Tax, Retirement & Estate Planning Services

TAX MANAGED STRATEGY #6

Lower the family tax bill – income splitting using loans

People often consider tax saving strategies on an individual basis, but overlook family strategies that can save significant tax dollars. The use of intra-family loans to split income and save taxes is a good example.

Income splitting involves the transfer of income from a high-income earner to a family member in a lower tax bracket. The lower income individual is taxed at a lower marginal tax rate, and the family pays less tax overall. If you loan your spouse money for the purpose of income splitting, the prescribed rate (the rate of interest you charge your spouse) remains fixed for the term of the loan.

The problem is that the Canada Revenue Agency (CRA) restricts most forms of income splitting through the Income Tax Act's attribution rules. An individual cannot simply give their spouse $100,000 to invest and have the spouse declare the investment income in their tax return at their lower marginal tax rate. In such a situation, the investment income would be "attributed" back to the original individual and taxed at their higher marginal rate.

There are, however, a few legitimate – and effective – ways to split taxable income with a spouse or minor child. One of the most effective strategies in a low interest rate environment is through a loan to a spouse or other family members.

Provided the loan is properly structured, the loan proceeds can be invested by the recipient, with the income taxed at their lower marginal rate. Of course, one of the keys to a successful income splitting strategy is to ensure that investment returns are higher than the interest rate charged on the loan.

An in-depth look at the issue and the opportunities

Intra-family investment loans most commonly involve a loan between spouses, either married or common-law. But this strategy can also be effective with minor children.

To ensure the income attribution rules do not apply to investment income earned by the loan proceeds, two loan conditions must be met:

- The loan must carry interest at a rate that is at least equal to the prescribed rate (updated quarterly) as set by the CRA at the time the loan is made. If the commercial loan rate is lower than the prescribed rate at the time the loan is made, this lower commercial rate can be used
- The annual interest owing on the loan must be paid to the lender no later than 30 days after the end of each particular year

Take advantage of today's low interest rates

If you loan your spouse money for the purpose of income splitting, the prescribed rate (the rate of interest you charge your spouse) remains fixed for the term of the loan. This is of considerable advantage in today's low interest rate environment. You can determine the current prescribed rate by visiting: https://www.canada.ca/en/revenue-agency/services/tax/prescribed-interest-rates.html

Already have a prescribed rate loan?

You can still take advantage of today's lower interest rate. If you and your spouse implemented this strategy in the past when the prescribed rate was higher, there is a way to take advantage of the current lower rate to increase the tax savings opportunities. First, your spouse will need to repay the existing loan – it's not enough to just re-sign the loan agreement. In order to repay the existing loan, investments may have to be sold which may result in capital gains. However, any gains would be taxed to your spouse and therefore the tax would be less than if you held the investment yourself. You can then enter into a new loan at the current lower rate and new investments can be purchased.

MAKING IT WORK

Spouses John and Jill are looking for ways to lower their family tax bill. They are in different tax brackets, John at 48 per cent and Jill at 20 per cent. John loans Jill $100,000 at a prescribed rate of 2 per cent.[1] Jill invests the money and earns 4 per cent or $4,000. She then pays John the $2,000 loan interest and deducts the same amount as "loan interest expense". Jill pays $400 in tax on the remaining $2,000, and John pays $960 on his interest income. Here's how it stacks up: John would have had to pay $1,920 in taxes had he invested the $100,000 himself. By loaning the money to Jill for the purpose of income splitting, the family tax bill is reduced by approximately 29 per cent to $1,360, representing a savings of $560.

	48% TAX RATE ($)	48% TAX RATE (JOHN) ($)	20% TAX RATE (JILL) ($)
Investment/loan principal	100,000	-100,000	100,000
4% investment return	4,000	–	4,000
2% interest on loan	–	2,000	-2,000
Net income	4,000	2,000	2,000
Tax payable per person	1,920	960	400
Total family tax payable	1,920	–	1,360

[1] Effective April 1, 2018, the CRA prescribed rate is two per cent. For illustration purposes only. This is a fictional scenario.

Ideal candidates

Income splitting through loans is best suited for those:

- With a pool of non-registered capital they are willing to invest
- Who have a spouse or minor children in a lower marginal tax bracket

Take action

To take advantage of income splitting:

- Select an investment with expected returns that are higher than the current prescribed interest rate
- Consider formalizing the spouse-to-spouse loan through a promissory note – which can be completed without the added expense of a lawyer

INVESTMENT OPTIONS WITH MANULIFE

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