Reduce your taxes with a Prescribed Rate Loan

In a low interest rate environment, a popular tax strategy involves the use of a prescribed rate loan to split income amongst family members. However, as a result of the recent decreases in the prescribed interest rate, the income-splitting benefits of this strategy have improved.

Under our tax system, the more you earn, the more you pay in income taxes on incremental dollars earned. With this in mind, it may make sense to spread income among family members who are taxed at lower marginal rates in order to reduce your family's overall tax burden. However, the income attribution rules prevent most income-splitting strategies in situations 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, including a prescribed rate loan.

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.

For loans made to a family member in the first quarter of 2025 (i.e., January 1 to March 31), the rate necessary to avoid the income attribution rules is 4%. 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. Loans made prior to the end of the current quarter (i.e., March 31, 2025) will lock in this 4% rate indefinitely, however, for loans made after the end of the first quarter, the CRA's prescribed rate at the time of the loan will apply. This rate, which is set quarterly, may stay at 4% or decrease further depending on the interest rate environment.

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 30 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. This interest charge is included in the income of the transferor and should be deductible to the transferee family member, if used for investment purposes. However, as the prescribed rate increases, the income-splitting benefit narrows. Based on the current 4% prescribed rate, long-term benefits of income splitting will only be achieved to the extent future investment returns exceed this higher 4% threshold. As such, the strategy may not be beneficial for most taxpayers, unless sufficient funds are advanced and there is a significant discrepancy in marginal rates between family members (depending on the amount and nature of investment income earned on the loaned funds).

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. It is also important to consider the possible recognition of capital gains or capital losses, the latter of 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 they are implemented and documented correctly, in order to achieve the desired results without any unanticipated implications.

For more information, please speak with your BMO Private Wealth professional.

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