The Navigator

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Income splitting using a prescribed rate loan

You may be able to reduce the overall amount of income tax paid by your family by setting up a prescribed rate loan to split income. This article explains how prescribed rate loans work.

Any reference to “spouse” also applies to common-law partners as they are treated the same as married spouses for Canadian tax purposes.

This article outlines strategies, not all of which will apply to your particular circumstances. The information in this article is not intended to provide legal or tax advice. To ensure that your own circumstances have been properly considered and that action is taken based on the latest information available, you should obtain professional advice from a qualified tax and/or legal advisor before acting on any of the information in this article.

Using a prescribed rate loan

The Income Tax Act (ITA) contains “attribution” rules and other anti-avoidance rules that generally do not allow income splitting (these are discussed later in the article). The application of these rules means that income and, in some cases, capital gains are taxable to the higher-income individual that provided the funds for investment; as a result no tax savings are achieved.

However, the ITA also contains rules that allow you to avoid the attribution rules and achieve your income splitting objectives in very specific circumstances. If properly implemented and administered, a “prescribed rate loan” may allow you to split income with your lower-income family members to reduce your family’s overall tax bill. This strategy allows you 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 lower-income family members, including your spouse, adult children, or minor children through a trust.

One of the specific circumstances in which the attribution rules do not apply is where a “loan for value” is made to lower-income family members or to a trust for the benefit of lower-income family members. A loan for value includes (but is not limited to) a formal loan arrangement that satisfies the following conditions:

- The rate of interest charged on the loan is at the Canada Revenue

The CRA considers a loan to be a low-interest loan if the interest rate charged on the loan is below the lesser of the CRA prescribed interest rate or a commercial interest rate that would be agreed to by arm's length parties.

Agency (CRA's) prescribed interest rate at the time the loan is made; and

- The interest is paid every year no later than 30 days after the taxation year (by January 30th).

The CRA prescribed rate

Every quarter, the CRA updates and publishes the prescribed interest rates. The rate is based on the average 90-day T-bill rates of the first month of the previous quarter. To implement a prescribed rate loan, the interest rate on your loan should be the CRA prescribed rate in effect during the quarter that you make the loan. Even if the prescribed rate changes in a future quarter, the interest on the outstanding prescribed rate loan remains the same.

The CRA considers a loan to be a low-interest loan if the interest rate charged on the loan is below the lesser of the CRA prescribed interest rate or a commercial interest rate that would be agreed to by arm's length parties. Low-interest or no-interest loans will trigger the income attribution rules, discussed later in this article, if one of the main reasons for making the loan is to split income.

Family income splitting

Using a formal loan at the CRA prescribed interest rate is an excellent way to split income with your spouse, adult children, your minor children through a trust, or with other family members. A formal loan meeting certain requirements may enable all income and capital gains earned on the loaned capital to be taxed in the hands of your lower-income family members. Lending funds to family members in lower tax brackets allows them to invest the proceeds of the loan to earn investment income. 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 to adult family members, other than a spouse. Gifting assets reduces your net worth and future income taxes; it also reduces taxes on death because you no longer own the asset. However, a prescribed rate loan allows you to maintain access to your capital should you need it. Gifting assets to a spouse or minor child triggers the attribution rules (discussed later on) therefore, it is more effective to loan the funds using a prescribed rate loan.

Examples of how prescribed rate loans can be used

Example of a prescribed rate loan to a spouse (the Spousal Loan Strategy)

Walter has excess cash and wants to utilize a loan at the CRA's 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% (prescribed rate at the time the loan was made), with interest paid annually.

Jane invests the $200,000 and generates an annual return of 5% in income, or $10,000. If the loan is outstanding for a full year, Walter will receive $2,000 of interest income from Jane, while Jane will have $10,000 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	$10,000
Interest expense	--	($2,000)
Net income	$2,000	$8,000

Walter, who is in the top tax bracket,

is able to shift $8,000 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 $1,600 ($8,000 x 20%) on their total tax bill annually. If you are interested in implementing a prescribed rate loan to your spouse, ask your RBC advisor for the article, “The Spousal Loan Strategy.”

