Prescribed rate loans: The one per cent solution

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In July 2020 the government's prescribed interest rate will drop to 1%, providing a significant opportunity to split income with a spouse or common-law partner, (grand)children or other family members. Here's how to use the drop in the prescribed rate to your advantage, either by making a loan directly to family members or, where minors are involved, using a family trust to do so.

The prescribed rates are set by the Canada Revenue Agency (CRA) quarterly and are tied directly to the yield on Government of Canada three-month Treasury Bills[1], albeit with a lag. The calculation is based on a formula in the Income Tax Regulations, which takes the simple average of three-month Treasury Bills for the first month of the preceding quarter rounded up to the next highest whole percentage point. As a result, the prescribed rate can never be zero and 1% is the lowest possible prescribed rate.

To calculate the rate for the third quarter (July through September) of 2020, we look at the first month of the second quarter (April 2020) and take the average of April's T-Bill yields, which were 0.24 per cent (April 7), 0.30 per cent (April 14), 0.27 per cent (April 21) and 0.27 per cent (April 28). That average is 0.27 per cent but when rounded up to the nearest whole percentage point, we get 1 per cent as the new prescribed rate for the third quarter of 2020.

This upcoming decrease marks the first time the prescribed rate has dropped since it increased to the current rate of 2 per cent on April 1, 2018.

For loans put into place between July 1, 2020 and the end of September 2020 (and possibly longer, depending on what happens to the prescribed rate in future quarters), the lower 1% rate would be locked in for the duration of the loan without being affected by any future increases.

Income splitting is the transferring of income from a high-income family member to a lower-income family member. Since our tax system has graduated tax brackets, by having the income taxed in the lower-income earner's hands, the overall tax paid by the family may be reduced. Prescribed rate loans can also be used to help fund minor children's expenses, such as paying for private school and extracurricular activities, by making a prescribed rate loan to a family trust with the minor children as beneficiaries.

The "attribution rules" in the Income Tax Act prevent some types of income splitting by generally attributing income or gains earned on money transferred or gifted to a family member back to the original transferor.[2] The Tax Act does provide an exception to this rule if funds are loaned, rather than gifted, at the prescribed rate in effect at the time the loan was originated and the interest is paid annually by January 30 of the following year.

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[1] Three-month T-bill rates that are used in the calculation of the prescribed rate can be found on the Department of Finance website at: bankofcanada.ca/rates/interest-rates/t-bill-yields/www.bankofcanada.ca/rates/interest-rates/t-bill-yields/. Prescribed interest rates can be found on the Government of Canada's website at canada.ca/en/revenue-agency/services/tax/prescribed-interest-rates.html.

[2] For loans to minor children, there is only attribution of income and not of capital gains.

So, if the loan is made when the prescribed rate is 1%, the net effect will generally be to have any investment return generated above the 1% prescribed rate taxed in the hands of the lower income family member. Note, that even though the prescribed rate varies by quarter and may ultimately rise, you need only use the prescribed rate in effect at the time the loan was originally extended.

Refinancing a 2% loan at 1%?

This brings to mind the following question: what if you entered into a loan with your family member when the prescribed rate was 2% (or higher) and the family member invested the proceeds? To be eligible to use the lower prescribed rate for determining if there will be attribution of income from the investments, the family member should sell the investments and repay the loan to you. You can then enter into a completely new loan agreement using the new 1% prescribed rate.

But, what if this results in unwanted tax consequences (such as triggering tax on capital gains) or brokerage fees? Furthermore, given the recent market decline, what if the fair market value of the investments is insufficient to pay off the original loan? In these cases, while you may be tempted to simply either adjust the rate on the loan or refinance it at 1%, both of these alternative measures may put you offside. You must enter into a new loan in order for the lower prescribed rate to apply. In fact, the CRA has stated[3] that simply repaying a higher prescribed rate loan with a lower rate loan could trigger the attribution rules.

Be sure to obtain tax and legal advice before implementing a prescribed rate loan, to determine the best way to structure and operate this type of arrangement, as well the implications in your particular circumstances.

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[3] See CRA technical interpretation 2002-0143985.

As with all planning strategies, you should seek the advice of a qualified tax advisor.

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