

THE NAVIGATOR



USING A FAMILY TRUST FOR PRESCRIBED RATE LOAN ARRANGEMENTS

A low prescribed rate can provide tax saving opportunities for you and your family

A family trust can be used to implement a prescribed rate loan income-splitting strategy to help you reduce your family's tax burden.

This article outlines strategies, not all of which will apply to your particular financial 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 advisor before acting on any of the information in this article.

USING A FAMILY TRUST

If structured properly, a family trust is a structure that may allow a parent or grandparent to split income with their low-income family members. The strategy is 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 low-income spouse, children, nieces/nephews and/or grandchildren.

The Income Tax Act contains "attribution" rules that attribute income and in some cases capital gains back to the individual that supplied the capital for investment. The result of triggering these rules is that no tax savings are achieved. The potential for application of the attribution rules in a family trust strategy depends on

the structure of the trust, who funds the trust and how it is funded and the type of investment income that is distributed from the trust and who gets that distribution. For a more general discussion on living trusts including details on the attribution rules and properly structuring a trust please ask your RBC advisor for our article, "Living/Family Trusts".

If a properly structured trust is funded using a prescribed rate loan, it may be possible to avoid triggering the attribution rules.

PRESCRIBED RATE LOAN

A prescribed rate loan is created when investment capital is loaned by a high-income family member (the lender) to a low-income family member or family

trust (the borrower) using a formal written loan agreement. In order for this loan strategy to work, the interest rate on the loan must be at least equal to the Canada Revenue Agency's (CRA's) prescribed rate in effect at the time the funds are loaned. Once the loan is established, the prescribed rate is maintained for the life of the loan regardless of any changes to the prescribed rate in the future.

The family trust must pay interest to the lender at the CRA's prescribed rate. The annual interest must be paid by the trust on or before January 30 of the following year. The lender must declare the interest received as income on their tax return, resulting in tax on the interest income at the lender's marginal tax rate.



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The benefit of the prescribed rate loan strategy is that there is no attribution on any investment income (e.g. interest, dividends) or taxable capital gains distributed from the trust to the beneficiaries, assuming the trust is structured properly and the interest on the loan is paid on or before January 30th each year. The trust pays the lender annual interest on the loan but, when properly implemented, the tax savings on the investment income distributed to the beneficiaries will generally compensate for this.

It is essential to adhere to the interest payment requirement. If an interest payment is made even one day late for any year, the attribution rules will apply for that year and all subsequent years. Consequently, this arrangement will no longer be effective as an income splitting strategy.

A LOW PRESCRIBED RATE ENVIRONMENT IS AN IDEAL TIME TO USE THIS STRATEGY

In 2007, the CRA prescribed rate on family loans was 5%. At this relatively

high rate, it was generally more difficult to achieve tax savings since the trust had to earn investment income in excess of 5% to compensate for the interest payment to the lender. As a result, some family trusts were funded using an interest-free loan. If an interest-free loan was made to the trust, then interest and dividends distributed to a beneficiary (regardless of age) were attributed back to the lender. However, taxable capital gains distributed from the trust were taxed in the hands of the beneficiary if the trust was structured properly. This limited the investment strategies available to the trust.

The CRA sets the prescribed interest rate every quarter based on the average rate of 90-day treasury bills sold during the first month of the preceding quarter, rounded up to the nearest percentage point. With the CRA prescribed rate currently at only 1%, it is easier to ensure that family trust earns sufficient income to cover the interest cost so there is no need to use an interest-free loan. This allows for

a much broader range of investment strategies that may be used while still achieving tax-efficiency.

POTENTIAL TAX SAVINGS

The table below illustrates the potential tax savings that may be realized if a parent makes a prescribed rate loan at 1% to a properly structured family trust, compared to investing the portfolio directly or making an interest-free loan to a family trust.

Assumptions:

- \$250,000 portfolio
- Annual rate of return of 6% (3% interest, 3% realized capital gains)
- Parent's tax rate: 50%
- One child beneficiary; child's tax rate: 0% (if the child's taxable income is below the basic personal exemption there will be zero income taxes payable)
- Basic personal exemption per beneficiary: \$10,000 (varies by province)

	Portfolio held directly by parent	Interest-free loan to family trust	Prescribed rate loan at 1% to family trust
Investment income (interest and capital gains)	\$ 15,000	\$ 15,000	\$ 15,000
Tax payable by parent	\$ 5,625	\$ 3,750	\$ 1,250
Tax payable by child	–	–	–
Tax saving in year 1	–	\$ 1,875	\$ 4,375
Tax savings over 10 years (actual dollars)	–	\$ 18,750	\$ 43,750

A trustee must be guided by the prudent investor standard in selecting the trust's investments.

For the family, the net tax benefit of having a prescribed rate loan at 1% is \$4,375 in one year alone compared to the parent investing the portfolio directly. If this loan remains in place for ten years with similar returns, the savings become \$43,750. These savings are further compounded if there is more than one low-income beneficiary to whom trust investment income is distributed or the returns on the investment increases.

