TD Wealth

# Prescribed Rate Loan Strategy Guide and FAQ

**Included with this guide:**

- Family Income Splitting Using a Prescribed Rate Loan (Article)
- Sample Demand Promissory Note for a Prescribed Rate Loan

**Tax management is often top of mind for clients, along with other wealth planning priorities such as investment and retirement.**

Canada has a progressive income tax system: the more you earn, the higher your tax rate will be. Tax advisors often suggest income splitting techniques to minimize taxes when couples or family members are subject to tax at different marginal tax rates. An income splitting technique that may be appropriate for some clients is the use of a "Prescribed Rate Loan". This strategy is most effective where one spouse/partner earns substantial income and is taxed at a high marginal tax rate, compared to the other spouse/partner who is taxed at a lower marginal rate.

Generally effective income splitting using a prescribed rate loan involves the following:

1. A written loan agreement, and at the time the loan is made, the interest rate charged is at least equal to the lesser of:
    - The Canada Revenue Agency's (CRA) prescribed interest rate for the quarter, or
    - An arm's length rate (e.g., a commercial rate);
2. A clear plan for loan interest to be paid annually on or before the following January 30th each year;
    - Loan interest paid must be included in the taxable income of the lender.
3. A tax deduction of the interest paid by the borrower is available if the loaned funds are used to earn income from a business or property, other than to acquire property the income from which would be exempt.

This guide is meant to provide you with more information on how this strategy works along with sample documents that can help you and your tax and legal advisors decide if this strategy is appropriate for you.

## We have included the following with this guide:

1. A TD Wealth article entitled "Family Income Splitting Using a Prescribed Rate Loan", and
2. A Sample Demand Promissory Note for Prescribed Rate Loans (Appendix 1).

The Sample Demand Promissory Note for Prescribed Rate Loans is provided as a sample for information purposes only and may not be applicable to your individual circumstances. You should seek independent legal and tax counsel. **When implementing this strategy, be aware that both the lender and borrower must be Canadian residents and if either is a U.S. person (which includes a U.S. citizen, resident or green-card holder), there may be adverse tax consequences.** Any change in personal circumstances (such as death, divorce, change in residency or citizenship status) or change in applicable law, may also have adverse tax or other consequences.

You should speak with your tax and legal advisors prior to implementing this strategy to ensure it is appropriate for your situation.

# Prescribed Rate Loan Frequently Asked Questions

## What is the CRA's prescribed rate?

- The CRA announces the prescribed interest rate on a quarterly basis, based on a three-month average of short-term Government of Canada T-bill rates and rounded up to the highest whole percentage number. The current rate can be found on the CRA's website: http://www.cra-arc.gc.ca/interestrates/.
- The CRA's current prescribed rate of interest is 1%, since July 1st 2020.

## How much can I loan and how long can the loan be outstanding?

- There is no limit on the prescribed rate loan amount or the length of time the prescribed rate loan is in place, as long as any interest which is due and payable is paid annually on or before January 30th of the following year.

## What needs to be included in a Prescribed Rate Loan?

- A prescribed rate loan would generally have the following features:
  - Be evidenced in writing by either a loan agreement or a promissory note;
  - Provide the names of the borrower and lender;
  - Stipulate the amount loaned (principal);
  - Stipulate the interest rate charged (generally, the lowest rate that can be used for the prescribed rate loan is the CRA's prescribed rate at the time the loan is put in place);
  - Stipulate that interest for the year is due and payable on or before January 30th of the following year; and
  - Be properly signed and dated.

## Do we need to actually transfer funds? Can we just report the loan amount in the borrowing spouse's name once the borrower signs the promissory note?

- Once the loan is in place, the lending spouse must transfer the funds to the borrowing spouse in accordance with the promissory note.
- The loan should be properly documented, payments of interest should be properly recorded, and appropriate bank records should be retained in order to indicate compliance with CRA rules.
- The onus is on the parties to prove to the CRA that the loan exists and that interest payments have been made.

