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ESTATEPLANNING

Lower Your Taxes

Prescribed Rate Loan

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Earning a one per cent return on your invested funds seems like a measly return but earning only one per cent interest on funds you loaned to family members - forever - that's good news.

This article considers an income splitting technique using a "prescribed rate loan." The tax savings associated with this strategy are maximized where one spouse/partner has significant assets and their income is taxed at a high marginal tax rate, compared to other family members who are taxed at a lower marginal rate but presents many situations where family tax savings can be enjoyed.

"As a result of changes introduced by the Canada Revenue Agency in recent years, a number of opportunities to split income with family members have been eliminated. Prescribed rate loan planning continues to work, though – and is a strategy that can have a meaningful impact while being relatively simple," says lawyer Matthew Getzler, a partner with Minden Gross LLP in Toronto.

The Strategy

In simplest terms, this strategy allows high-income earners to take advantage of the lower tax rates of other family members with less or no income. The high-income earner lends money or assets either directly or through a trust to one or more family members with lower tax rates. Any income earned with the borrowed funds in excess of the prescribed rate of interest can be taxed in the hands of the one or more family members with lower tax rates.

(It is called a prescribed rate loan because the federal government prescribes - sets - that rate every three months based on short-term Government of Canada T-bill rates.)

Not to be missed is this crucial part of the strategy: it only works if the person making the loan charges interest on it. With current rates at historical lows, one per cent is the minimum rate a lender must charge to avoid any income attribution (i.e., having all of the income taxed to the lender even if not paid to him/her), and that rate can be locked in forever. Interest rates will certainly rise eventually, but once a prescribed rate loan interest rate is established, it isn't subject to change.

The federal government has strict attribution rules when they apply, but those rules do not apply when it comes to a prescribed rate loan.

How it works

Ellen and Jack are married with three young children. Jack is a medical specialist with high income, Ellen does not currently earn any income.

Their three young children attend private school, summer camp and participate in several

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extra-curricular activities. Those activities add up to expenses of $10,000 per child. Until now, the parents have paid those expenses with income earned on Jack's $1 million investment portfolio.

Jack earns 5 per cent annually on that portfolio, resulting in $50,000 of income, on which he pays about $26,765 in taxes, leaving him with $23,235, and a shortfall of $6,765 to pay the kids' expenses. Did you notice that taxes consume more than half of that income?

For the prescribed-rate strategy to work, the higher income person making the loan must charge interest on the funds advanced, and the minimum interest rate charged to avoid any income attribution is currently one per cent.

Often, there is just one spouse who is the high-income earner, as is the case for Jack and Ellen. If Jack lent his $1 million to Ellen, then Ellen would report income of $40,000 while Jack would report only $10,000 of income instead of earning $50,000. In this case, tax savings of ~$16,000 could be enjoyed in each year.

The more people in your family you can split with the greater the tax savings you can enjoy.

Suppose, instead, that Jack made a $1 million loan to a trust, whose beneficiaries include Ellen and the three children. By using the prescribed rate method and charging interest calculated at one per cent, or $10,000, he would pay taxes of about $5,353 on that income. The remaining $40,000 of income can be divided among Ellen and the children (each of whom weren't otherwise earning any income) and they would each report $10,000 of income on their tax returns. The basic personal amount in Ontario (i.e., the amount of income a person can earn without having to pay any tax) exceeds this amount and, as a result, neither Ellen and the children need to pay any tax on their $10,000 of income. As a family unit, they just went from having to pay $26,765 of tax on that $50,000 of income to paying $5,353 of tax on that income. Every year as a family unit they save $20,000+ in taxes by basically using other family member's lower tax rates of income, instead of using Jack's top rate alone.

Just a modest income

You don't need to have $1 million to make this work. You can do it with much less. And it's not just limited to your own children – it can be for grandchildren's education or family trips, with the grandparents using their grandchildren's marginal tax rates.

And you don't have to be a high-net-worth earner for this strategy to work. It could be someone who has just come into an inheritance or anyone sitting on investable capital while also earning income and getting taxed at a high rate.

Like many other excellent strategies, this one comes should be approached with caution.

A person can't just allocate a certain sum of income to a child and then put it into his/her own bank account. It must be paid out to that child or paid for his/her benefit.

Another requirement is that the loan payment be made each year by January 30, otherwise the attribution goes back to the high income earner. And if even one interest payment is missed, the attribution rules will apply to all future income (and not just for that one year). On the other hand, there are times when an investment goes sour and missing an interest payment could put you back into the attribution rules on purpose.

