

THE NAVIGATOR

INCOME SPLITTING USING PRESCRIBED RATE LOANS

You may be able to reduce the overall amount of income tax paid by your household by using a prescribed rate loan to split income with a family member in a lower tax bracket. Now is a terrific time to consider this strategy because the Canada Revenue Agency (CRA) prescribed rate is at a historic low of 1%.

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 CRA's prescribed rate of interest is an excellent way to legally split income with your adult children, your spouse or through a trust with your minor children. A formal loan meeting 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 is reset quarterly and at the time of writing the rate is 1%. Once the loan is set up, the rate can be fixed for the life of the loan, making today's low interest rate environment a terrific time to implement this strategy. If you already have a prescribed loan in place at a higher rate, you may be able to replace it with one at the current 1% rate.

FAMILY INCOME SPLITTING?

Lending funds to family members in lower tax brackets allows them to invest the proceeds of the loan. The net

income earned (investment income less interest paid) on the loan will be taxed in the hands of your family members at their lower income tax rate.

It is also possible to income split by making an outright gift of assets in certain circumstances. However, unlike the advantage of the prescribed rate loan where you do not reduce your net worth, you will give up your right to the assets you gift to your family members. A parent can make an outright gift to an adult child to benefit from family income splitting but if the parent feels more comfortable lending funds instead, the interest rate on the loan must be at or above the CRA's prescribed rate of interest in order for the family 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.



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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; and
- The interest is paid by the borrower to the lender annually no later than 30 days after December 31st of the year.

EXAMPLES OF HOW PRESCRIBED RATE LOANS CAN BE USED

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 find a way to split her income with her child, the family 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 must report the interest income Jimmy is paying her on the loan; but as it is only 1% and Jimmy is earning 3% tax-free (4% net of the 1% interest expense) the combined family tax bill is lower than if Judy had earned the bond interest in her name. 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 the \$100,000 was loaned to Jimmy at a lower rate loan or as an interest free loan, all of the interest income Jimmy earned on the bond would be attributed to Judy and the income will be taxable at her marginal tax bracket..

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.

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 the first full year that the loan is established.

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

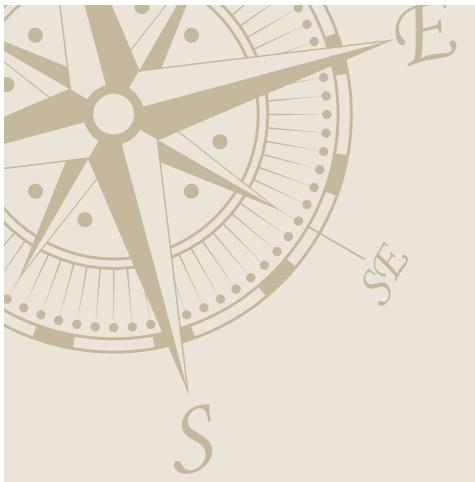
Walter, who is in the top tax bracket, is able to shift \$12,000 of taxable income to Jane, who is in a lower tax bracket.

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 x 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.

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 cash 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 paid to you within 30 days



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.

after the end of the year, you will be responsible for reporting and paying income tax on the investment earnings on the funds loaned; this is because of the income attribution rules. 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 full advantage of the current low prescribed interest rate, it may make sense 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.

INCOME 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.

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.

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.

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 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.

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



Discuss this income-splitting strategy with your tax advisor to ensure that it is appropriate for your circumstances.

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 more appropriate. See "Example of a Prescribed Loan to an Adult Child" above.

SUMMARY OF HOW TO IMPLEMENT THE PRESCRIBED RATE LOAN STRATEGY

■ Discuss this income-splitting strategy with your tax advisor to ensure that it is appropriate for your circumstances. However, it is important to be aware that if you are selling appreciated securities to fund the loan, you will trigger a capital gain on which income tax will be payable.

- Discuss the requirements for a formal loan agreement, promissory note and annual payment of interest with the family member you are lending fund to.
- Have your tax and/or legal advisor draft a promissory note for you and renew it as required to ensure that the demand feature remains in effect. You could use 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 periods. 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 will need to draw a cheque on your account or conduct a transfer in accordance with your loan arrangement.
- If you are implementing the Spousal Loan Strategy, it is recommended that the borrowing spouse establish a separate investment account for the loaned funds. 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

If you are implementing the Spousal Loan Strategy, it is recommended that the borrowing spouse establish a separate investment account for the loaned funds.

to add a spouse as the secondary account holder to this account for estate planning purposes.

- 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 the trust, in the case of a

minor child, who will be making the interest payments actually issues a cheque payable from their account to yours. This will allow you to substantiate the interest payment with a cashed cheque, if necessary,

- We also recommend that you keep track of the CRA’s prescribed interest rate. If the rate falls, it could be to your advantage to repay your current 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 about the topics discussed in this article.

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NAV0086-EN (02/2013)