

LOW INTEREST LOANS

In appropriate circumstances, an interest-bearing loan made by one family member to another can provide an opportunity to split income. This strategy saves tax to the extent that the borrower earns income in excess of the interest rate and is subject to a lower rate of taxation than the lender would have been on that income.

In order to avoid the application of the attribution rules under the *Income Tax Act*, interest would have to be charged on the loan at a rate equal to the lesser of the prescribed rate set by Canada Revenue Agency (the "CRA") at the time the loan is made, or the normal commercial rate at the time.

The prescribed rate of interest is currently 4% (for the period April 1 to June 30, 2008). This interest *must be paid* on an annual basis, on or before January 30 of the following year.

For the purposes of this discussion we will assume that the prescribed rate is the more advantageous rate. Note that the prescribed rate in effect on the date the loan is made will be the interest rate for the duration of the loan (i.e. the rate can be "locked-in" indefinitely at 4% if the loan is advanced before June 30, 2008).

The following is a simple illustration of this loan strategy using a loan of \$500,000 from a lender taxed in Ontario's highest marginal bracket to a borrower taxed in Ontario's lower marginal tax bracket. Please note that the illustration does not reflect the loss of tax credits to the lender (or other family member) as a consequence of the borrower earning income through this strategy.

April 2008

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Current situation:

	Lender
Lender's investment capital	\$500,000
Rate of return	7.00%
Interest income	\$35,000
Lender's marginal tax rate	46.4%
Income tax payable	\$16,240
Lender's after-tax income	\$18,760

Implementing the low interest loan strategy:

	Lender	Borrower
Loan amount	\$500,000	\$500,000
Rate of return	4.00%	7.00%
Interest income		\$35,000
Interest income/(expense)	\$20,000	(\$20,000)
Net income	\$20,000	\$15,000
Marginal tax rate	46.4%	22.2%
Income tax payable	\$9,280	\$3,330
After-tax income	\$10,720	\$11,670
Family's aggregate after-tax income	\$22,390	

It may be necessary for the borrower to review his or her current Investment Policy Statement in order to implement this strategy, as the investment portfolio should be structured to generate sufficient income to pay the interest on the loan. However, long-term investment strategies should always take precedence over strategies designed to reduce taxes.

Please note that:

- ❖ if the borrower's investment earns less income than the prescribed rate of interest, or

- ❖ if the investment income earned by the borrower is primarily in a form which attracts preferred tax rates (such as dividends or capital gains),

there may be an increase in the taxes payable by the family in the short term. These conditions could even lead to a short-term erosion of capital.

Accordingly, this strategy should only be implemented if there is a long-term investment horizon for the loaned funds.

LOANS TO SPOUSES

Loans from one spouse to another are fairly straightforward. In order to implement the strategy the following steps should be taken:

1. Determine with an accounting and financial advisor the amount that can be loaned and project the amount of potential annual tax savings over the long term;
2. Review the investment policy statement to ensure that implementing the strategy will not negate investment objectives and strategies;
3. Have a legal advisor prepare the appropriate documentation to evidence the terms of the loan. This would typically include a loan agreement and a promissory note payable on demand bearing interest at the prescribed rate. The interest must be payable annually, in respect of each year that the loan is outstanding, on or before January 30 of the following year; and
4. Implement a reminder system to ensure that interest is paid in respect of each year that the loan is outstanding, on or before January 30 of the following year and that the interest payment is properly documented (e.g. cancelled cheques evidencing payment should be retained and payment receipts should be issued). Note that the CRA takes the view that interest has not been paid if “payment” is made by the borrower issuing a promissory note for the amount of interest, or if a new loan is made to cover the interest cost.

LOANS TO MINORS

The implementation of the strategy is more complex in the case of minors and is typically not recommended unless the loan amount will be greater than \$500,000. Since minors cannot be contractually bound to a loan agreement, the strategy must be implemented through a trust established for the minor’s benefit.

We recommend the following steps in addition to the steps described above:

1. The establishment of a trust for the benefit of the minor evidenced by a written trust agreement;

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2. Documentation of the decisions of the trustees to make the income earned in the trust paid or payable to the beneficiary on or before the end of each taxation year; and
3. Where the income is paid to a guardian or to third parties for the benefit of the minor, a system of documenting the payment to the guardian or third party with evidence that the amounts related to expenditures incurred for the benefit of the minor.

The strategy should be implemented in consultation with legal and accounting advisors familiar with the taxation of trusts. There are a number of other attribution rules that may apply to cause the income of the trust to be attributed to the lender if the trust and loan strategy are not properly implemented.

PREVIOUS LOANS

If the low interest loan strategy was implemented in the past, at a time when the prescribed rate was higher, consideration might be given to having the borrower repay the loan. A new loan at current rates could then be made, thereby increasing the tax saving opportunities. Note that this will involve a disposition of assets by the borrower, which may result in capital gains.

Similarly, if a prior loan was made without interest, or if a payment of interest was missed, so that the attribution rules would apply, the loan could be repaid and a new, qualifying loan could be advanced. This will also require the borrower to dispose of the loaned property (e.g. investments bought with the loaned funds).