TaxNewsFlash Canada

Lock in Family Income-Splitting Loans Starting July 1

June 3, 2020
No. 2020-53

Taxpayers should act quickly to realize future tax savings once the CRA's prescribed interest rate for family income-splitting loans falls to 1% on July 1, 2020. Because the prescribed interest rate will soon drop to 1%, your family may realize significant long-term tax benefits by entering into income-splitting loan arrangements. Similarly, employees who have entered into qualifying home purchase loans with their employers should consider how the lower prescribed interest rate may reduce their related taxable benefit.

Although current economic conditions may not be ideal for investors, making a family loan arrangement now will set you up to realize income-splitting tax benefits in the future when the economy recovers and interest rates and investment returns rebound. To be sure you can lock in loan arrangements at 1%, you'll need to act between July 1 and September 30, 2020, though the rate may remain at 1% after September 30 as well.

Secure family loan arrangements for future income splitting

You may achieve significant future tax savings by locking in a family loan at the prescribed 1% interest rate and shifting income earned on the investment of the lent funds to your spouse (including common-law or same-sex spouse) or another family member, including a minor child by way of a family trust, who has little or no other income and thus pays little or no tax. To qualify, annual interest payments must be made by the following January 30 of each year, among other requirements.

In effect, if you lock in the loan between July 1 and September 30, 2020, all investment income over 1% may be taxed at a lower-income family member's tax rate indefinitely. Though you may not realize a tax savings immediately, you may want to lock in the loan sometime between July 1 and September 30 since it's not known how long the CRA's prescribed rate will remain at this low rate of 1%.

Ordinarily, if you lend funds to your spouse or a trust for the benefit of minor children, the attribution rules will apply and any income earned on the lent funds will be taxed in your hands. However, if the loan is properly structured and governed by a written agreement that stipulates the terms of repayment and an interest rate at least equal to the CRA's prescribed rate at the time the loan is made, then the attribution rules should not apply.

The tax on split income (TOSI) rules generally should not apply to prescribed rate loan arrangements between spouses. However, where a prescribed rate loan is made to a trust, TOSI could apply if the trust is considered to be carrying on a "related business" (e.g., where a "source individual", such as a parent, is actively managing the trust's investment portfolio). The TOSI rules are extremely complex. Please contact your KPMG Enterprise advisor to ensure the TOSI rules do not apply to your situation.

Inter-spousal arrangement

In a typical inter-spousal arrangement, the higher-income spouse lends a sum of money to the lower-income spouse. Under a written loan agreement, the lower-income spouse agrees to pay interest at the prescribed rate of 1% (if entered into on or after July 1, 2020). The lower-income spouse invests the borrowed funds and subsequently earns a higher rate of return, say 3% (to generate tax savings on the interest rate spread, the lower-income spouse must earn a rate of return greater than 1%).

Provided the lower-income spouse makes annual interest payments by the following January 30 of each year, 2% of the income in our example (that is, the difference between the 3% rate of return and the 1% prescribed interest rate) will be taxed in the hands of the lower-income spouse. In this example, on a $100,000 loan, the amount of income shifted to the lower-income spouse would be $2,000 annually.

KPMG observations
Generally, the TOSI rules should not apply to investment income earned by the lower-income spouse or family trust from certain portfolio investments (e.g., shares of the capital stock of a corporation of a class listed on a designated stock exchange, publicly listed debt, or deposits in a Canadian bank or credit union). However, investment income earned from private company shares and/or debt may be "split income" and thus subject to the TOSI rules.

Lock in interest rate benefit on employee home purchase loans at 1%

Employees may also achieve significant future tax savings by renewing their home purchase loans between July 1 and September 30, 2020, thereby ensuring that the interest rate benefit for the next five years remains at 1%.

If you receive a low-interest or interest-free loan from your employer, you are considered to have received a taxable benefit from employment. The benefit is set at the CRA's prescribed rate of interest, which varies each quarter, minus any interest you actually pay during the year or by January 30 of the following year. But if the loan is used to purchase a home, the prescribed interest rate applied in calculating the imputed interest for the first five years is capped at the prescribed rate in effect at the time the loan is made. After five years, the loan is considered a new loan and the prescribed rate at that time becomes the rate in effect for the next five years.

So if you enter into a new home purchase loan during the third quarter of 2020, the interest rate benefit will not exceed 1% for the next five years, no matter how high interest rates actually climb.

Employees with existing home purchase loans may be able to benefit from the third quarter's 1% rate if they can arrange to take out a new loan to replace the current one and restart a new five-year period at the 1% prescribed interest rate. In particular, the definition of "home purchase loan" in the tax rules extends to any loan used to repay a home purchase loan, and the prescribed interest rate in effect on the date the substituted home purchase loan is entered into will be the new "ceiling" for the next five years. You must ensure that the old loan is repaid and a new loan obtained, or that a novation has occurred, as evidenced by a newly negotiated loan agreement having, for example, terms and conditions that differ significantly from the original loan. Your KPMG Law advisor can help to ensure a new loan is legally effective.

Ensure loans are legally effective

Loan agreements must satisfy very specific requirements to be fully enforceable. As a result, these agreements should be drafted with care to help ensure that they meet legally required interest rate disclosure rules and address other requirements. KPMG Law can assist with the drafting of promissory notes and loan agreements that meet legislative and CRA administrative requirements.

We can help

To maximize the tax benefits of these planning opportunities, it is important to properly structure interest payment terms and other loan arrangements and meet all other requirements. As such, these arrangements should only be undertaken with appropriate professional advice. To explore these or other tax planning opportunities, please contact your KPMG Enterprise or KPMG Law advisor.