Wealth Management

the Navigator

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC WEALTH MANAGEMENT SERVICES

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Save taxes by taking advantage of the low prescribed interest rate

Lock-in loans at 1% and potentially save on overall family taxes

Income splitting is a great way to save tax if implemented properly. It shifts income that would otherwise be taxed in your hands at a high marginal tax rate to your lower income spouse, children or other family members in order to take advantage of their lower marginal tax rates. One way to do this is by making a loan to a lower-income family member for investment purposes and charging the Canada Revenue Agency (CRA) prescribed interest rate on the loan.

Currently, the CRA prescribed interest rate is at 2% but it will be decreasing to 1% for the quarter beginning July 1, 2020. As the interest rate on a prescribed rate loan is locked-in for the life of the loan regardless of any future interest rate increases, setting up a new loan at 1% may lead to significant tax savings in future years. To lock-in the 1% rate, the loan must be implemented on or after July 1, 2020.

The CRA prescribed interest rate

The CRA has a number of prescribed rates that apply in different situations. This article focuses on the prescribed interest rate which is used to calculate the taxable benefit on interest-free or low-interest employee or shareholder loans. This rate also applies to loans between family members who want to split income.

The prescribed rate is calculated quarterly and is based on the average rate of 90-day treasury bills sold during the first month of the previous quarter. The average is rounded up to the next whole number. For example, if the average of the 90-day T-bill rate for the relevant month is 0.85%, the CRA will round up the prescribed rate to the next whole number of 1% for the next quarter.

Income splitting basics

Income tax is based on a progressive tax system where, as your taxable income increases, so does your marginal tax rate. In some provinces, the top marginal tax bracket can be as high as 54%. This can result in families with one high-income earner and one low-income earner paying more tax than those with two family members who have equal incomes, even if the total household income is the same in both cases.

Income splitting is a tax planning strategy whereby you may be able to reduce your family's overall tax bill. It involves moving income from a family member in a high tax bracket to one in a lower tax bracket. However, there are attribution rules designed to prevent family income splitting in certain circumstances. If the attribution rules apply, the income earned by the lower-income family member is attributed back to the higher-income individual who provided the funds, resulting in no tax savings and defeating the purpose of the strategy.

There is an exception to the attribution rules where you loan money to family members, including your spouse, adult children, or minor children through a family trust at the CRA prescribed interest rate – this type of loan is called a prescribed rate loan. If properly implemented, it may allow you to avoid attribution and achieve your income splitting objectives.

Prescribed rate loan strategies

The prescribed rate loan strategy involves making a formal loan to family members or to a family trust at the CRA prescribed interest rate in effect at the time the loan is made. Your family members can then invest the loaned funds and earn investment income. The net income earned is taxed in their hands at their lower marginal tax rate.

To ensure that the income earned is not attributed back to you, the annual interest on the loan must be paid by January 30th of the following year (and by January 30th of every subsequent year that the loan is in place). It is crucial to meet the January 30th deadline, because if the interest payment is late by even one day, the attribution rules will apply for the year that the interest payment relates to, and all subsequent years, until the loan is repaid.

With the prescribed rate decreasing to 1% in July, you may be able to realize substantial tax savings by implementing a prescribed rate loan strategy after the rate decreases. This low rate allows you to split income earned in excess of the 1% interest. In order for the loan to be tax-efficient, the rate of return on investments should exceed the interest paid. The advantage of setting up a loan when the prescribed rate is 1% is that this low rate is locked-in for the life of the loan, regardless of any increases that may occur to the prescribed interest rate.

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Below we have outlined two commonly used prescribed rate loan strategies that illustrate income-splitting in action.

The spousal loan strategy

With the spousal loan strategy, you make a loan to your lower-income spouse, who then invests the entire proceeds of the loan in their name. When properly structured, the investment income is taxed at your spouse's lower marginal rate, reducing your family's overall taxes. The interest income paid (on or before January 30 the following year) is taxable to you and your spouse may be able to deduct the interest paid on the prescribed rate loan.

The family trust strategy

With this strategy, a family trust is established for the benefit of your lower-income family members such as your spouse, children or grandchildren. You can then loan funds to the trust at the CRA prescribed interest rate. The money loaned to the trust is then invested in the trust and the investment income (less 1% paid to you by January 30 of the following year) can be taxed in the hands of your spouse, children or grandchildren.

By loaning the money to the trust, you retain access to the capital loaned, and the investment income can be used to benefit your spouse, children or grandchildren. For example, the investment income allocated to your children or grandchildren can be used to pay for private school tuition, camp fees, lessons or gifts.

An example

The table below illustrates the potential tax savings you could achieve by making a prescribed rate loan to a family trust for the benefit of your child, compared to investing the portfolio directly and paying for the child's expenses with the after-tax returns. We assume you have a $300,000 non-registered portfolio with an annual rate of return of 3.0% interest. Let us also assume that your marginal tax rate is 54% and that your child has no taxes payable since

the total taxable income they receive is less than their basic personal exemption. The interest paid in this scenario is deductible as the borrowed funds are used to invest in a portfolio with the purpose of earning income.

	Portfolio held directly by you	Prescribed rate loan to family trust at 1%	Prescribed rate loan to family trust at 2%
Investment income	$9,000	$9,000	$9,000
Interest deduction	$0	$3,000	$6,000
Net taxable income	$9,000	$6,000	$3,000
Taxes payable by parent	$4,860	$1,620	$3,240
Taxes payable by child	$0	$0	$0
Tax savings over 1 year	$0	$3,240	$1,620
Tax savings over 10 years	$0	$32,400	$16,200

The tax savings are the result of the investment income being taxed in your lower-income child's hands, as opposed to your own. Your family's net tax benefit of having a prescribed rate loan at 1% is $3,240 in one year alone. If this loan remains in place for 10 years with similar returns, the savings become significantly higher.

Modifying your loan

If you have already made a loan to a family member or a family trust at a time when the prescribed rate was higher than the current rate, you may be able to benefit from the lower prescribed interest rate by modifying your loan. For more information, please ask your RBC advisor for our article on modifying a prescribed rate loan. Please note, it is important you speak with a qualified tax advisor before modifying your loan because if the loan is not modified properly, the income attribution rules may apply, resulting in negative tax consequences.

Who can help?

A prescribed rate loan strategy can be an excellent vehicle for families to split income tax-efficiently. The prescribed interest rate in effect at the time the loan is made will be locked-in for as long as the loan is outstanding, regardless of subsequent changes to CRA prescribed interest rate. The lower the interest rate, the greater the tax saving opportunity for you and your family. To lock-in the 1% rate, your new loan must be implemented on or after July 1, 2020.

If you are interested in learning more about the prescribed rate loan strategy, please contact your RBC advisor. Before implementing a prescribed rate loan strategy, be sure to speak to a qualified tax and/or legal advisor about whether it makes sense for you and your family.

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Wealth Management

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