RAYMOND JAMES | Steele Wealth Management

Spousal Loans

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Introduction

Since 2009, the Canada Revenue Agency has provided High-Net-Worth, single breadwinner households with the greatest tax break in modern times: the 1% prescribed rate spousal loan.

The concept of a spousal loan is quite simple. The higher earning spouse in the higher tax bracket loans the lower earning spouse in the lower tax bracket money to invest and tax on investment income is reduced overall. This strategy is most effective after the higher earning spouse has already maxed out his/her RRSPs and TFSAs and is now looking for non-registered investment vehicles.

Example. Assume that we have a married couple, Bill and Cathy, and that Bill currently earns $130,000 and is in the highest tax bracket (46.41%) and Cathy currently earns $20,000 and is in the lowest tax bracket (20.05%).

If Bill was looking for bond exposure and had $100,000 to invest, he could currently buy a basket of 10-year corporate bonds yielding approximately 5%. Should he invest the full amount, his annual interest income would be $5,000 and his annual tax bill would be $2,321.

Now consider if Bill loaned the $100,000 to Cathy at an interest rate of 1% for her to invest in the aforementioned bond basket. Bill would incur taxable interest income of only $1,000 due to the loan interest and Cathy would incur taxable interest income of $4,000 ($5,000 less the $1,000 paid to Bill). Cathy would end up paying tax on interest of $4,000 and Bill would pay tax on interest of $1,000. Their combined tax bill would amount to $1,266, a whopping $1,055 or 45% less than if Bill invested the funds himself.

As the example above shows, the tax savings of a spousal loan can be significant. Assuming one spouse is in the highest tax bracket and the other is in the lowest and a 5% rate of return on interest, tax benefits will continue to be seen on loans up to at least $1.8 million. If a spouse is non-working and has no income, benefits can be seen on loans up to $3.175 million with total tax savings in this best-case scenario being just over $19,500.

Although many individuals will not be able to make loans close to the maximums listed above, they will still experience some material tax savings. Also, for those approaching retirement, spousal loans can assist reducing or eliminating the OAS clawback for the higher earning spouse.

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Eligibility & Rules

In order to be considered "spouses", you must be either legally married or living and registered as common-law partners.

The loan must be formally documented with a promissory note that includes the date, amount lent and the interest rate.

The loan interest must be paid every year by January 30th for the duration of the loan. If you miss one deadline, all current and future interest will be taxable in the hands of the lending spouse, in effect canceling the loan agreement.

The loan proceeds must be used for the purchase of investment vehicles including stocks, bonds, GICs, a private business, or property.

Loans can be made for any duration and can even be stated as perpetual. The prescribed rate on the loan never changes and is set at the prevailing rate at the date the loan was registered.

"Spousal" loans can also be made to children but it is recommended that one set up a formal family trust to hold the investment assets. Establishing a family trust will avoid legal issues related to minors signing voidable contracts.

Why Now?

The prescribed rate on spousal loans is currently 1% and this is the lowest the rate can possibly go. The historical average rate is between 5-6%. The lower the prescribed rate, the greater the tax advantage from income splitting using a spousal loan. Once a loan is made at 1%, it will always be at 1%, as changes in the prescribed rate do not affect outstanding spousal loans. As mentioned above, loans can be made for indefinite periods of time, meaning one can lock in a loan today and the rate will always be set at 1%.

We expect the prescribed rate to increase with the Canadian benchmark interest rate, which is now slowly being increased by the Bank of Canada. The Canada Revenue Agency sets the prescribed rate every calendar quarter.

We believe that the time to make a spousal loan is now. Should we continue to see further normalization in business and economic conditions, it is expected that the prescribed rate will be increased by Q2 2012.

At Steele Wealth Management, we can assist you in determining how to best use this limited time tax break. Please feel free to contact us and we will explore your options.

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