Prescribed rate loan deadline fast approaching…

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For prescribed rate loans that were outstanding in 2021, it's critical that the borrower pay the loan interest no later than 30 days after the end of the year; otherwise, income splitting benefits will be lost for 2021 and all future years.

Income splitting is the transferring of income from a higher-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 can be reduced. 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.[1] The *Income Tax Act* does provide an exception to this rule if funds are loaned, rather than gifted. One of the conditions of the loan is that the rate of interest on the loan must be no lower than the prescribed rate in effect at the time the loan was originated.

Although often done between spouses or partners[2], prescribed rate loans can also be used to help pay for minor children's expenses, such as paying for private school and extracurricular activities, by making a prescribed rate loan to a family trust of which the minor children are beneficiaries.

Prescribed rates are set by the Canada Revenue Agency (CRA) quarterly and the rate is currently 1 per cent until at least March 31, 2022. So, if the loan is made when the prescribed rate was 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.

Make sure the borrower pays interest within 30 days after year-end

While much attention has been given to the prescribed rate[3], there has been less focus on a critical condition that must be met annually for the attribution rules not to apply: that is that **the borrower must pay the required interest to the lender within 30 days of the end of the year**. If this condition is not met, then attribution starts to apply and the loan will stop being effective for income splitting for the year in which the interest arose and all future years.

For loans that were outstanding in 2021, the borrower must pay interest within 30 days of the end of 2021, which would normally be Sunday, January 30, 2022. For 2022, however, you may actually have until Monday, January 31, 2022 as the thirtieth day falls on a Sunday.[4]

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

2 In this article, spouse refers to someone to whom you are legally married. Partner refers to a common-law partner under the *Income Tax Act*, which means someone who cohabits with you in a conjugal relationship, provided the two of you have cohabited for the past 12 months or are jointly parents of a child.

3 More information is available in our report, "Prescribed rate loans: The one per cent solution," which is available online at cibc.com/content/dam/personal_banking/advice_centre/tax-savings/prescribed-rate-loans-en.pdf.

4 Under the *Interpretation Act*, where the time limited for the doing of a thing expires or falls on a holiday, the thing may be done on the day next following that is not a holiday. A holiday is defined to include Sundays.

To make the interest payment for 2021, the borrower must actually transfer funds to the lender by the deadline. Some ways to make the interest payment include sending funds electronically (such as an e-transfer) or writing a cheque, both of which provide hard evidence should the CRA ever ask for proof that the interest was paid on time. To this end, the borrower should obtain and keep payment documentation (such as a registered mail receipt, transaction documents for electronic transfers, or a receipt from the lender for payments delivered in-person) as evidence that the payment was made by the deadline.

Note that the interest must actually be paid – it's not sufficient to issue a promissory note for the interest owing or to add the accrued interest to the loan balance.

Forgot to pay the interest?

As noted above, if the borrower does not actually pay interest by the deadline for any year, then attribution applies and the loan will stop being effective for income splitting for the year in which the interest arose and all future years. The only way to fix the problem is to enter into a new prescribed rate loan to prevent attribution from applying in the future.

To implement a new prescribed rate loan, the borrower should sell the investments and repay the loan to the lender. A completely new loan agreement should then be put into place. Note that this could have unwanted tax consequences (such as triggering tax on capital gains) or brokerage fees so professional legal and tax advice should be sought if you find yourself in this situation.

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