



CESTNICK

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TAX MATTERS

## **A primer on the taxman's prescribed rate and what it means for taxpayers**

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I have to admit that when we disagree, my wife Carolyn is always right. But if she's always right, and I'm always wrong, then I tell her she's right – so does that make me right or wrong? It's all very confusing. The only thing that will make your head spin more than this conundrum is our tax law.

At the start of every quarter, I think about Income Tax Regulation 4301 – which defines the prescribed rate that applies to taxpayers. It can be confusing to understand how the rate affects the average person – and what opportunities exist to save tax. Here's a primer on what you need to know.

Five ways to move Tax Freedom Day a little earlier this year

The rate

Actually, there's more than one interest rate prescribed in our tax law. There's a rate owing on overdue taxes, a rate paid to taxpayers on tax overpayments and different rates applying to corporations. When people talk about the prescribed rate, they generally mean the base rate from which the other rates are derived.

It's this base rate – which is simply called the prescribed rate – that's most relevant and creates planning opportunities.

The prescribed rate is set quarterly based on the average 90-day Government of Canada treasury bill rate for the first month of the prior quarter, rounded up to the nearest full per cent. The rate dropped to an all-time low of 1 per cent on April 1, 2009, stayed there until it rose in the second quarter of 2018, then returned to 1 per cent for two years during the pandemic. Today the rate is 3 per cent.

The applications

The prescribed rate applies in several situations. Consider the following:

### 1. Prescribed-rate spousal loans

This is probably the best-known planning use. A higher-income spouse can lend money to a lower-income spouse at the prescribed rate. If the loan bears interest at least equal to the prescribed rate in effect when the loan is made, and the interest is actually paid

no later than 30 days after year-end – by Jan. 30 – you’ll avoid the attribution rules, which determine who is liable for paying tax.

By the way, that rate can be locked-in forever. Suppose, for example, that you lent \$100,000 to your spouse on Jan. 1 and are charging the prescribed rate in effect when you made the loan (3 per cent, in this case). If your spouse invests that money and earns, say, \$5,000 each year, your spouse can pay the tax on that income provided they pay you the \$3,000 interest by Jan. 30 each year. You’ll face tax on the \$3,000, but your spouse can deduct that interest, with the net effect is that your spouse pays tax on \$2,000. If your spouse is investing solely for growth and doesn’t earn income annually, this idea won’t make as much sense because you’ll still face tax on the \$3,000 each year (you could have kept the \$100,000, earned the growth yourself and not paid any tax until you realize the capital gains). Spousal loans make more sense when you’re splitting fixed-income investments.

## 2. Loans to family trusts

Since a minor child can’t legally borrow money from a parent, the funds could be lent to a trust for the benefit of the child instead. The trust would borrow from a parent or grandparent, invest the funds, pay the required prescribed-rate interest annually by Jan. 30 each year, and allocate income or capital gains from the trust to the beneficiaries. If they’re minors, they’ll likely pay little or no tax on the income. You could make loans to adult children directly, rather than using a trust, and these loans don’t have to bear interest to avoid attribution as long as your reason for making the loan wasn’t to reduce your own taxes.

## 3. Transfers or sales to a spouse or trust

The prescribed rate can also matter when property is transferred or sold to a spouse or trust for a promissory note. Our tax law includes an exception from the attribution rules where fair market value consideration is paid by the purchaser. And where debt is part of that consideration, interest should be charged at the prescribed rate and paid by Jan. 30 each year.

## 4. Employee low-interest or interest-free loans

If an employer gives an employee a low-interest or interest-free loan, the employee could have a taxable benefit. CRA calculates the benefit using the prescribed interest rate for each quarter, reduced by interest the employee actually pays by the required deadline. CRA says the prescribed rate must be used quarter-by-quarter for these calculations. This can apply to employee home purchase loans, relocation loans and other employment-related loans.

## 5. Shareholder loans

If a corporation lends money to a shareholder, or to someone connected with a shareholder, the loan could be taxable to the recipient under subsection 15(2) of our tax law. Even where subsection 15(2) doesn’t apply, a low-interest or interest-free shareholder loan can create a taxable interest benefit calculated using the prescribed rate.

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