Sun Life

Creating tax efficiencies with prescribed rate loans

Income-splitting strategies are few and far between as the Canada Revenue Agency (CRA) continues to target strategies that shift income to lower income taxpayers. However, prescribed rate loans remain as a tax planning strategy to split income between family members.

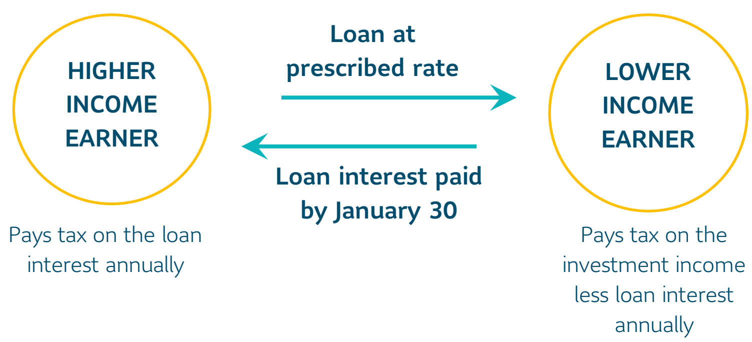
Our current tax system requires taxpayers to pay income tax based on graduated rates. This means you gradually pay more income tax as you earn more income. Shifting income from a higher-income earner to a lower-income earner may make sense where the family's total tax load is reduced.

Prescribed rate loans

A prescribed rate loan involves transferring income-producing assets from a higher-income earner to a lower-income earner. This transfer can be in cash or in-kind to a spouse, family member, minor child, or family trust. As consideration for this transfer, the higher-income earner will document a loan agreement with the recipient. This loan agreement can be made in the form of a promissory note and should be evidenced in writing. The loan is for fair value of the assets transferred at the CRA's prescribed interest rate in effect at the time of the loan.

The CRA sets the prescribed rate on a quarterly basis. The prescribed rate has varied between 1% and 3% over the last decade.[1] The rate for the loan is set on the date the recipient receives the funds and remains in effect for the duration of the loan. The loan rate does not change if the prescribed rate increases or decreases from the rate that was in effect when the loan was made.

The lower-income earner must pay the interest owed on the loan within 30 days of the end of the calendar year. It is very important the loan interest is actually paid and documented with a paper trail, and further reported as income by the recipient and as a deduction by the payor. A missed payment can cause the attribution rules to apply discussed later in this article.



The mechanics of the strategy

The interest paid is taxable income for the higher-income earner but is deductible from income for the lower-income earner. The purpose of the strategy is to take advantage of the spread between the low prescribed interest rate and the taxable income produced by the invested assets. By shifting the spread to a lower-income earner there is a lower total tax bill on the same income.

Let's take a look at an example:

In the chart below, we have a higher-income earner who has accumulated a $1 million non-registered portfolio. This taxpayer earns a salary that already puts them in the top tax bracket. Therefore, the additional investment income is taxed at the top rate. The taxpayer's spouse on the other hand has a part-time job with a significantly lower income. There is a large discrepancy between the couple when it comes to the tax burden each is carrying on an annual basis. A prescribed rate loan strategy may be one strategy to reduce the family's tax burden.

Before the loan:

The higher-income earner will pay tax on the income at their assumed top tax rate producing a $25,000 tax bill.

No loan	Higher-income spouse	Lower-income spouse
Invest	$1,000,000	-
Return	5 %	-
Income	$50,000	-
Tax Rate	50%	-
Taxes	**$25,000**	-

After the loan:

The same $1 million invested by the lower-income spouse will produce the same amount of income. The lower-income spouse will pay the higher-income spouse the interest payment based on the prescribed rate but deduct it from their income. In this example, the lower-income spouse pays tax on the net amount of investment income, $30,000. The higher-income spouse pays tax on the $20,000 interest payment. Based on our assumed tax rates the total family tax bill reduces to $16,000 from the $25,000 without the loan. This produces an annual tax savings of $9,000.