The tax saving in one year is \$2,500 higher using a prescribed rate loan compared to an interest-free loan (\$4,375 - \$1,875). The additional tax saving is a result of interest being taxed in the hands of the beneficiary, whereas when the funds are loaned interest-free the interest is taxed in the hands of the parent at their high marginal rate because of the attribution rules.

INVESTING FAMILY TRUST ASSETS

Decisions relating to the investment and allocation of the assets in the family trust will depend on the purpose and goals of the trust, as well as the investment powers contained in the trust agreement. It is common for the trustee to invest in marketable securities in the family trust that generate interest income, dividends and/or capital gains every year to take advantage of the beneficiary's low tax bracket each year for income splitting purposes and to help fund annual expenses. Income and capital

gains maintain their character when distributed to a Canadian resident beneficiary. In general, a trustee must be guided by the prudent investor standard in selecting the trust's investments, unless the trust agreement grants the trustee broader investment powers, and reasonably assess the risk and return of each investment.

U.S. SECURITIES IN A FAMILY TRUST

Depending upon how the family trust is structured or funded, the value of the trust assets may be included in the settlor, lender and/or beneficiary's worldwide estate for U.S. estate tax purposes on their death. If the trust is in existence at the time of the settlor, lender and/or beneficiary's death, and the trust owns U.S. securities, the settlor, lender and/or beneficiary may be subject to U.S. estate tax on the value of these U.S. situs assets. Note that Canadian mutual funds (including iShares trading on the TSX) or Canadian pooled funds that invest in U.S. securities are not considered to be U.S. situs assets for U.S. estate tax purposes.

If the value of the settlor, lender and/or beneficiary's worldwide estate (including the trust assets) is below the U.S. estate tax exemption in place in the year of their death, U.S. estate tax will not be payable.

If you are the settlor, lender and/or

beneficiary of a trust that holds U.S. situs assets, it is important to review the trust agreement as well as how the trust was funded to determine whether you have U.S. estate tax exposure. If you are considering setting up a family trust, you should seek advice from a cross-border tax advisor about how to structure the trust to avoid U.S. estate tax exposure.

MODIFYING AN INTEREST-FREE LOAN OR EXISTING PRESCRIBED RATE LOAN

If you have an existing interest-free loan or prescribed rate loan at a higher interest rate, you may want to consider repaying your current loan and making a new loan to take advantage of the 1% prescribed rate. This rate is subject to change quarterly so the new loan needs to be set-up and funds advanced while the 1% rate is in effect. While it is possible to repay the current loan and establish a new loan using the current CRA prescribed rate, there are some considerations that you should review before making such a change. For more information on modifying a loan to take advantage of the lower CRA prescribed rate, ask your RBC advisor for a copy of our article titled "Modifying a Prescribed Rate Loan".

USING A FAMILY TRUST TO PAY FOR BENEFICIARIES' EXPENSES

A family trust established during your lifetime is an inter-vivos trust. In general, if the trust is properly

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

structured, investment income earned in the trust will be subject to tax in the trust at the top marginal tax rate in the trust's province of residence. If, however, the investment income is paid or made payable to a beneficiary, the income can be taxed in their hands at their marginal tax rate, subject to the attribution rules.

Income may be considered "paid" to a minor beneficiary if the income is used to pay for expenses that directly benefit the beneficiary. There is no official list of expenses that can be paid from a family trust. However, CRA has stated that expenditures made for a child's benefit would be an amount paid for the support, maintenance, care, education, enjoyment and advancement of the child including the child's necessities of life. Some types of expenses that may qualify include private school fees, camp expenses, and vacation costs to the extent they can be allocated to the child.

IMPORTANCE OF RECORDKEEPING

There are a number of recordkeeping duties that the trustee(s) must adhere to on an annual basis to ensure that the trust is properly administered and the income splitting benefits of the trust are achieved. These duties include (but are not limited to): keeping a copy of the original signed trust agreement and settlement property (e.g. \$20 bill used to settle the trust), signing a resolution before year-end to allocate the trust's income to the beneficiary, documenting payments made to a beneficiary or a third party for the benefit of the beneficiary, keeping receipts for any payments made to a third party or a parent as a reimbursement for an expenditure, maintaining promissory notes for any income that has been made payable to the beneficiary and ensuring the timely and accurate filing of the trust's tax return and T3 slips to the beneficiary. It is also very important to document and maintain

source documents for the interest payments on the prescribed rate loan and any repayments of principal.

It is recommended that the trustee(s) consult with qualified tax and legal advisors to discuss their recordkeeping responsibilities related to the family trust and the prescribed rate loan.

IMPLEMENTING A PRESCRIBED RATE LOAN STRATEGY USING A FAMILY TRUST

RBC offers a family trust solution with prepared legal agreements which can be used to implement a prescribed rate loan strategy. Speak to your RBC advisor for more information on family income-splitting strategies or if you would like to consider a family trust. You should also discuss this strategy and have the RBC family trust and loan agreements reviewed by a qualified tax and legal advisor. In some cases, it may be appropriate to have a lawyer draft your own customized family trust and loan agreements.

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