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Is a Prescribed Rate Loan Right for You?

No one will deny that the economic fallout from COVID-19 will be substantial. With this in mind, opportunities have and will continue to present themselves for those in the position to capitalize on them. As Winston Churchill said, “Never let a good crisis go to waste”.

Bill C-74, outlining new private company tax rules, received Royal Assent on June 21, 2018. Upon receiving Royal Assent, income splitting options were drastically reduced. One option that remains on the table is prescribed rate loans and COVID-19 has brought this tax planning tool into relevance again.

CRA will be reducing prescribed rates to 1% (from 2%) effective July 1, 2020 https://www.canada.ca/en/department-finance/services/lending-rates/revenue-canada-rates.html. This rate will remain in place until September 30th and possibly longer depending on yields on Government of Canada three-month Treasury bills.

Simply put, income splitting is the transfer of income from a higher income earning family member to a lower income member. Due to Canada's graduated tax rate system, income splitting can reduce the overall family tax burden. Prescribe rate loans can be used to fund educational expenses of a minor (use of a trust suggested) or allow for a non-working spouse to generate income and accumulate wealth. Funds of the lower income spouse should be segregated, and household bills and income taxes of the lower income spouse should be paid by the higher income spouse in order to maximize funds available to the lower income spouse for re-investment.

Attribution rules would typically result in income and gains on property transferred to a family member to be attributed back to the transferor, eliminating access to income splitting. Prescribed rate loans are an exception to this rule as long as interest is paid annually on the loan, no later than January 30th of the following year.

As a result, investment income earned on the loan less the prescribed rate of interest would be taxed in the hands of the lower income spouse (interest charged on the loan would be reported as income by the higher income spouse). Even if the prescribed rate changes in future, current loans will not be impacted and would be subject to the rate in effect at the time the loan contract was entered into.

Loans that were previously set up at higher rates can be refinanced but care should be used to ensure back-to-back transaction rules don't apply. The original loan should be paid off in its entirety and a new loan issued to avoid potential attribution rules. Care should also be given to the disposal of assets associated with the original loan as market values have decreased recently.

If you feel like this type of tax planning may be beneficial to you, please ensure you consult a tax advisor prior to entering into a prescribed rate loan to ensure the loan contract is set up to meet your specific tax and legal needs.