Prescribed rate loans for income splitting

Wealth Management Taxation, The Bank of Nova Scotia

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Background

Individuals resident in Canada are subject to graduated tax rates. As an individual's income level increases, so does the tax rate on that incremental level of income. In some cases, prescribed rate loans are used to achieve tax savings by shifting income from one family member to another and benefiting from their lower tax rates. However, when considering these types of loans there are certain income attribution rules in the *Income Tax Act* ("Canada") ("ITA") to be aware of.

Types of loans

Spousal loans

Where one spouse earns a higher level of income than the other, the couple's overall tax bill can potentially be reduced by shifting investment income between spouses. One effective option is to consider a prescribed rate loan, where the higher income spouse lends money to the lower income spouse to invest, thereby allowing the lower income spouse to claim the investment income from those assets.

When money is lent directly to purchase investment assets – or when investment assets are directly transferred from one spouse to another – the income from those investments will normally be attributed back to the transferor and taxed in their hands as if they earned it themselves. The ITA provides for some exceptions to these attribution rules including where the funds are lent to the spouse at the prescribed rate published by Canada Revenue Agency ("CRA"). The current prescribed rate is 2% as of the fourth quarter of 2018. This exception can apply in certain particular circumstances, including when the interest on the loan is paid annually by the deadline (January 30th of the following year) and the loan is formalized through a written legal agreement. These loans can be "locked-in" at that prescribed rate at the time the loan is established until the time the loan is fully repaid. The rate applied to the loan can remain unchanged even if the prescribed rate increases in the future, which could result in significant tax savings, especially if the loan remains outstanding for an extended period of time. These types of loans are often structured as due-on-demand loans with no set repayment terms and could be outstanding for an unlimited amount of time.

Trusts for minors

A prescribed rate loan can also be made to a trust for minor children in order to achieve similar tax savings and income splitting results. These types of trusts typically have the ability to allocate income annually to their beneficiaries. Borrowed funds are invested inside the trust for the benefit of the minor children and can be a powerful tool for saving for post-secondary education costs or other expenses of the children without being taxed at the highest marginal tax rates, but rather taking advantage of the lower tax rates of each of the beneficiaries.

In addition, this may provide an opportunity to educate children about investments and investing.

Please note that income attribution rules would apply equally to trusts for minors. In addition, certain Tax on Split Income ("TOSI") rules may apply for private company shares held inside the trust. Please refer to our TOSI memo and consult your tax professional advisors before establishing trust arrangements.

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Transferring assets

As mentioned, a prescribed rate loan is one option spouses can consider in order to split income, but so is transferring assets from one spouse to the other. Generally, transferring property between spouses does not trigger any capital gains tax, but rather, the transfer occurs on a "rollover" basis. However, any future capital gains or losses arising from the transferred property will generally be attributed back to the spouse who originally transferred the asset.

Generally, exceptions to these attribution rules include circumstances where the transferor elects to have the transaction occur at fair market value ("FMV"), and the lower income spouse pays that FMV for the property at the time of transfer, or provides a promissory note for the FMV bearing interest at the prescribed rate in effect at that time. In this case, capital gains may be triggered and tax may be payable in the year if the transferred assets have accrued gains. It is important that individuals consult their tax advisors to have a complete understanding of the tax implications if they are considering this type of transfer of assets.

Prescribed rate loan example

Mrs. X is a high income earner and has a tax rate of 50%. Mr. X is the lower income spouse with a tax rate of 25%. If Mrs. X were to invest $500,000 in income producing assets generating a rate of return of 5%, the investment income earned would be $25,000 and her tax payable would be $12,500 ($500,000 x 5% x 50%).

Alternatively, if Mrs. X chose to lend the $500,000 to Mr. X, with Mr. X issuing a promissory note bearing interest at a prescribed rate of 2% at that time, the $25,000 of income would be taxed in his hands instead. However, he would be eligible for a $10,000 deduction for the 2% interest he is paying to Mrs. X. He would therefore have tax payable of $3,750 ($15,000 x 25%).

Mrs. X would still need to pay tax of $5,000 ($500,000 x 2% x 50%) on the 2% of interest income she is receiving from Mr. X.

In summary, the first scenario would result in an aggregate tax liability of $12,500. The second scenario would result in an aggregate tax liability of $8,750. The overall tax savings achieved is $3,750 annually, which can be significant over a long period of time.

Summary

Overall, prescribed rate loans may be a method for reducing a family's overall tax liability, particularly where one spouse earns significantly more income than another. Any strategy is best considered as part of a comprehensive financial plan, where an individual's overall goals and entire financial situation can be factored into any and all recommendations.

Speak with your own tax advisors about your own tax situation when evaluating and before implementing any tax planning strategies.

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