- While it is not mandatory to set up a new account (in the case where spouses have joint accounts) when making the funds transfer, it is generally recommended that spouses have separate accounts to help keep track of the investment income generated from the loan so that the paper trail is easily traceable. (Following the transfer, the borrowing spouse may wish to consider adding the lending spouse as a joint account holder with right of survivorship for probate planning purposes, but the full income would still be reported as income of the borrowing spouse.)

## As the borrower, do I need to invest the borrowed funds?

- Borrowed funds do not necessarily need to be invested and can be used for other purposes; however, income splitting and tax minimization can best be achieved if the funds borrowed are used for investment purposes and generate investment income. If the funds are used for an income-earning purpose, the annual interest on the borrowed funds may be deducted as an expense against the earned income. If the funds will not be invested at all, from a tax perspective it may not make sense for the loan to bear interest at all.

## What happens if I do not pay the interest on time?

- If interest payments on the prescribed rate loan are not made at least annually on or before January 30th of the following year, the attribution rules will apply in that particular year and in every subsequent year in which the borrower receives income from the loaned property. To establish a new prescribed rate loan, the old loan should be repaid by the borrower (with care taken regarding the source of the funds to avoid attribution rules), and a new prescribed rate loan agreement should be drafted. It should be noted that the CRA does not consider a promissory note or loan created for unpaid interest as interest paid.

## If the CRA's prescribed interest rate drops, can the loan be refinanced?

- To refinance an existing prescribed rate loan to provide for a lower prescribed interest rate, the borrower may be required to dispose of the acquired property and use the proceeds to repay the original loan. This disposition will generally result in income tax implications to the borrower. A new loan at the lower prescribed rate could then be advanced to the borrower to allow the borrower to acquire an income-producing property. Note that the prescribed rate can never fall below 1%.

## What happens if the CRA's prescribed interest rate increases?

- The prescribed interest rate is locked in at the time the prescribed rate loan is implemented. For example, if a loan is put in place when the prescribed interest rate is 1%, this rate is locked in for as long as that loan is in existence, regardless of any changes in the prescribed interest rate announced by the CRA thereafter.

## Can I loan property such as stocks in-kind?

- If property other than cash is loaned, there may be tax implications associated with the loan.

## I want to increase the loan amount. Can I add to the outstanding loan balance at the current rate?

- To ensure attribution rules do not apply, a new loan agreement must be drafted at the prevailing prescribed rate for any additional loaned funds.

## Does the Prescribed Rate Loan strategy work if one spouse is a U.S. Person?

- Careful consideration must be taken where one spouse (lender or borrower) is a U.S. person (which includes a U.S. citizen, resident or green-card holder). You should speak to your tax advisor about the implications of a prescribed rate loan where one spouse is a U.S. person prior to implementing such a strategy as there may be consequences such as additional U.S. filing requirements, U.S. income tax, gift tax, and/or estate tax.

## Can I forgive the loan amount?

- It is possible to forgive the loan, however there may be adverse tax consequences in doing so. For example, the debt forgiveness rules would be applied to the borrowing spouse who could potentially have an income inclusion of the forgiven amount. You should speak to your tax advisor.

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# Family Income Splitting

## Using a prescribed rate loan

Canada has a progressive tax rate system which means that an individual's marginal rate of tax increases as their income surpasses various brackets. To mitigate the effect of being in a higher tax bracket, individuals may look for ways to split income with family members such as spouses/common-law partners, adult and minor children/grandchildren.

Income splitting between family members typically involves shifting taxable income from a high-income earner to a lower- income earner, with the objective of having the income taxed at a lower rate in the hands of the lower-income earner. If implemented appropriately, this strategy could reduce the family's overall tax liability.

While income splitting is appealing, Canada has "attribution rules" designed to limit an individual's ability to income split with close relatives. In general, under the attribution rules, where an individual transfers or loans income-producing property to close relatives, either directly or indirectly, or by means of a trust, the income from the property may be attributed back to the transferor. Without these rules, a taxpayer could derive a tax benefit by gifting or loaning the income-earning investment property to a lower-income spouse/ common-law partner, or minor children, grandchildren, nieces, or nephews.

