Wealth Management

the Navigator

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC WEALTH MANAGEMENT SERVICES

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Modifying a prescribed rate loan

Benefit from historically low rates, but beware of potential adverse tax consequences

As a high-income earner, you may have implemented a prescribed rate loan strategy, for example, a loan to your spouse or to a family trust, to lower your family's overall tax burden. The prescribed interest rate at the time the loan was made may have been higher than the current prescribed rate. As a result, you may be wondering if you can modify the interest rate on your existing loan to benefit from the prevailing lower interest rate. This article discusses the tax rules to consider when modifying your prescribed rate loan.

Income splitting basics

Income splitting is a tax planning strategy whereby you may be able to reduce your family's overall tax bill. It involves moving income from a family member in a high tax bracket to one in a lower tax bracket. However, there are attribution rules designed to prevent family income splitting in certain circumstances. If the attribution rules apply, the income earned by the lower-income family member is attributed back to the higher-income individual who provided the funds, resulting in no tax savings and defeating the purpose of the strategy.

There is an exception to the attribution rules where you make a prescribed rate loan to family members, including your spouse, adult children, or minor children through a family trust. A prescribed rate loan involves making a formal loan to your intended family members at the Canada Revenue Agency (CRA) prescribed interest rate in effect at the time the loan is made.

Your family members can then invest the loaned funds and earn investment income. The net income earned is taxed in their hands at their lower marginal tax rate. One other condition that must be satisfied to ensure that the income earned is not attributed back to you is that the annual interest on the loan must be paid by January 30th of the following year (and by January 30th of every subsequent year that the loan is in place).

The CRA prescribed interest rate

The CRA prescribed rate of interest is calculated every quarter based on the average rate of 90-day treasury bills sold during the first month of

the preceding quarter. This average is rounded up to the nearest percentage point. For example, if the average of the 90-day T-bill rate for the relevant month is 0.85%, the CRA will round up the prescribed rate to the next whole number of 1% for the next quarter.

While the CRA prescribed rate is subject to change every quarter, the interest rate that you use at the time the loan is set-up remains locked-in for the life of the loan, regardless of any future interest rate changes. This is the case unless you take certain steps to refinance or modify your loan.

Modifying your loan

If you have already made a loan to a family member or a family trust at a time when the prescribed rate was higher than the current rate, you may be able to benefit from the lower prescribed interest rate by modifying your loan. However, simply changing or resetting the interest rate on your existing loan will likely have adverse tax consequences because the income attribution rules may be triggered. Upon triggering the income attribution rules, all future investment income earned on investments purchased with the loan will be taxed in your hands at your higher marginal tax rate. If you made a loan to your spouse or a trust where capital gains are allocated to your spouse, the capital gains earned on the loaned funds would also be attributed back to you.

While there are various strategies available to minimize the risk of triggering the income attribution rules, you may wish to consider having your family member or family trust liquidate all or part of their investments so that the cash proceeds can be used to repay the existing loan. Once the existing loan is repaid, you may decide to advance a new loan at the prevailing prescribed interest rate. Speak to your tax advisor about the steps you will need to take in order to substantiate that this is a new loan. This may include issuing a new loan for a different amount, including different terms from the original loan and perhaps using a source of the funds for the new loan other than those funds received on the repayment of the original loan. Be sure to duly document the new loan.

Prior to liquidating the investments, there are some key considerations your family member or the family trust may want to keep in mind. First, liquidating investments may trigger taxable capital gains or losses for your family member or the family trust. If capital gains are realized, there are immediate tax consequences that your family member or the family trust should consider. Second, if a security is sold at a loss, and your family member or the family trust intends to repurchase the same securities, they should be aware of the superficial loss rules. The superficial loss rules may deny their immediate use of the loss where they, or an affiliated person, repurchase the identical security and own it on the 30th day after the settlement date of the disposition. To prevent the superficial loss rules from applying, your family member or family trust can consider waiting 30 days before repurchasing the security or purchasing a different security with similar exposure to the markets.

Conclusion

You may be able to benefit of the current low prescribed interest rate, but it is important you speak with a qualified tax advisor before modifying your loan. If not modified properly, the income attribution rules may apply, resulting in negative tax consequences.

This article may contain strategies, not all of which will apply to your particular financial circumstances. The information in this article is not intended to provide legal, tax, or insurance advice. To ensure that your own circumstances have been properly considered and that action is taken based on the latest information available, you should obtain professional advice from a qualified tax, legal, and/or insurance advisor before acting on any of the information in this article.

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