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Spousal Prescribed Rate Loan Strategy

An innovative financial planning strategy that can result in significant tax-savings for your clients!

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Advisors are always interested in hearing about innovative strategies and products to help their clients meet their financial goals and also differentiate them from the competition.

This article introduces the Spousal Loan Strategy, a method of income-splitting that enables certain spouses (typically in cases where one spouse has significantly more income than the other) to lower their family tax bill by entering into a prescribed rate loan.

Revenue generating opportunity

Review your book or prospect couples who could benefit from income-splitting strategies to reduce their family tax bill. The prescribed rate spousal loan strategy is one of the most effective, yet underutilized, of all income-splitting strategies. It is particularly designed to benefit couples where one spouse is earning a significantly higher taxable income than the other.

This second quarter, from April 1, 2009, to June 30, 2009, is a particularly opportune time to establish the prescribed rate loan strategy in order to lock in a very low prescribed loan rate since the CRA recently announced that the prescribed annual interest rate will decrease from 2% to 1%. As the CRA prescribed loan rate is subject to change each quarter, please check back with us to confirm the rate should your client decide to implement this strategy after the second quarter of 2009.

The spousal prescribed rate loan strategy in brief

This strategy aims to shift capital 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 on future investment income. This results in annual tax savings for the family, with even larger tax savings at retirement arising from years of accumulation of capital in the lower income spouse's hands.

Why not just make a simple transfer of funds instead of going through all this trouble of shifting capital from one spouse to the other? Because if the borrowing spouse (lower income spouse) does not pay any consideration to the lending spouse (higher income spouse), the investment income will be attributed back to the higher income spouse and the strategy will not work.

To implement this strategy, the higher income spouse simply makes a demand loan to their lower income spouse. This demand loan is backed by a simple 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 keep the demand feature of the loan in effect. For further guidance, provide your clients with the Loan Agreement and Demand Promissory Note package while also encouraging them to consult their own legal and/or tax advisor to help draft this legal document.

It is important to note that in order to avoid income being attributed back to the lending spouse (higher income earner), the borrowing spouse (lower income earner) must pay interest on the loan each year to the lending spouse (higher income spouse). The interest charged must be at least equal to the Canada Revenue Agency (CRA) prescribed rate that is in effect when the loan is made (1% from April1 to June 30, 2009). 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.

Should the CRA prescribed rate subsequently rise, the loan rate will stay fixed at the lower prescribed CRA rate that was in effect at the time that the demand loan was established. That's a big advantage! With the prescribed rate being so low, there's a real incentive to encourage your clients to lock-in their demand loan before rates rise!

Target clients

Spouses with divergent incomes who also have non-registered assets: Consider spouses with divergent taxable earnings/marginal tax rates looking for tax saving opportunities.

Consider future projected retirement income: While both spouses may be in similar marginal tax brackets today, this might change by retirement in situations where one spouse has a generous pension plan while the other spouse doesn't. In this case, the spousal loan strategy may help to balance future retirement income by legally shifting capital from the spouse with the more generous pension plan into the hands of the spouse with the less generous pension plan.

Sole ownership accounts: Look for significant holdings in accounts registered under sole ownership. These assets may have come from inheritances, stock options, bonuses, etc.

Spouses with minor children: The prescribed rate loan strategy can also be used to split income with minor children.

Benefits to client

Tax savings can be significant: The greater the amount loaned, the longer the life of the loan; and the higher the investment yield above the prescribed rate, the greater the tax savings.

Accumulation of capital in the lower income spouse's hands — arising from income generated over the prescribed rate without triggering income attribution back to the higher income spouse.

Higher combined after-tax retirement income — arising from the accumulation of capital in the hands of the lower income spouse over a period of time leading up to retirement.

Client considerations

Beware of the interest payment deadline to avoid attribution: The borrowing spouse must pay interest to the lending spouse on an annual basis no later than 30 days after year-end. Otherwise, all present and future income will be attributed back to the higher income spouse who originally loaned the funds, thereby defeating the objective of this strategy.

Example: If the loan was made in April 2009, then the interest accrued from April to December 2009 will be due by January 30, 2010.

Tax considerations

The lending spouse (higher income spouse) is taxed on the interest income received each year from the borrowing spouse. This applies to the original capital borrowed only (i.e. there is no attribution for "income on income").

Note: This strategy may not save the family taxes if the family has a very tax-effective portfolio (i.e. deferred capital gains, return of capital, etc.). The tax payable by the higher income spouse on the loan interest may exceed any tax savings from shifting the investment income to the lower income spouse.

The borrowing spouse (lower income spouse): The interest paid by the borrowing spouse is tax-deductible as the demand loan was used to buy a portfolio of income-producing assets.

Benefits to advisor

Solidify your client relationships: Remind your clients how much tax savings they're getting each year thanks to your making them aware of this strategy; and that this tax savings has potentially even paid for their fees!

Consolidate business: Increase your chances for consolidating business from other financial institutions to fund the demand loan.

Increase your book size: The less your clients pay to the CRA, the greater the assets on your books!

Steps to implement

1. **Spousal Loan Calculator:** Use the calculator to illustrate the net after-tax benefit to your client. Provide an illustration for different loan amounts to help clients determine their optimal loan value.

2. **Source of funding the loan:** Assist the client in determining the source of funds to lend to their lower income spouse — this could require consolidating non-registered assets from the competition!

3. **Promissory demand note:** Spouses must sign a promissory demand note specifying the following: amount of the loan, CRA prescribed rate in effect at the time and any predetermined finite repayment period (or it can specify that the loan is for a lifetime with no set period). They should also renew their promissory note as required to ensure that the demand feature remains in effect.

4. **Authorization to transfer funds:** Get client authorization to debit the account of the higher income spouse for the amount of the loan and to credit the account of the lower income spouse accordingly.

5. **Buy a portfolio in the name of lower income spouse:** Invest the entire amount of the loan in a portfolio in the name of the lower income spouse. Ensure the portfolio yield will exceed the CRA prescribed rate, and that it will generate sufficient income to cover the loan interest payments each year.

6. **Facilitate interest payment at year-end:** Consider sending a reminder and authorization to debit the account for interest (e.g. in November of each year) to the borrowing spouse to remind them to pay interest to the lending spouse by January 30 of the following year. Remind the borrowing spouse that this interest is tax-deductible to them, but taxable to the lending spouse.

Advisor resources and tools to help you implement this opportunity

Call us or e-mail us with your questions

- Phone: 1-877-722-3278
- Email: Financial Advisory Support (from the Global Address Book in Outlook)

Website

- Click on the Spousal Loan Strategy found in the Opportunities section of the following link for complete supporting information http://advisornet.rbcds.com/category/1,1080,FP-T50,00.html.