THE GLOBE AND MAIL

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TAX MATTERS

Now is the time to make loans to save tax

SPECIAL TO THE GLOBE AND MAIL
PUBLISHED MARCH 3, 2022

Perhaps you've heard the story of the business owner who had employees who always showed up to work on time. Turns out he had 30 employees, 29 free parking spots and one paid parking spot at work. Showing up on time meant saving money.

Showing up on time can mean saving tax dollars, too. You see, time is running out to take advantage of the lowest prescribed rate in Canadian history. This week marked the start of what is surely to be a stretch of increasing interest rates in this country. And as interest rates rise, so does the prescribed rate. So, acting fast is a good idea. Let me explain.

The rate

The prescribed rate in our tax law is used for a few things. Most notably, it's the interest rate that should be charged on certain loans between individuals, or between businesses and their employees or shareholders. When loans are set up properly at the prescribed rate the result can be tax savings.

The lower the prescribed rate, the greater the tax benefits can be. Today, the prescribed is just 1 per cent – but it's very likely to rise this year. The rate is set every quarter and is tied to the average 90-day Treasury Bill rate from the prior quarter, rounded up to the nearest whole percentage point. The average 90-day T-Bill rate for the fourth quarter of 2021 was under 1 per cent, so the prescribed rate was rounded up to 1 per cent for the first quarter of 2022. You get the idea.

There's no doubt we'll see a prescribed rate of 1 per cent for the second quarter of 2022, but it's possible that we could see the rate rise to 2 per cent on July 1. Consider the following ideas before July to take advantage of the current prescribed rate.

The spousal loan

Consider making a loan to your lower-income spouse. If you charge your spouse the 1 per cent prescribed rate on the loan, then any income earned by your spouse on the loaned funds will be taxed in your spouse's hands – not your hands.

Normally, the attribution rules will apply to cause you to pay the tax instead, but charging the 1 per cent gets you out of those rules.

You'll have to pay tax on the 1 per cent paid by your spouse, and he or she will have to pay you by Jan. 30 each year for the prior year interest charge. Your spouse will be allowed a deduction for the interest paid to you. The great news? That 1-per-cent rate can be locked-in for as long as the loan is outstanding.

The child loan

Similar to a spousal loan, you can lend money for the benefit of a minor child – typically to a trust – to have those dollars invested and the income taxed in the hands of the child. Again, you'll need to charge the prescribed rate on the loan, but the 1-per-cent rate can be locked-in indefinitely if you set this up before the rate increase.

As an aside, if you set up a loan at a higher prescribed rate later, and then rates drop again, you can't simply redo the loan at the lower rate unless the higher-rate loan is paid off first.

The employee loan

As an employee, you can borrow money from your employer at low rates today. You'll be deemed to have received a taxable employment benefit for any interest-free or reduced-interest loan. The taxable amount equals the prescribed rate of interest (1 per cent today) less the actual amount of interest you pay on the loan. By this math, you won't have a taxable employment benefit if you pay just 1 per cent on the loan.

In addition, there's a special rule that applies if you borrow from your employer for the purpose of buying a home. Under this rule, the taxable benefit for the first five years is calculated using the lesser of the prescribed rate in effect when the loan was made, or in the particular quarter that the benefit is being calculated. The rules are a little complex, so speak to a tax pro if your employer has made a home loan to you.

The shareholder loan

There are special rules around loans to shareholders that could cause the loan to be included in your income if you're a shareholder and have borrowed from your company. Some loans will avoid these rules. In this case, there could still be a taxable interest benefit, but if you pay the prescribed rate – just 1 per cent today – you'll avoid this taxable benefit. Borrowing today while the prescribed rate is low could make sense. Speak to a tax pro for more details.

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