It is generally recommended that spouses have separate bank and investment accounts to keep track of the income earned from the loan so a paper trail can be easily traced.

In time, interest rates will rise again and with it, the prescribed rate for those who have not yet made a prescribed rate loan. As the rates rise, so too should the spread and that means increased tax savings.

You should be aware of potential tax consequences if you put together a prescribed rate loan where one or more of the borrowers or the beneficiaries of a trust are U.S. citizens, U.S. residents of U.S. green card holders. "The tax implications in this regard may be far-reaching and the importance of considering them cannot be overstated", says Mr. Getzler.

But in most circumstances, the savings in the first year of a prescribed-rate loan strategy exceed the cost of implementation – and those savings can continue to be enjoyed annually thereafter (and without the implementation costs!)

While prescribed rate loans have been around for many years, most people don't know about them. "I wish I could tell everyone about this planning – most people would be happy to pay a lot less than 50 per cent tax on their investment income if they knew that tax-saving opportunities like this are available" says Mr. Getzler. "This kind of planning is a basic form of income splitting that makes so much sense."

Using prescribed rate loans is just one way to minimize your taxes now and maximize the value of your estate.

Other Ways to Cut Taxes

There are other methods to reduce or eliminate your taxes -- whether on investment income, capital gains or death, a key plank for your estate plan.

☛ One of the most versatile and reliable financial products is life insurance, which enjoys special treatment under the Income Tax Act and allows people to leave more tax-free funds to family.

Canadians who die without a spouse or financially dependent child or grandchild unknowingly leave the government up to 54 per cent (in Ontario) of the value of their RRSPs and RRIFs because of taxes.

Another 26 per cent is levied on the growth of their non-registered holdings, like stock portfolios, investment real estate and private equity holdings. But life insurance can reduce the pain of paying taxes because it provides dollars obtained for pennies.

Only four remaining assets types do not get taxed. Life insurance is one of them. The others are your principal residence (but you are limited to one at time), lottery winnings (difficult to arrange) and Tax-Free Savings Accounts (TFSAs). The only problem with a TFSA is the annual maximum deposit of only $6,000. There is a solution to that problem. Read my Feb 2020 TaxLetter® article "No-Limit TFSA".

☛ Your beneficiaries can collect the full death benefit on your Life Insurance and won't have to pay income tax on the amount they receive. Depending on how the life insurance is structured, it can also help reduce your final death taxes.

☛ An estate freeze is another way to reduce the tax bite. It's a tax planning strategy in which the owner/parents undertake a corporate reorganization resulting in their children (or trusts which include their children as beneficiaries) owning shares in a family business entitled to all of the growth thereof. Using this method, the owner/parents cap their own tax liability and the future growth of the corporation accrues for the benefit of the next generation (or even the generation after that!

☛ You can also minimize taxes through joint ownership of assets, whether it's a home, a cottage or an investment account. Joint ownership allows the assets to pass to the second owner, such as adult children, without probate taxes. You need to be mindful that if children are made joint owners, their share is subject to creditors' claims, marital breakdowns, litigation, and possible dissension from other siblings. There are a multitude of other probate tax planning strategies that should be considered as well as part of a comprehensive estate plan.

The biggest thing to remember in all of these transactions is that it's crucial to have a reliable, experienced financial advisor at your side to give you directions on how to ensure you are lowering taxes while staying on the right side of the government. We would be pleased to help.

Please do not hesitate to contact us for a no-obligation consultation. Our advisors across Canada look forward to helping you. ❑

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He guides successful business owners, professionals, and affluent families through the complex process of ensuring the people and organizations they care about are taken care of. If you are like his other clients, you are looking to reduce your tax obligations, preserve your wealth and leave a legacy.

Mark collaborates with your professional advisory team to achieve your desired outcomes. His simple approach makes sure what is important to you gets done. He will suggest appropriate strategies to get your financial affairs meticulously organized, help you take action, and simplify the complicated so you and your family can rest easy.

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-Estate Planning Checklist
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Watch "The New Philanthropy", my recent "Ted Talk" at Moses Znaimer's ideacity conference http://bit.ly/MarkHalpern

Mark's corporate goal is the creation of $100 million in new charity each year working with clients, generous donors of non-profits and collaborating with allied professionals.