A Prescribed Rate Loan (PRL) arrangement, however, enables income splitting outside the ambit of the attribution rules. This arrangement involves transferring funds, using a formal loan agreement, to lower income family members (or a trust for their benefit - discussed further, below) for investment purposes.

In order to prevent the attribution rules from applying, the following criteria should be met:

- there is a written loan agreement;
- at the time the loan is made, the rate of interest charged is at least equal to the lesser of:
  - the federal prescribed rate of interest, and
  - an arm's length rate (e.g., a commercial rate); and
- the loan interest for the current calendar year must be paid on or before January 30th of the following year (and every year thereafter while the loan is outstanding). <u>If the interest payments are not made when required, the attribution rules will apply for the current and all future years</u>.

If the funds are used for investment purposes in a non-registered account, the lower income family member may be able to deduct the interest paid on the loan against any investment income earned. Any income in excess of the interest paid would be taxable in the hands of the lower income earner. The interest paid is income earned by, (and taxable to), the higher income earner.

When considering a PRL arrangement, individuals should consider:

- the tax rates of the borrower and lender;
- the rate of interest tied to the PRL; and
- the anticipated rate of return generated from the borrowed funds.

## PRL Example

Alex lends $100,000 to his common-law partner Tyler at a time when the prescribed rate is 1%. Assume that Alex is in a 50% marginal tax bracket, and Tyler is in a 25% marginal tax bracket.

If Alex had kept and invested $100,000 for himself and earned a return of 5%, the full $5,000 of income would have been taxed in his hands, yielding an after- tax income of $2,500 which is significantly lower than the $3,500 generated where a PRL is implemented.

| Alex | Income for Alex | Income for Tyler | Tyler |
|---|---|---|---|
| Lends to Tyler $100,000 at 1% | | $500 | Invests the $100,000 |
| Earns 1% Interest (from Tyler) | $1,000 | $5,000 | Earns 5% (from his investment) |
| Alex's Taxable Income | $1,000 | $4,000 | Tyler's Taxable Income (net of $1,000 interest paid to Alex) |
| Tax @ 50% | $500 | $1,000 | Tax @ 25% |
| After-Tax Income | $500 | $3,000 | After-Tax Income |
| Total Income (After-Tax) | $3,500 | | |

Generally speaking, in order for a PRL arrangement to be worthwhile, the borrower (i.e. Tyler) would typically need to remain in a lower tax bracket than the lender, (i.e. Alex) and the invested funds would need to generate a return that is greater than the interest on the loan and any associated administrative costs.

## PRLs and estate planning issues

As previously discussed, with a PRL, a written loan agreement should be in place, often in the form of a promissory note, outlining the terms of the loan agreement. One of the important issues to address when entering into a PRL arrangement is the possibility that either the borrowing or lending partner passes away before the loan is repaid.

Upon the death of the borrower, a PRL arrangement would typically be treated like any other outstanding debt, unless the lender forgives the debt. When this occurs, the debt forgiveness rules within the *Income Tax Act (ITA)* may apply. If the debt is not forgiven, the borrower's estate would be required to repay the outstanding loan amount.

If the lender's death occurs before the loan is repaid, his or her executor will need to work with the borrower to ensure the loan is repaid, unless there is documentation stipulating that the lender forgives the loan on death. The *ITA* debt forgiveness rules do not apply to loans forgiven by way of bequest or inheritance.

Since forgiving a loan can be complex and may impact the distribution of an estate, it is recommended that a discussion take place with an estates lawyer, both as part of the PRL process, and in the broader estate planning context.

## Income Splitting and an Inter Vivos Family Trust

You may also wish to consider the possibility of making a PRL to a discretionary *inter vivos* trust for the benefit of spouses, children and/or grandchildren.

