Wealth Management

the Navigator

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC WEALTH MANAGEMENT SERVICES

Time to lock in historic low rates

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

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

You may be able to reduce your overall family taxes by splitting income with lower-income family members. One way to split income is by making loans to your lower-income family members for investment purposes and charging the Canada Revenue Agency (CRA) prescribed interest rate on the loan.

Currently, the CRA prescribed interest rate is at a historic low of 1%, but it will be increasing to 2% for the quarter, beginning July 1, 2022. At that time, it will become less advantageous to implement this income splitting strategy. 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, now is the time to consider setting up a new loan at 1%!

The CRA prescribed interest rate

The CRA has a number of prescribed rates that apply in different situations. This article focuses on the lowest 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 90-day T-bill rate for the first month of the previous quarter. The average is rounded to the next higher whole number. For example, if the average of the 90-day T-bill rate for April 2022 is 1.35%, the CRA will round up the prescribed rate to the next higher whole number (i.e., 2%) for the next quarter, Q3 2022.

Income splitting basics

Income tax is based on a progressive tax system where, as your taxable income increases, so does your marginal tax rate on an individual basis. In some provinces, the top marginal tax bracket can be as high as 55%. 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 result is that the income earned by the lower-income family member is attributed back to the higher-income individual who provided the funds, so there will be no tax savings.

There is an exception to the attribution rules where you loan money to family members and receive at least a minimum rate of interest prescribed by the CRA — 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, including your spouse, adult children or minor children through a family trust, at the CRA prescribed interest rate. 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 the income earned is not attributed back to you, the interest on the loan must be paid by January 30th of the following year (and by January 30th of every subsequent year 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 present low prescribed rate of 1%, you may be able to realize substantial tax savings by implementing a prescribed rate loan strategy prior to the expected increase in rates. This low rate allows you to effectively split income earned in excess of 1%. 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 future increases that may occur to the prescribed interest rate.

The following sections outline two commonly used prescribed rate loan strategies that illustrate income splitting in action.

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The spousal loan strategy

With the spousal loan strategy, you make a loan to your lower-income spouse, who then invests the entire 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 30th of 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 your lower-income family members, then funds are loaned 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 30th of the following year) can be taxed in the hands of your spouse, children or grandchildren. Each of these family members can earn approximately $10,000 of interest income, $20,000 of capital gains or between $18,000 and $54,000 of eligible dividends from Canadian public companies tax-free federally every year if they have no other income. The actual tax-free amounts may vary, depending on their province of residence.

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

Prescribed rate loan illustration

The following table 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. In this example, it's assumed you have a $300,000 portfolio with an annual rate of return of 4.0% interest. Let's 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	$12,000	$12,000	$12,000
Interest deduction	$0	$3,000	$6,000
Net taxable income	$12,000	$9,000	$6,000
Tax payable by parent	$6,480	$1,620	$3,240
Tax payable by child	$0	$0	$0
Tax savings over 1 year	$0	$4,860	$3,240
Tax savings over 10 years	$0	$48,600	$32,400

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 $4,860 in one year alone. If this loan remains in place for 10 years with similar returns, the savings become significantly higher.

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Who can help?

Prescribed rate loan strategies can be excellent vehicles for families to tax-efficiently split income. 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 the CRA prescribed interest rate. The lower the interest rate, the greater the tax saving opportunities for you and your family.

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

This article may contain strategies, not all of which will apply to your particular financial circumstances. The information in this article is not intended to provide legal, tax or insurance 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, legal, and/or insurance advisor before acting on any of the information in this article.

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