ALL IN THE FAMILY

How to take advantage of income-splitting using intra-family loans.

AFTER JUST TWO YEARS, the "family tax cut" was eliminated in the 2016 federal budget. However, families still have other opportunities to split their income to save taxes. One strategy is to make an "intra-family loan" to your spouse (married or common-law) or to your minor child. Provided the loan is properly structured and formalized through a promissory note, the recipients can invest the loan proceeds, and any investment income they earn will be taxed at their lower marginal rates.

What is income splitting?

Income splitting transfers income from a high-income earner to a family member in a lower tax bracket. Because the lower-income individual is taxed at a lower marginal rate, the family pays less tax overall.

Most forms of income splitting are restricted through the Income Tax Act's attribution rules. For example, if you simply give your spouse $100,000 to invest, the Canada Revenue Agency (CRA) will not allow your spouse to declare the investment income on his or her tax return. The investment income, in that case, would be "attributed" back to you and taxed at your higher marginal rate.

However, when you lend the money to a spouse or minor child, and you charge and collect interest on the loan, the attribution rules don't apply.

How does an intra-family loan work?

An intra-family loan must meet two conditions to ensure investment income earned by the loan proceeds is not attributed back to the lender:

- The lender must charge interest at a rate that is at least equal to the rate set by the CRA at the time the loan is made (the CRA updates these rates quarterly), or at least equal to the commercial loan rate if that rate is lower than the CRA prescribed rate.
- The annual interest owing on the loan must be paid to the lender no later than 30 days after the end of each calendar year.

Since the lender must declare the interest he or she receives as income, one of the keys to a successful income-splitting strategy is to earn higher investment returns than the interest rate being charged.

That's easier to achieve when the CRA's prescribed interest rate (available at www.cra-arc.gc.ca/interestrates) is low. And the great news is you can lock in a low rate, because with an intra-family loan, the interest rate remains fixed for the term of the loan.

All is not lost if you happened to make an intra-family loan when the prescribed rate was higher. You may be able to increase your tax-saving opportunity by repaying the existing loan in full and making a new one at the current, lower, set rate. Paying the existing loan may mean selling investments and realizing capital gains. However, any gains will be taxed in the hands of the lower-income family member – and, once the new loan is in place, he or she can purchase new investments.

Is an intra-family loan right for you?

An intra-family loan may be appropriate if you have a spouse or minor children in a lower marginal tax bracket and a pool of non-registered (taxable) capital to invest. Your advisor can help you evaluate the tax-saving opportunity and choose investments that have the potential to beat the CRA's prescribed rate without taking on too much risk. ■

CASE STUDY:

AN INTRA-FAMILY LOAN IN ACTION

Aisha is a lawyer taxed at a 45 per cent marginal rate, and her husband, Sachin, is a freelance graphic designer taxed at a 22 per cent marginal rate.

Aisha lends Sachin $100,000 at the CRA's prescribed interest rate of one per cent.[1] Sachin invests the money and earns four per cent, or $4,000. He then pays Aisha the $1,000 loan interest and deducts the same amount as a "loan interest expense." Sachin pays $660 in tax on the remaining $3,000, and Aisha pays $450 on her interest income.

The total tax bill is $1,110.

Had Aisha invested the money herself, she would have had to pay $1,800 in taxes on the investment income of $4,000.

So, in this case, the intra-family loan saved the couple $690.

[1] Effective July 1, 2016, the CRA's prescribed interest rate is one per cent. For illustration purposes only. This is a fictional scenario.