Family Trust with Prescribed Rate Loan

Exploring and quantifying the concept of "wealth management alpha" — the incremental benefit that's added to your financial situation when recommended strategies are implemented.

The Changs — Family of Three

James and Amy Chang have one child, Rosie, who's four years old. They're keen on having Rosie attend private school and are already thinking ahead to potential post-secondary education costs. They're also interested in reducing their family's overall tax bill. The Changs currently have $1 million to invest and are wondering whether to invest it in their own name or to loan the capital to a family trust.

Assumptions: A 6% balanced rate of return (ROR), a time frame of 21 years, and known expenses for Rosie per year will be about $20,000, with a 2% inflation rate on the annual expenses.

Option A — Investment Portfolio in Own Name

The Changs decide to put the $1 million of capital into an investment portfolio in their own name. In pursuing this option, all interest income, dividends and capital gains are taxed in their hands, at their marginal tax rate of 45% (actual tax rates may vary by province or territory of residence and based on an individual's tax situation).

Here's how Option A unfolds over time:

Year	Opening Portfolio Balance	Investment Income*	Investment Management Fee	Beneficiary's Expenses	Ending Portfolio Balance	Annual Taxes
1	$1,000,000	$60,000	$10,000	$20,000	$1,030,000	$15,104
2	$1,030,000	$61,800	$10,300	$20,400	$1,061,100	$15,557
3	$1,061,100	$63,667	$10,611	$20,808	$1,093,348	$16,026
19	$1,754,371	$105,263	$17,544	$28,565	$1,813,525	$26,497
20	$1,813,525	$108,812	$18,135	$29,136	$1,875,065	$27,391
21	$1,875,065	$112,504	$18,751	$29,719	**$1,939,099**	$28,320

*Investment income includes dividends, capital gains and interest.

Total taxes	**$(439,445)**
Total after-tax growth	**$499,654**

At the end of 21 years, their total after-tax growth on the investment is $499,654, beyond the initial $1 million investment.

Option B — Family Trust Strategy

Here, the higher-income spouse loans the $1 million to a family trust at the CRA prescribed rate of 2%. With this option, all interest income, dividends and capital gains paid or payable to Rosie as the beneficiary are taxed at her marginal tax rate (which in Rosie's case is zero).

For this illustration, it's assumed the Changs re-invest the annual interest payments on the loan to the trust and that the investment return is the same as the trust. This option also assumes annual trust administration costs of $500, and that the Changs also make sure to consult with their qualified tax and legal advisors to ensure the trust is correctly set up and that it continues to operate properly.

Here's how Option B unfolds over time:

Year	Trust Opening Balance	Investment Income*	Investment Management Fee	Interest Paid	Beneficiary's Expenses	Trust Ending Balance	Tax on Interest Received	Tax on Net Reinvestment of Income	Closing Balance on Reinvestment of Income
1	$1,000,000	$60,000	$10,000	$20,000	$20,000	$1,009,500	$9,000	$–	$11,000
2	$1,009,500	$60,571	$10,095	$20,000	$20,400	$1,019,076	$9,000	$216	$22,444
3	$1,019,076	$61,144	$10,191	$20,000	$20,808	$1,028,721	$9,000	$440	$34,351
19	$1,177,657	$70,659	$11,777	$20,000	$28,565	$1,187,474	$9,000	$5,550	$305,566
20	$1,187,474	$71,248	$11,875	$20,000	$29,136	$1,197,211	$9,000	$5,990	$328,909
21	$1,197,211	$71,833	$11,972	$20,000	$29,719	**$1,206,853**	$9,000	$6,448	**$353,196**

*Investment income includes dividends, capital gains and interest.

At the end of the 21 years, with the family trust approach, the Changs end up with a total after-tax growth of $560,049, after the $1 million loan is paid back.

Results

After the 21 years, the investment portfolio approach results in an after-tax growth that's just shy of $500,000. With Option B of the family trust and the invested interest payments, the Changs end up with just over $560,000 in after-tax growth. They were also effectively able to reduce the family's overall tax bill.

Even after trust administration fees, this is a *wealth alpha* of about $60,000 and the benefit of paying lower taxes.

To learn more about why RBC Wealth Management is right for you, please visit rbcwealthmanagement.com.

RBC Wealth Management