Take Advantage of Income Splitting Loans

Wealth Management Taxation, The Bank of Nova Scotia

On December 16, 2016 the Canada Revenue Agency ("CRA") announced that the prescribed interest rate applicable to income-splitting loans would remain at 1% for the first quarter from January 1, 2017 to March 31, 2017 . Any future changes will be communicated at a later date.

Background

The CRA prescribed interest rate is often used in what is commonly referred to as income-splitting loan arrangements. By entering into these loan arrangements, an individual can realize tax savings by shifting income to another family member and utilizing their lower tax rates.

In order to set up an income-splitting loan arrangement, all loans will need to bear interest at the CRA prescribed rate and will essentially be locked in at the prescribed rate up until the time the loan is fully repaid. This rate remains unchanged even if future rates increase, 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.

If these income-splitting loan arrangements are made before March 31, 2017, the interest rate will be fixed at 1%.

Taking advantage now

There are several tax planning strategies that an individual can consider in order to take advantage of the 1% prescribed rate.

Spousal loans

In general, Canadian income tax rates for individuals are based on graduated income levels. As an individual's income level increases, so does their marginal tax rate.

Income splitting and tax savings can be achieved for higher income individuals by lending funds at the CRA prescribed interest rate to their spouse, who otherwise earns little to no income. These funds are then used to purchase income producing assets and thereby shifting investment income from an individual normally taxed at a higher marginal tax rate to a spouse who is taxed at a lower marginal tax rate.

However, there are certain income attribution rules in the Income Tax Act to be aware of when implementing this type of strategy. When investment assets are directly transferred from one spouse to another (or when money is lent directly to purchase investment assets), the income from those investments will normally be attributed back to the transferor and taxed in their hands as if they earned it themselves.

In order to have these attribution rules not apply, it is important to note the following:

< A written legal agreement needs to be drafted, stipulating that interest charged must be equal to or greater than the CRA prescribed interest rate on the loan at the time the loan was made. If the loan arrangement is completed before the prescribed rate changes, the interest rate will be locked in at 1% until the loan is fully repaid even if the prescribed rate increases in the future.

< Principal repayments are not required each year. However, the interest payable on the loan must be paid annually by January 30th of the following year. This is a very important point as many individuals forget to maintain the annual interest payments, which would cause this plan to be ineffective. Even one late payment can cause the attribution rules to apply for not only that year, but also all previous and subsequent years.

< In some situations, the higher income spouse will decide to transfer investment assets to the lower income spouse in order to split income. Generally, transferring property between spouses does not trigger any capital gains tax. However, any future capital gains or losses arising from the transferred property will be attributed back to the spouse who originally transferred the asset. This is unless the lower income spouse paid Fair Market Value ("FMV") for the property at the time of transfer. The transfer must have taken place at FMV and the transferor must file a special election as part of their income tax filings for the year of transfer. As a result, capital gains will be triggered and tax will be payable in that year. If this is done in conjunction with a prescribed rate loan, all future capital gains or losses realized, along with income produced by the investments, will be taxed in the hands of the lower income spouse instead.

Example

Mr. X is a high income earner and has a tax rate of 46%. Mrs. X is the lower income spouse with a tax rate of 25%. If Mr. 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 the tax payable would be $11,500 ($500,000 x 5% x 46%).

Alternatively, if Mr. X chose to lend the $500,000 to Mrs. X, using a prescribed rate loan of 1% (as discussed above), $25,000 would be taxed in her hands instead. However, she would be eligible for a $5,000 deduction for the 1% interest she is paying to Mr. X. She would therefore have tax payable of $5,000 ($20,000 x 25%).

Mr. X would still need to pay tax of $2,300 ($500,000 x 1% x 46%) on the 1% of interest he is receiving for the loan.

In summary, the first scenario would result in an overall tax liability of $11,500. The second scenario would result in a tax liability of $7,300. The overall tax savings achieved is $4,200 annually, which can be significant over a long period of time.

Trust for minors

Similarly, a prescribed rate loan can be made to a trust for minor children in order to achieve similar tax savings and income splitting results. These special types of trusts have the ability to allocate income annually to its beneficiaries without having to actually distribute it. As a result, the income earned inside the trust can be retained in the trust without being taxed at the highest marginal tax rates, but rather taking advantage of the lower tax rates of each of the beneficiaries.

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

Please note that the income attribution rules discussed above would apply equally to trusts for minors and special attention should be given to ensure that the requirements are met. In addition, certain "Kiddie Tax" rules also exist which would limit certain types of investments available to be purchased inside the trust. A legal professional should be consulted before trusts are established.

Summary

Overall, income-splitting loans are a great tool for reducing your family's overall tax liability.

We urge individuals who are interested in this type of planning to have a discussion with their tax advisor.