In an *inter vivos* trust, assets are transferred during your life to a trustee who ensures that the terms of the trust deed are carried out and that the trust assets are professionally managed. By using a PRL, the creation of a family trust may allow you and your family to split income. Some of the advantages and disadvantages of this strategy are summarized below:

| PROS | CONS | TO NOTE |
|---|---|---|
| • Reducing the family's overall tax burden by distributing income to individuals in lower tax brackets<br>• Directing monies to family members who may need the funds (e.g. paying for private school for the children/grandchildren)<br>• Trustees able to control when and to whom the income is directed<br>• Probate fee minimization | • Unrealized capital gains will be recognized after 21 years unless appreciated assets are transferred tax-deferred to capital beneficiaries<br>• The costs associated with setting up and maintaining the trust<br>• Income retained in the trust is taxed at the highest marginal rate | • Proper trust drafting is key. If you act as the settlor and maintain control over the trust property / benefits (i.e. as a trustee), you may be liable for tax on all the trust's income<br>• Income earned within the trust is taxed at the highest marginal tax rate, but any income paid out to the beneficiary is deductible to the trust and taxable to the beneficiary. For this reason, trust income is generally distributed to the beneficiaries, who are presumably taxed at lower rates |

By loaning rather than gifting assets to the family trust by way of a PRL, you can apply the income (interest, dividend, capital gains) earned by the trust for the benefit of other family members and have this income taxed in their hands. Since they presumably will have little other income, they will consequently pay little, if any, tax on the trust income allocated to them.

## Summary of Key Points

- The Canada Revenue Agency (CRA) announces the prescribed interest rate on a quarterly basis.
- The prescribed interest rate is locked in under a PRL. For example, if the prescribed interest rate at the time the PRL arrangement is entered into is 1%, this rate is locked in for as long as the loan is in existence, regardless of any subsequent increases to the prescribed interest rate.
- In some instances, individuals may use a family trust as part of their PRL arrangement. The family trust would act as the borrower and would be required to pay interest to the lender based on the criteria previously outlined above.
- There will be legal costs associated with having a loan document properly prepared outlining the terms of the PRL. In addition, where a family trust is used as part of a PRL arrangement, there may be costs associated with establishing and maintaining the family trust structure, such as legal fees and annual accounting and tax filing fees for the family trust.
- There is no limit on the PRL amount, or the length of time for which the PRL remains in place.

## Considerations

Prior to the implementation of a PRL arrangement, especially in the family trust context, consider seeking the advice of a tax advisor and lawyer to ensure that this planning strategy is appropriate to your particular circumstances.

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Appendix 1

**The following Sample Demand Promissory Note for Prescribed Rate Loans is provided as a sample for information purposes only and may not be applicable to your individual circumstances. You should seek independent legal and tax counsel to review and modify it to suit your particular situation.**

## DEMAND PROMISSORY NOTE FOR PRESCRIBED RATE LOANS

$_______________________________ Canadian    Dated: _________________________

FOR VALUE RECEIVED, the undersigned, ______________________ (the “Borrower”) promises to pay to or to the order of _________________________ (the “Lender”) on the first day following demand for payment hereunder, the principal sum of $____________ (the “Principal Amount”) in lawful money of Canada, together with interest thereon calculated from the date of receipt of the Principal Amount at the rate of _______% per annum (“Interest”), being the prescribed rate of interest on the date hereof for the purposes of subsection 74.5(2) of the *Income Tax Act* (Canada).

Interest shall be calculated annually in arrears and shall accrue on the Principal Amount outstanding from time to time during the year at the above rate both before and after default and/or judgment, if any, until payment thereof. Interest shall be paid by the Borrower to the Lender by January 30th of the year following the year in which such Interest accrued.

The Borrower shall be entitled to repay the whole or any part of the Principal Amount at any time without penalty or bonus.

No delay or failure by the Lender in the enforcement of any obligation of the Borrower hereunder shall constitute or be deemed to constitute a waiver of such obligation. No single or partial exercise of any of the Lender’s rights hereunder shall preclude other and further exercise thereof, or the exercise of any other right.

This Demand Promissory Note will inure to the benefit of and be binding upon the respective heirs, executors, administrators, successors and legal personal representatives, as the case may be, of the Borrower and the Lender.

This Demand Promissory Note shall be governed by the laws of the Province of ________________ and the laws of Canada applicable therein.

All payments hereunder will be made without days of grace, presentment, protest, notice of dishonour or any other notice whatsoever, all of which are hereby expressly waived by the Borrower and each endorser hereof.

Sign: ___________________________________

Print Name: ___________________________________

SAMPLE