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 19-year old son, Jimmy, however, has no taxable income. If Judy could find a way to split her income with Jimmy, the family could reduce their total tax liability.

Judy approaches her advisor at RBC, who understands her present situation and overall objectives. As Jimmy 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 Jimmy, her RBC advisor recommends that she consider approaching her tax advisor to discuss the merits of income splitting with Jimmy through the use of a loan at the CRA prescribed rate.

To illustrate the benefits of family income splitting, let’s assume that Judy is considering investing $100,000 in a bond yielding 4% (interest is paid annually). Through discussions with her RBC advisor and her qualified tax advisor, she decides to lend $100,000 to Jimmy to enable him to purchase the bond.

At the beginning of the year, Judy loans $100,000 to Jimmy at the CRA prescribed interest rate which at the time is 1%. 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, so she is reporting 1% instead of the 4% she would have reported if she bought the bond herself. As 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. Judy must include the interest on the loan on her income tax return. The timing of the income inclusion depends on the year the interest is related to, when the interest is paid and the method (cash vs. accrual) Judy regularly follows in computing her income.

Important factors to keep in mind

To make this strategy worthwhile, not only should the invested funds generate a return at least equal to the interest expense on the loan and any additional administrative costs, but the borrower must also be able to actually pay the interest to you each year by the deadline to avoid the application of the attribution rules.

If you dispose of appreciated securities to fund the loan, you will trigger capital gains on which income tax will be payable.

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A simple transfer of funds does not achieve maximum family income splitting due to the attribution rules.

Once you formally establish a prescribed rate loan, the rate applies for the life of the loan, even if prescribed rates subsequently increase or decline. There is no legislative restriction on the amount of the loan or the term of the loan. It is possible to implement a prescribed rate loan strategy using a demand loan.

In the first year of the loan, the amount of interest payable should be prorated based on the number of days in the year that the loan is outstanding. This is also the case if the loan is repaid during a year.

If the annual interest payments are not paid to you by January 30th of the following year, the attribution rules will apply and you will have to report and pay income tax on the investment income earned on the loaned funds. Even if this deadline is missed by one day, the attribution rules will be triggered. Once this occurs, attribution will apply to the year that the deadline was missed and all subsequent years. In other words, your income splitting strategy will be rendered ineffective.

You should ensure that the demand loan remains legally enforceable. Some legal advisors believe that making the annual interest payments on the prescribed rate loan is sufficient action to avoid the loan from becoming unenforceable. Making the interest payment annually is an acknowledgement by the borrower that the loan is still outstanding and enforceable. The alternative is to renew the promissory note on an annual basis or to have the borrower acknowledge in writing that the promissory note is still valid. You should consult with a qualified legal advisor to determine what is required to keep the loan enforceable in your jurisdiction.

Attribution rules

As we mentioned earlier, a simple transfer of funds to your spouse or minor children, or a low or no-interest loan to your spouse, adult children or minor children through a trust, does not achieve maximum family income splitting due to the attribution rules. The following sections explain how the attribution rules could affect income splitting.

Spousal attribution

If you gift or loan (at low or no interest) funds to your spouse, any investment income/loss and capital gain/loss earned on the funds, or substituted property, will be taxable in your hands because of the attribution rules. You cannot simply transfer assets to your lower income spouse in the hope of having the income taxed in your spouse's hands. However, you can avoid the attribution rules by implementing a prescribed rate loan (Spousal Loan Strategy) in accordance with the terms and conditions described earlier.

Attribution and adult children

The income and capital gains 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 and access to the funds. As a parent, you may not be comfortable with that for a number of reasons. In order to retain access to the funds, 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 and one of the main reasons for making the loan was to reduce or avoid tax by causing income from the loaned

Generally, a loan at the CRA prescribed rate, which is outside of the terms of the trust, would not fall within these super attribution rules.

property to be included in the income of your adult child, then generally interest and dividend income, but not capital gains/losses, that is earned on the loaned funds (or substituted property) will be taxed to the parent who made the loan instead of in the hands of the adult child. You can avoid these rules by charging interest on the loan at the CRA prescribed rate. These rules also apply to low- or no-interest loans that you make to non-arm's length individual where one of the main reasons for the loan is income splitting.