Loan to Spouse	Higher-income spouse	Lower-income spouse
Loan	$1,000,000	n/a
Assumed prescribed rate	2 %	-
Invest	-	$1,000,000
Return	-	5 %
Income	$20,000	$50,000
Deductible loan interest	-	($20,000)
Tax rate	50 %	20 %
Taxes	$10,000	$6,000
Family total taxes	**$16,000**	
Annual Savings : $25,000 – $16,000 = $9,000		

Savings vary depending on the current prescribe rate[1], your marginal tax rates and amount loaned.

Attribution rules

The *Income Tax Act* (Canada) (ITA) contains attribution rules to prevent many income-splitting strategies where transfers occur between related parties such as a spouse or minor child. When the attribution rules apply, income reported by the lower-income earner is transferred back to the higher-income earner for tax purposes. A properly structured and documented prescribed rate loan should not trigger the attribution rules.

Other considerations

Implementing a prescribed rate loan does not come without warning. You should discuss all considerations along with the general strategy itself with your financial advisor and professional tax and legal advisors to ensure it is appropriate for your situation.

Some additional considerations include:

- **Decrease in the prescribed rate** – this is a planning opportunity in which a lower rate can be locked-in to increase tax-efficiency of the strategy. This involves repaying the loan with the previously loaned assets and re-advancing a new loan under the new rate. There may be tax consequences to consider where the portfolio has accrued gains when making this repayment.
- **Tax efficient income** – different investments produce different taxable income. When investing the funds in a low-income earner's hands, you may want to invest in assets that provide additional tax credits or tax-efficient income to increase the annual tax savings. Discuss these options with your financial advisor.
- **Use a family trust** – the above example shows the efficiency of splitting income with a lower- income spouse. The total tax bill could be lower where income is split with more than one person using a family trust. Using a family trust is more complex and requires professional advice before implementing the strategy.
- **Loss of spousal tax credit** – where the higher-income spouse has been enjoying the benefit of the spousal tax credit, they will no longer be entitled to this credit to reduce their taxes as the spouse will have income to report and use their own credits. This loss has value based on the credit available in each province and should be considered as part of the annual tax savings.
- **Accrued capital gain** – where the income-producing asset in the higher-income earner's name has an accrued gain, transferring these assets will trigger capital gains. Where this is not avoidable, consider the tax cost against the annual tax savings the prescribed rate loan strategy produces to determine if there is a benefit.
- **Accrued capital losses** – when transferring assets in-kind there may be securities in a loss position. Any security transferred in-kind at a loss will have its loss denied when the asset transfers to an "affiliated person", as defined in the ITA. Consider triggering the loss through an actual sale of the security to offset any realized gain to make use of the losses. Further, it is important not to replace the investment with the same investment within 30 days of its disposition or the loss rules will still apply.
- **Keep the loan a round number** – for ease of calculating the interest payment, it is best to keep the outstanding loan amount a round number. Where transferring assets in-kind, consider topping up the amount with cash to the nearest thousand. For example, if your in-kind transfer has a fair market value of $1,085,235, add $14,765 of cash to have a loan amount of $1,100,000.

Loans from your corporation

If you own shares in a corporation, you may be tempted to give a prescribed rate loan to yourself personally. Especially if your corporation has accumulated savings. However, the ITA contains special rules that prevent a shareholder from using corporate assets for personal purposes. These rules result in a taxable benefit included in your income for the full value of the loan. There are limited exceptions to avoid the taxable benefit,[2] but the prescribed rate loan strategy is not one. If you wish to use corporate funds for personal purposes, speak with your professional tax advisor prior to implementing.

Summary

The prescribed rate loan strategy can provide annual tax savings and amount to large savings over a long period. The strategy does not come without its challenges and administration to keep it going. Please review the strategy with your professional advisors to ensure you are aware of the tax and legal consequences.

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[1] The CRA publishes the prescribed rate quarterly on its website: https://www.canada.ca/en/revenue-agency/services/tax/prescribed-interest-rates.html
[2] One exception is if the shareholder repays the loan within one year after the end of the corporation's tax year in which the loan was made. Other limited exceptions apply if the shareholder is also an employee of the corporation and the loan is used for specific purposes.