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TAX MATTERS

Deadline looms for prescribed rate loans

SPECIAL TO THE GLOBE AND MAIL
PUBLISHED JUNE 23, 2022

"You must pay taxes. But there's no law that says you gotta leave a tip."

So goes a Morgan Stanley advertisement from a few years ago. So, in the interest of paying less tax, Canadians have turned to many strategies, and perhaps one of the best-known ideas is the prescribed rate loan.

Here's the deal: You can lend money to certain individuals and gain some tax benefits if you charge the prescribed rate of interest on the loan. I'll get to an example in a minute, but the important thing to note is that the prescribed rate is about to increase on July 1. This gives you a few days to put a loan in place at the current prescribed rate of just 1 per cent if you can benefit from the idea.

The rate

The prescribed rate in our tax law is used for a few purposes. It's the rate that should be charged on certain loans between individuals, loans to trusts, or on loans between businesses and their employees or shareholders.

The rate is set each quarter and is calculated as the average 90-day treasury bill rate for the first month of the prior quarter, rounded up to the next highest percentage point. The average 90-day T-bill rate for the month of April was 1.2 per cent, so this is rounded up to 2 per cent for the prescribed rate starting July 1, 2022. With the current 90-day T-bill yielding 2.1 per cent as of the time of writing, we know that the prescribed rate starting Oct. 1, 2022, will be 3 per cent.

The example

When you set up a loan between spouses as a tax strategy, you can lock in, indefinitely, the rate in effect when loan is made. Take a married couple, Fred and Wilma, as an example. Wilma is in the highest tax bracket in Ontario, so her marginal tax rate (MTR) is 53.5 per cent. Fred, on the other hand, has lower income and his MTR is 31.5 per cent. So, each $100 of taxable investment income that Wilma earns will cost her $53.50 in taxes. Fred will pay just $31.50, so it makes sense to invest more dollars in Fred's name. But Wilma can't simply give Fred money to invest because the attribution rules in our tax law will kick in and cause Wilma to pay the tax, rather than Fred, if she gives him money.

Instead, Wilma is going to lend Fred $100,000 to invest. If she charges the prescribed rate of interest on the loan, Fred will pay the tax on the investment earnings from the portfolio. Fred will have to pay Wilma the interest by Jan. 30 each year for the prior year interest charge. Wilma is going to make this loan on or before June 30, 2022, so she'll lock in a rate of 1 per cent on the loan indefinitely.

For 2022, this means that Wilma will charge Fred 1 per cent on $100,000 for six months in 2022, or $500 in interest ($100,000 times 1 per cent times 0.5 year). If Fred can earn, say, 5 per cent per annum on this money in 2022, he'll earn $2,500 ($100,000 times 5 per cent times 0.5 year). Fred can deduct the $500 he pays to Wilma (she'll pay tax on this interest), leaving a net amount of $2,000 taxed in his hands. So, the total taxes paid by Wilma and Fred combined will be $898 for 2022 ($500 at her MTR of 53.5 per cent plus $2,000 at his MTR of 31.5 per cent). If Wilma had not made the loan to Fred, she'd pay tax on all the investment earnings herself, which would amount to $1,338 for 2022. The couple cuts their tax bill by one-third, or $440 in taxes saved, in this example.

The nuances

It's a good idea to document any spousal loan with a promissory note. If you want to make a loan on or before June 30, the important thing is to make the transfer of funds. You can always finalize the promissory after the fact – say, in July.

Also, I mentioned the idea of making a loan to a family trust, which works much the same as a loan to a spouse. In the case of a trust, the income earned in the trust on the loaned funds can be taxed in the hands of the income beneficiaries, potentially at lower tax rates than your rate.

Finally, there are other prescribed rates that will be going up on July 1. For example, interest owing on overdue taxes will increase to 6 per cent (up from 5 per cent). You can see a full list of rates changing on July 1 by visiting the Canada Revenue Agency website and entering "prescribed rates" in the search field.

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