

Reduce Your Taxes With a Prescribed Rate Loan

Under our tax system, the more you earn, the more you pay in income taxes on each incremental dollar earned. With this in mind, it makes sense to spread income among family members who are taxed at lower marginal rates in order to lower your family's overall tax burden. However, the income attribution rules can prevent most income splitting strategies where there has been a transfer to a spouse or minor child for the purpose of earning investment income. The attribution rules transfer the taxation of investment income (and capital gains in the case of a gift to a spouse) back to the person who made the gift regardless of whose name is on the investment. While there are significant restrictions, there are still a number of legitimate income-splitting strategies available to you.

Prescribed Rate Loan

A simple, yet effective income-splitting strategy involves transferring income-generating assets (ideally cash) to a lower-income spouse (or other family member) and taking back a loan (equal to the fair market value of the assets transferred) at the Canada Revenue Agency's (CRA) prescribed interest rate in effect at the time of the loan. Given the current low CRA prescribed rates, implementation of this strategy presents a very compelling opportunity. For loans made to a family member, the rate necessary to avoid the income attribution rules is only 1% effective for loans made in the third quarter of 2013 – this continues to be an all time low for CRA's prescribed rate. Most importantly, if structured properly the prescribed rate in effect at the time of the loan will continue to apply until the loan is repaid, regardless of future changes to the prescribed rates. For loans made after September 30, 2013 (i.e. the end of the third

quarter of 2013), the CRA's prescribed rate at the time of the loan will apply.

How it Works

Briefly stated, an interest-bearing loan is made from the person in the higher marginal tax bracket to a family member (such as a spouse) in a lower tax bracket for the purpose of investing. To avoid the income attribution rules there are a number of requirements that must be met. For example, interest must be charged at a rate at least equal to the CRA's prescribed rate in effect at the time the loan is made. Interest is charged annually at this rate and must be paid by the following January 30th each year. In order for there to be a net benefit, the annual realized rate of return on the borrowed funds must exceed the annual interest rate charged on the loan, which is included in the income of the transferor and should be deductible to the transferee family member, if used for investment purposes. By locking in this strategy at this low rate, long-term benefits of income-splitting can be achieved to the extent future investment returns exceed this low 1% threshold.

The impact of increased income to the transferee family member (e.g. loss of spousal tax credit) should also be considered before employing this strategy. Finally, it is important to consider the possible recognition of capital gains or capital losses, which may be denied, when assets other than cash are loaned or transferred to a family member. Given the complexity of the income attribution rules, you should consult with your tax and legal advisors to review and structure any income splitting strategies to ensure that the strategies are implemented and documented correctly and achieve the desired results without any unanticipated implications.

June 2013

© "BMO (M-bar Roundel symbol)" and "Making Money Make Sense" are registered trade-marks of Bank of Montreal, used under licence. "Nesbitt Burns" is a registered trade-mark of BMO Nesbitt Burns Inc. BMO Nesbitt Burns Inc. is a wholly-owned subsidiary of Bank of Montreal. The comments included in the publication are not intended to be a definitive analysis of tax law. The comments contained herein are general in nature and professional advice regarding an individual's particular tax position should be attained in respect of any person's specific circumstances. If you are already a client of BMO Nesbitt Burns, please contact your Investment Advisor for more information.

Member-Canadian Investor Protection Fund

EWPG-13-012



Making money make sense®