Attribution and minor children

If you gift or loan (at low or no interest) funds to your minor child to invest, typically through a trust arrangement, any interest and dividends earned on the funds, or substituted property, that is paid or made payable to the minor, will attribute back to you and be taxed in your hands. Capital gains/losses earned on the funds, or substituted property, are not subject to the attribution rules. Where the taxable capital gains are earned in a trust for the minor's benefit and are paid or made payable to the minor, the taxable capital gain will be taxed in the minor's hands.

Attribution and trusts ("super attribution")

Special attribution rules, that we refer to as the "super attribution" rules, may apply if a Canadian resident trust holds property on condition that the property:

- may revert back to the person from whom the property was received; or
- the person from whom the property was received has the power to determine who receives the property, or substituted property, after the creation of the trust; or
- during the lifetime of the person from whom the property was received, the trust property cannot be disposed of without their consent.

An example of when the first condition may exist is where the settlor is also a capital beneficiary of the trust or if the trust is a revocable trust. One example of when the second and third conditions may exist is where the settlor is the sole trustee of the trust.

When the super attribution rules apply, income/losses and taxable capital gains/allowable capital losses on the property transferred to the trust (or substituted property) are attributed back to the person from whom the property was received. In addition, the trust property cannot be rolled-out to beneficiaries at cost. If the person from whom the property was received or their spouse is a capital beneficiary of the trust and the terms of the trust allow it, then the trust property can be rolled-out at cost to either of these two individuals.

Generally, a loan at the CRA prescribed rate, which is outside of the terms of the trust, would not fall within these super attribution rules.

How to implement a prescribed rate loan strategy

- Discuss this income-splitting strategy with a qualified tax advisor to ensure that it is appropriate for your circumstances.
- Discuss this income splitting strategy and the requirements for a formal loan agreement, promissory note and annual interest payments

Interest for a particular year must be paid no later than January 30th of the following year or attribution will apply.

with the person you are lending funds to.

- Have a qualified legal advisor either draft or review your loan agreement and promissory note to ensure that it is effective. Your loan documents should specify the interest rate, which should be the CRA prescribed interest rate in effect at the time the loan is made.

- You should either write a cheque from your account or transfer funds from your account to the borrower. Either way, there should be evidence that funds actually changed hands from the lender to the borrower. If you are selling appreciated securities to fund the loan, you will trigger a capital gain on which income tax will be payable. The date on the loan documents and the date the funds changed hands should be the same. This makes it easy to determine the applicable CRA prescribed rate and the date that interest has to be calculated from.

- Interest for a particular year must be paid no later than January 30th of the following year or attribution will apply and you will not achieve your income splitting objectives. This deadline is critical because once the loan is "offside" there is no way to get that loan back "onside." If the interest deadline is missed then attribution will apply to the year the interest relates to and every subsequent year thereafter, rendering the strategy ineffective. Make sure that the borrower actually issues a cheque for the interest payment from their account or that there is a transfer of funds that can be traced from their account to yours.

- Consider keeping track of the CRA's prescribed interest rate. If you establish a prescribed rate loan and the CRA's prescribed rate falls, it could be to your advantage to call your current loan and establish a completely new loan at the lower rate. However, the process of refinancing an existing loan requires careful steps since the income attribution rules could be triggered if the refinancing is not executed correctly. For more information, ask your RBC advisor for a copy of the article, "Modifying a Prescribed Rate Loan." You should always seek guidance from a qualified tax advisor to modify a prescribed rate loan.

Conclusion

Reducing the family tax bill is the main benefit of family income splitting. A prescribed rate loan between a higher income earner and lower taxed family member(s) is a great way to achieve this. Keep in mind though that a prescribed rate loan does need to be managed. It is not a "set-up and forget" strategy as you will need to ensure that the correct interest payments are made on-time annually. Speak with a qualified tax advisor about whether this strategy makes sense in your circumstances.

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

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