Reduce your Taxes with a Prescribed Rate Loan

A popular tax strategy involves the use of a prescribed rate loan to split income amongst family members. Despite the recent increase in the prescribed interest rate, the income splitting benefits of this strategy remain.

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 third quarter of 2019, the rate necessary to avoid the income attribution rules is 2%. If structured properly, the prescribed rate in effect at the time of the loan will continue to apply throughout the term of the loan until the loan is repaid, regardless of future changes to the prescribed rate. Despite the fact that the prescribed rate recently increased from an all time low of 1% to 2%, the ability to lock in the current 2% rate is still attractive. For loans made after Sepetember 30, 2019, 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 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. By locking in this strategy at the current rate, long-term benefits of income-splitting can be achieved to the extent future investment returns exceed this current 2% threshold.

Continued

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, speak with your BMO Financial Professional.

We're here to help.™

BMO Wealth Management provides this publication for informational purposes only and it is not and should not be construed as professional advice to any individual. The information contained in this publication is based on material believed to be reliable at the time of publication, but BMO Wealth Management cannot guarantee the information is accurate or complete. Individuals should contact their BMO representative for professional advice regarding their personal circumstances and/or financial position. The comments included in this publication are not intended to be a definitive analysis of tax applicability or trust and estates law. The comments are general in nature and professional advice regarding an individual's particular tax position should be obtained in respect of any person's specific circumstances.

BMO Wealth Management is a brand name that refers to Bank of Montreal and certain of its affiliates in providing wealth management products and services. Not all products and services are offered by all legal entities within BMO Wealth Management.

BMO Private Banking is part of BMO Wealth Management. Banking services are offered through Bank of Montreal. Investment management services are offered through BMO Private Investment Counsel Inc., an indirect subsidiary of Bank of Montreal. Estate, trust, planning and custodial services are offered through BMO Trust Company, a wholly owned subsidiary of Bank of Montreal.

BMO Nesbitt Burns Inc. provides comprehensive investment services and is a wholly owned subsidiary of Bank of Montreal. If you are already a client of BMO Nesbitt Burns Inc., please contact your Investment Advisor for more information. All insurance products and advice are offered through BMO Nesbitt Burns Financial Services Inc. by licensed life insurance agents, and, in Quebec, by financial security advisors. ®"BMO (M-bar roundel symbol)" is a registered trade-mark of Bank of Montreal, used under licence.

All rights are reserved. No part of this publication may be reproduced in any form, or referred to in any other publication, without the express written permission of BMO Wealth Management.

07/19-1417