The Stan Clark Financial Team's

PERSPECTIVES

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Financial planning

Prescribed rate loans

By Sylvia Ellis, Senior Estate Planning Advisor

Were you aware that you can save family taxes by having a high-income family member lend cash to a lower-income family member, like a spouse, minor children or grandchildren?

Money that you earn from your job, or through investing, is deemed to be yours for tax purposes. In most circumstances, it cannot be given to your family members, as described above, to invest, without triggering attribution. This means that any income or gains earned on the money transferred may need to be reported on your income tax return, not theirs. But, there is a way to avoid these rules by way of a prescribed rate loan (PRL).

The prescribed rates, set by the Canada Revenue Agency (CRA) quarterly, will be reduced this July to 1%. Tied directly to the yield on Government of Canada three-month Treasury Bills, the new rate will then be the lowest it can possibly be.

For loans put into place between July 1, 2020 and the end of September 2020 (and possibly longer, depending on what happens to the prescribed rate in future quarters), the 1% rate would be locked in for the duration of the loan without being affected by any future increases.

You can use this to your advantage by either making a loan directly to your spouse, or in the case of minor children or grandchildren, via a family trust which can have multiple beneficiaries. It's a great way to help fund their education, activities, etc.

Remember, the objective is to shift future investment income from a higher-income earner to a lower-income earner, to take advantage of the latter's lower marginal tax rates. This results in more after-tax income for the family. The greater the difference in marginal tax rates, the greater the savings.

The process is fairly simple:

- Make a demand loan to your lower-income spouse, minor child or grandchild via a trust
- The loan is backed by a promissory note and a loan agreement which sets out the terms
- Lend money from an account in your name to one in their name (vs. joint)
- The lower-income family member or trust invests the funds
- Annual interest payments are made no later than January 30th of the following year.

There will be legal costs associated with having a loan document properly prepared outlining the terms. In addition, where a family trust is used as part of a PRL arrangement, there may be costs associated with establishing and maintaining the family trust structure, such as legal fees and annual accounting and tax filing fees for the family trust.

Let's consider the following example.

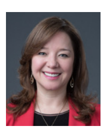
David is in a 50% tax bracket and his spouse Susan in a 20% one. David has $1,000,000 cash and wants to utilize a loan at the 1% prescribed rate to split income with Susan. Susan invests the $1,000,000 and is able to generate an annual return of 5%. The tax savings per year is $12,000, as shown in the table.

	Without a Spousal Loan Strategy	With a Spousal Loan Strategy	
	David	David	Susan
Initial Investment	$1,000,000	$0	$1,000,000
Income earned @ 5%	$50,000	$0	$50,000
Interest on loan @ 1%	n/a	$10,000	($10,000)
Pre-tax income	$50,000	$10,000	$40,000
Taxes payable @ 50%/20%	$25,000	$5,000	$8,000
Total tax	**$25,000**	**$13,000**	
Tax savings 1st year	**$12,000**		

Over a 10- or 20-year period, the tax savings could be significant, as there is no limit on how long the loan can be in place, as long as the interest due is paid on time.

Borrowed funds do not necessarily need to be invested and can be used for other purposes; however, income splitting and tax minimization can only be achieved if the funds borrowed are used for investment purposes and generate investment income. If the funds are used for investment purposes, the annual interest on the borrowed funds can be deducted as an expense against the earned income.

As always, we recommend that you obtain tax and legal advice before implementation, to determine the best way to structure and operate this type of arrangement. If you have any questions or would like to discuss this further, please let us know. ■



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