Prescribed Interest Rate to Climb to 2% in July 2022

Canadians currently enjoy access to a significant income splitting opportunity. The prescribed interest rate - which has remained at 1% since July 2020 – has allowed families to employ loans and trusts to reduce their overall tax burden by shifting income from a high earning family member to one or more lower earning family members and/or related entities. The 1% prescribed rate has been effective in both controlling risk and increasing the amount of income taxed at the marginal rates of the lower-income family member(s).

The effectiveness of prescribed rate loans will soon be moderately diminished. On July 1, 2022, the prescribed rate will climb from 1% to 2% for the first time in two years. Discussed below is an overview of prescribed rate loans and the effect of the upcoming increase to 2%.

Income Splitting Generally

Income splitting refers to the shifting of income from an individual with a high marginal tax rate to a family member of a lower marginal rate. In the hands of the lower-earning family member, any future income generated from the shifted income will be taxed at a more favorable (lower) rate, thus increasing the family's after-tax income.

The *Income Tax Act* employs attribution rules to limit the ability of taxpayers to split income. For example, if an individual loaned $100,000.00 to her minor child or spouse on an interest free basis, any income generated from the loan would be attributed to the original transferor and taxed in her hands. The tax reduction goal of the loan would therefore be defeated. Attribution rules may apply even where the interest rate of the loan is above 0%.

Prescribed Rate Loans and Trusts

Properly constituted prescribed rate loans are exempt from the application of the attribution rules. Under a prescribed rate arrangement, an individual can loan funds to lower income family members, or a trust for their benefit. The income generated from the loan is then taxed at the lower marginal rates of the family member(s).

Strict requirements must be followed for an arrangement to qualify as a prescribed rate loan. Namely:

1. There must be a written loan agreement.
2. The interest rate of the loan must be at least equal to the lessor of:
   a. The interest prescribed by the Canada Revenue Agency ("**CRA**"); and
   b. An arm's length rate (i.e., a commercial rate).
3. The interest must be payable **and paid** by the borrower to the lender no later than January 30 of the following year, and for each year thereafter that the loan is in existence; and
4. There must be evidence of the interest being paid **by** the borrower.

If interest payments are not made, or there is insufficient evidence that the interest was paid by the borrower, the attribution rules will attach to the loan for the current and all future years.

Calculating the Prescribed Rate of Interest

The prescribed rates are set by the CRA each quarter and are tied to the average yields of certain Government of Canada Treasury Bills. The formula for calculating the rate is set out in section 4301 of the Income Tax Regulations. The average yield of 3-month Treasury Bills ("**T-bills**") sold at auction during the first month of any given quarter, rounded up to the nearest whole percentage point, will be the prescribed rate of interest for the next quarter.

For example, take the first month of Q2 (April). 3-month T-bills were auctioned on April 12, 2022, and April 26, 2022, with average yields of 1.02 and 1.38, respectively. The average of those yields is 1.20, which is then rounded up to the nearest whole percentage - 2%. Accordingly, the prescribed rate of interest for loans made in Q3 (July – August) will be 2%.

The average T-bill yields are published by the Bank of Canada and can be found on their website. The 3-month T-bill auctions occur on alternating Tuesdays and the yields are released the next day.

The prescribed rate can never fall below 1%, as the average yield must always be rounded up to the nearest whole percentage.

The prescribed rate applicable to the entire period of a loan is the prescribed rate in effect at the time of the loan agreement. If a prescribed rate loan was made in January 2022, for example, when the rate was 1%, it would be unaffected by the prescribed rate subsequently rising to 2%.

The converse will also be true. A loan established when the prescribed rate is 2% will be unaffected by the prescribed rate falling to 1%. To access the lower rate, the borrower would need to repay the full amount of the loan and execute a new loan agreement. In Technical Interpretation TI 2002-0143985, the CRA suggested that this type of re-financing may trigger the attribution rules if the purported new loan is considered to merely be an extension of the prior loan. As such, substantive alterations to the terms of the arrangement may be necessary. Changes might be made to the parties, the principal of the loan, or the structure of the arrangement itself (e.g., the first loan may be from spouse to spouse, while the second loan is from a spouse to a trust, with a non-spouse trustee and a class of beneficiaries). Individuals considering such re-financing should first seek tax advice.

Example of effect of the climb from 1% to 2% Assume Spouse A, who has a marginal rate of 50%, loans $2,000,000 to a trust in which her spouse and children, each who have a marginal rate of 25%, are beneficiaries. Further assume the annual return on investment of 6%, and a cost of investment of 0.8%, yielding a net annual return of $104,000.

At a prescribed rate of 1%, $20,000 must be repaid as interest to the lender, Spouse A. The remaining $84,000 is distributed among the beneficiaries. After payment of 25% tax, the net income of the borrowers is $63,000.

At a prescribed rate of 2%, $40,000 must be repaid as interest, leaving $64,000 to be distributed among the beneficiaries. After payment of 25% tax, the net income of the borrowers is $48,000.

In each case, the amounts repaid to Spouse A as interest will be taxed at her 50% marginal rate.

The net income available to lower income beneficiaries is generally the most significant factor when calculating the potential tax savings. The value of a prescribed rate arrangement is affected significantly by a change in the prescribed rate.

Overall, a climb in the prescribed rate from 1% to 2% diminishes the value of a prescribed rate arrangement in two ways:

1. The recipient of the loan must now generate more investment income to break even vis-à-vis the now 2% yearly interest that is payable to the lender and taxable at her high marginal rate. This increases the overall risk of the arrangement; and

2. The borrowers receive less net income overall, thereby lowering the amount that is taxed at their lower marginal rates.

Jesse Porter

Pallett Valo Wills, Estates & Trusts Practice

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jporter@pallettvalo.com
(289) 805-4633

PALLETT VALO LLP
Lawyers