at least equal to the CRA's prescribed rate in effect at the time the loan is established. Once the loan is established, the prescribed rate is maintained for the life of the loan regardless of any increases that may occur to the prescribed rate.

The family trust must pay interest to the lender at the CRA's prescribed rate. The annual interest must be paid by the trust on or before January 30 of the following year. The lender must declare the interest received as income on their tax return in the calendar year the interest is received, resulting in tax on the interest income at the lender's marginal tax rates.

The benefit to the prescribed rate loan strategy is that there is no attribution on any investment income (interest, dividends) or capital gains distributed from the trust to the beneficiaries, assuming the trust is structured properly. The trust pays the lender annual interest on the loan but, when properly implemented, the tax savings on the investment income distributed to the beneficiaries more than compensate for this.

It is essential to adhere to the interest payment requirement. If a payment is made even one day late for any year, the loan will lose its exemption from the attribution rules for that year and all subsequent years and consequently will no longer be effective as an income splitting strategy.

A low prescribed rate environment is an ideal time to use this strategy

As recently as 2007, the CRA prescribed rate on family loans was 5%. At this relatively high rate, it was generally more difficult to achieve tax savings since the trust had to earn investment income in excess of 5% (the CRA prescribed rate). As a result, some family trusts were funded using an interest-free loan. If an interest-free loan was made to the trust, then interest and dividends distributed to a beneficiary (regardless of age) were attributed back to the lender. However capital gains distributed from the trust were taxed in the hands of the beneficiary if the trust was structured properly. This limited the investment strategies that provided the best tax efficiency.

The CRA sets the prescribed interest rate every quarter based on the average rate of 90-day treasury bills sold during the first month of the preceding quarter, rounded up to the nearest percentage point. With the CRA prescribed rate currently at only 1%, the family trust can more effectively be funded using a prescribed rate loan. This allows for a much broader range of investment strategies that may be used while still achieving tax efficiency.

Potential tax savings

The table below illustrates the potential tax savings that may be realized if a parent makes a prescribed rate loan at 1% to a properly structured family trust, compared to investing the portfolio directly or making an interest-free loan to a family trust.

Assumptions:

- $250,000 portfolio
- Annual rate of return of 6.6% (2.8% interest, 0.55% Cdn dividends, 3.25% realized capital gains)
- Parent's tax rate: 46.41%
- One child beneficiary; child's tax rate: 20.05% (if the child's taxable income is below the basic personal exemption there will be zero tax payable)
- Basic personal exemption per beneficiary: $10,822 (varies by province)

	Portfolio held directly by parent	Interest-free loan to family trust	Prescribed rate loan at 1% to family trust
Taxable investment income	$16,500	$16,500	$16,500
Tax payable by parent	$5,540	$3,655	$1,160
Tax payable by child	–	–	–
Tax saving in year 1	–	$1,885	$4,380
Tax savings over 10 years	–	$18,850	$43,800

For the family, the net tax benefit of having a prescribed rate loan at 1% is $4,380 in one year alone compared to the parent investing the portfolio directly. If this loan remains in place for ten years with similar returns, the savings become $43,800. These savings are further compounded if there is more than one low-income beneficiary to whom trust investment income is distributed or the returns on the investment increases.

The tax saving in one year is $2,495 higher using a prescribed rate loan compared to an interest-free loan ($4,380 - $1,885). The additional tax saving is a result of interest and dividends being taxed in the hands of the beneficiary, whereas when the funds are loaned interest-free the interest and dividends are taxed in the hands of the parent at the high marginal rate.

Modifying an interest-free loan or existing prescribed rate loan

If you have an existing interest-free loan or prescribed rate loan at a higher interest rate, you may want to consider repaying your current loan and making a new loan to take advantage of the lower 1% prescribed rate. While it is possible to repay the current loan and establish a new loan using the current CRA prescribed rate, there are some considerations that you should review before making such a change. For more information on modifying a loan to take advantage of the lower CRA prescribed rate, ask your RBC advisor for a copy of our article titled “Modifying a Prescribed Rate Loan”.

Implementing a prescribed rate loan strategy using a family trust

RBC offers a family trust solution which can be used to implement a prescribed rate loan strategy. The RBC Family Trust can be used to fund your children’s education and expenses while providing a mechanism for income splitting. Speak to your RBC advisor for more information on family income-splitting strategies or if you would like to consider a family trust.

› Please contact us for more information.