

Reduce your Taxes with a Prescribed Rate Loan

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.

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 now 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 second quarter of 2015 – which represents an all time low for the 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 June 30, 2015 (i.e., the end of the second quarter of 2015), the CRA's

prescribed rate at the time of the loan will apply so it will be important to lock in this low rate now, in advance of future possible increases.

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, 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.



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