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Income splitting loans – act now to benefit from low rates

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For the past several years, in an effort to stimulate the economy, the government has followed a policy of maintaining low interest rates. At some future date, the prescribed rate may increase. Therefore, it may be wise to act sooner rather than later. The increase in the top marginal tax rates applicable in 2016 increase the cash benefit that can result from this planning.

For the past several years, in an effort to stimulate the economy, the government has followed a policy of maintaining low interest rates. The base federally prescribed quarterly interest rate is calculated by taking the average equivalent yield of the Government of Canada 90-day treasury bills (rounded to the next highest whole percentage point) sold during the first month of the immediately preceding quarter. This base rate applies to taxable benefits for employees and shareholders, low-interest loans, and other related party transactions. The prescribed rate in effect for this purpose has been set at 1% since the first quarter of 2014 and will remain at 1% through June 30, 2016.

One tax planning opportunity that flows from this low prescribed rate of interest is the use of income splitting loans. Provided the loan is made while the prescribed loan rate is still 1%, the interest rate on the loan will remain at 1% for as long as the loan is outstanding, regardless of how much interest rates increase in the future. In situations where spouses will be in different marginal tax brackets for the foreseeable future, the cumulative tax savings can be significant.

In this regard, the following planning strategies should be considered:

1. One spouse can loan funds to the other spouse to make an investment. For attribution to be avoided, the borrowing spouse must pay interest to the lending spouse at the prescribed interest rate in effect at the time the loan is made. The loan should be made pursuant to a written agreement and interest payable on the loan for each year must be paid no later than January 30 after the year-end; otherwise, the attribution rules will apply. Attribution means that the spouse who loans the funds will have to report any income/gains or losses from the investment of the funds, thereby defeating the income splitting opportunity.

2. Owner-managers with a significant credit balance in their shareholder loan account and who have a spouse (or adult child) with little or no income can use a similar strategy—with a twist. If the original shareholder loan is payable on demand, the company can repay the loan. The amount repaid will be loaned to the spouse (or adult child), who will re-loan it to the company on an interest-bearing basis (prime plus a certain percentage). If the loan is made before any increase in the rates, the spouse will only have to pay 1% interest on the loan to the owner-manager for as long as it remains outstanding.

3. Existing income splitting loans can be repaid and a new loan can be set up to benefit from the 1% rate. However, the features of the new loan should be differentiated from the old loan. Otherwise

the CRA could view them to be the same loan, in which case this planning strategy could be offside.

As a simple example, assume Mr. X loans $2 million to his spouse and follows all of the steps needed to avoid the attribution rules. Mrs. X invests in a 5-year GIC at 2.5%. Mrs. X must pay $20,000 each year to Mr. X, who will have to report the amount as income. Mrs. X's net income (after deducting the interest) will be $30,000 ($50,000 - $20,000). Assume that after five years the new five-year GIC rate is 6%. Mrs. X will still only have to pay $20,000 each year to Mr. X, but her net income after deducting the interest will increase to $100,000. If Mrs. X has either no other sources of income or only earns a small amount of other income, and Mr. X is already subject to the highest marginal rate of tax, the tax savings for this couple by implementing this planning strategy could be significant.

To maintain interest deductibility and avoid attribution, certain rules must be followed. Contact a Grant Thornton tax specialist for assistance in implementing any of the above planning strategies.

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