

Reduce Your Taxes with a Prescribed Rate Loan

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A popular tax strategy involves the use of a prescribed rate loan to split income amongst family members. Although the prescribed interest rate had been set at 2% by the Canada Revenue Agency since the second quarter of 2018, the rate decreased to 1% beginning the third quarter of 2020. As a result of the lower rate, you should consider planning now to take advantage of the enhanced income-splitting benefits of this strategy.

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 2021 (i.e., January 1 to March 31, 2021), the rate necessary to avoid the income attribution rules is 1%, 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 March 31, 2021 (i.e., the end of the first quarter of 2021), the CRA's prescribed rate at the time of the loan will apply, so it will be important to lock in this low rate 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 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 now at the current low 1% prescribed rate, long-term benefits of income-splitting can be achieved to the extent future investment returns exceed this 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. 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.

Refinancing of an existing loan

For existing prescribed rate loans that were established at a rate higher than 1%, it is important to note that simply changing the rate on the existing loan to the lower 1% rate, or using the proceeds of a new loan at the 1% rate to repay an existing loan at a higher rate will likely not be sufficient to avoid the attribution rules. Specifically,

the CRA has previously expressed concerns in various technical interpretations about the re-financing of a prescribed rate loan, as to whether or not the original loan was extinguished and a new loan established. The CRA suggests that each situation should be evaluated on all pertinent facts, including the terms of the loans and the source of funds used to repay the original loan, in particular.

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.



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