Start Your Engines...July 1, 2020, is Open Season for Prescribed Rate Loan Planning (Again)

Kenneth Keung CA, CPA (CO, USA), CFP, LLB, MTAX, TEP
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The prescribed rate of interest is a tool the Income Tax Act uses as a yardstick for what constitutes "proper" cost of financing. Examples of some of the situations the prescribed rate of interest is used are:

- The minimum rate of interest required on loans to avoid attribution of income and gains;
- Deemed income inclusion to a shareholder on interest-free loans;
- Arrears interest when a taxpayer owes the Canada Revenue Agency (CRA) money, at prescribed rate + 4%.

The prescribed rate of interest is based on the Government of Canada Treasury Bill yield. Since April 1, 2018, the prescribed rate of interest has been 2%. The CRA has just announced that the prescribed rate of interest will drop to 1% as of July 1, 2020. This gets the tax geeks at Moodys Tax trembling with excitement. Why?

When non-arm's length parties transfer property to each other, the Income Tax Act prevents income splitting by sometimes causing the income from the property to be attributed back to the property transferor. For instance, if an individual transfers property to a spouse under a spousal rollover, all future realized property income and capital gains from that property is attributed back to the transferor spouse pursuant to sections 74.1 and 74.2 of the Income Tax Act. Similarly, property income (but not capital gains) is attributed back to a parent for transfers to a minor child. However, the Income Tax Act recognizes that an individual can sometimes enter into bona fide sale with a close family member, and in such cases, the attribution rules should not apply. How does it draw the line as to whether a sale is bona fide: when a sale is transacted at fair market value and no tax rollover is relied on so that the transferor reports whatever gains arises on the transfer. What if the transferee has no cash to satisfy the purchase? Then the transferor can receive as consideration a promissory note owing from the transferee. As long as at least the prescribed rate of interest applicable at the time of the arrangement is charged on the note and such interest is paid on or before January 30th of each year, the Tax Act will not apply the attribution rules.

In other words, the prescribed rate of interest is the price to pay to avoid attribution and split income with family members. The transferor has to report the interest income. The lower the prescribed rate, the lower the tax cost of the arrangement. As long as the transferee is using the property to earn income, the transferee should be able to deduct the interest expense. Properly structured, a prescribed rate loan arrangement may be used to income split with multiple family members, including minors, without the dreaded tax-on-split-income (TOSI) applying. Such an arrangement becomes even more powerful when combined with a discretionary family trust.

Since the prescribed rate of interest depends on Treasury Bills yield, an increase in market interest rate will eventually increase the prescribed rate of interest. Executing a prescribed rate loan arrangement now means locking in the tax cost of income splitting at 1%, even when the prescribed rate climbs back up (and it definitely will). Start your engine…and let's get income splitting!! ?? ?? ??