Spousal Loans

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Wealth Management

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The recent investment environment has been more than challenging with low interest rates reflected in the returns of fixed income markets and volatility affecting the equity markets. However, these conditions make this an opportune time to consider a spousal loan, also known as a prescribed rate loan, as an income-splitting strategy to minimize taxes.

Why a Spousal Loan?

Under Canadian tax law, rules have been set up to generally block attempts to shift income between spouses, attributing income back to the original owner for tax purposes. Spousal loans are one way to potentially avoid these income attribution rules.

A spousal loan may be attractive in situations in which one spouse is in the top tax bracket and the other spouse is in a substantially lower tax bracket. Instead of investing funds personally and paying tax on the income at the highest tax rate, the higher-earning spouse can lend these funds to the lower-earning spouse at the prescribed rate.

The current rate in effect at the time of writing remains at one percent (as of January 2018) — the lowest possible rate. The prescribed rate is determined every quarter and is based on the rates of certain Government of Canada Treasury Bills.

The prescribed rate prevailing at the time that the loan is made is the rate of interest that remains in effect for the entire life of the loan. **If you want to take advantage of this rate, you must act quickly as the rate is set to double on April 1, 2018.**

Assuming that returns on investments made using the loan will be greater than the prescribed rate, income has been effectively split and the overall tax burden of the couple has been reduced.

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How Does It Work?

There are several requirements to properly set up a spousal loan. Documentation of the loan must be kept, indicating the date that the loan was entered into, the rate of the loan, and the principal due on demand.

The borrowing spouse must pay the interest on the loan by January 30th following the end of every year that the loan is outstanding to ensure that tax attribution rules will not apply. A record of this transaction should be kept. Interest earned by the loaning spouse must be recorded on his/her tax return and interest paid by the borrowing spouse may be deducted from that spouse's investment income.

As always, seek the assistance of an accountant if you are considering implementing this tax strategy.