Family Loans for Potential Tax Savings

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Tax planning can be undertaken by a high-income earner who receives investment income by using prescribed rate loans for income splitting that could lower the overall taxes paid within their family. The goal of prescribed rate loan tax planning is for the high-income person to provide a loan to a lower income spouse or children who then use the proceeds of the loan to purchase investments that will generate income of more than the interest rate being charged on the prescribed rate loan. The goal of this type of tax planning is to avoid the income attribution rules which could attribute income back to the person that made the loan. Attribution normally applies when loans are provided at no interest, at an interest rate that is lower than the prescribed rate, or when the agreed-upon loan interest is not actually paid.

Example:

Mrs. A is a high income earner and has an investment portfolio that generates an annual return of approximately 8% per annum. Mrs. A's spouse also is a high income earner but, does not have any investment income however, their 3 children are not high income earners. An option for Mrs. A could be to setup a prescribed rate loan to her children or a trust for her children with the loan proceeds then used by the trust for her children to purchase an investment portfolio. The investment portfolio is expected to generate investment income in the range of 5% to 8% which is higher than the current prescribed rate which is 1% until June 30, 2022. Assuming that the investment portfolio generates the same rate of return of 8% that Mrs. A's investments were generating then, Mrs. A would have a tax savings because instead of reporting investment income of 8% she would only report the prescribed rate interest at 1% as her income. The net 7% earned in excess of 1% would be income for Mrs. A's children using the prescribed rate loan planning. This should result in overall tax savings for the family as Mrs. A's children are not high-income earners.

This type of tax planning works well where an individual is subject to personal taxes at high marginal tax rates and other family members are subject to lower marginal tax rates. The key items to keep in mind:

- the current prescribed rate for loans made to non-arm's length parties is set at 1% per annum; however, this interest rate will be increasing to 2% on July 1, 2022
- the interest owing on the prescribed rate loan must be paid every year within 30 days of the end of the calendar year (i.e. no later than January 30th each year) or attribution will apply for that year and all subsequent years, thus undoing the tax planning
- investments need to generate a return of more than the prescribed rate on the loan