Prescribed rate loans for family income splitting

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Prescribed rate loans can provide an opportunity to split income with a spouse or common-law partner, (grand)children or other family members. Here's how to use 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.

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* (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 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 within 30 days after the end of the year.

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[2], 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. Most recently, the prescribed rate was at the lowest level of 1% between July 1, 2020 and June 30, 2022.

To calculate the rate for the fourth quarter (October through December) of 2022, we look at the first month of the third quarter (July 2022) and take the average of the month's three-month T-Bill yields, which were 2.1962% (July 7) and 2.6959% (July 21). That average is 2.44605% but, when rounded up to the nearest whole percentage point, we get 3% as the prescribed rate for the fourth quarter of 2023.

For loans put into place between October 1 and December 31, 2022, the 3% rate would be locked in for the duration of the loan without being affected by any future increases.

So, if the loan is made when the prescribed rate is 3%, the net effect will generally be to have any investment return generated above the 3% 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.

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

2 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.

Refinancing a loan when the prescribed interest rate decreases

This brings to mind the following question: what happens if you enter into a loan with your family member when the prescribed rate is 3% (or higher) and the rate drops again in the future? 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 any investments made with funds from the original 3% loan and repay the loan to you. You can then enter into a completely new loan agreement using the new, lower 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 the lower rate, 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.

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