

Prescribed Rate Loan Strategy Guide and FAQ

Tax management is often top of mind for clients, along with other Wealth planning priorities such as investment and retirement.

Included with this guide:

- *Family Income Splitting Using a Prescribed Rate Loan (Article)*
- *Sample Demand Promissory Note for a Prescribed Rate Loan*

Canada has a progressive income tax system, the more you earn, the higher your tax rate will be. Tax advisors often suggest income splitting techniques to minimize taxes when couples or family members are subject to tax at different marginal tax rates. An income splitting technique that may be appropriate for some clients is the use of a “Prescribed Rate Loan”. This strategy is most effective where one spouse/partner has significant assets and their income is taxed at a high marginal tax rate compared to the other spouse/partner who is taxed at a lower marginal rate. The larger the disparity between their tax rates, the more tax savings can be achieved.

Generally effective income splitting using a prescribed rate loan involves the following:

1. A written loan agreement, and at the time the loan is made, the interest rate charged is at least equal to the lesser of:
 - The Canada Revenue Agency's (CRA) prescribed interest rate for the quarter, or
 - An arm's length rate (e.g., a commercial rate);
2. A clear plan for loan interest to be paid annually on or before the following January 30th each year;
 - Loan interest paid must be included in the taxable income of the lender.
3. A potential tax deduction of the interest paid by the borrower if the loaned funds are used for investment purposes.

This guide is meant to provide you with more information on how this strategy works along with sample documents that can help you and your tax and legal advisors decide if this strategy is appropriate for you.

We have included the following with this guide:

- 1) A TD Wealth article entitled “Family Income Splitting Using a Prescribed Rate Loan”, and
- 2) A Sample Demand Promissory Note for Prescribed Rate Loans.



Prescribed Rate Loan Strategy Guide and FAQs

The Sample Demand Promissory Note for prescribed rate loans is provided as a template for convenience purposes only and may not be applicable to your individual circumstances. You should seek independent legal and tax counsel. ***When implementing this strategy, be aware that both the lender and borrower must be Canadian residents and if either is a U.S. person (which includes a U.S. citizen, resident or green-card holder) or citizen or resident of another country, there may be adverse tax consequences.*** Any change in personal circumstances (such as death, divorce, change in residency or citizenship status) or change in applicable law, may also have adverse tax or other consequences.

You should speak with your tax and legal advisors prior to implementing this strategy to ensure it is appropriate for your situation.

Prescribed Rate Loan Frequently Asked Questions

What is the CRA's prescribed rate?

- The CRA announces the prescribed interest rate on a quarterly basis, based on a three-month average of short-term government of Canada T-bill rates and rounded up to the highest whole percentage number. The current rate can be found on the CRA's website: <http://www.cra-arc.gc.ca/interestrates/>.
- The CRA's current prescribed rate of interest is 2% (third quarter of 2019).

How much can I loan and how long can the loan be outstanding?

- There is no limit on the prescribed rate loan amount or the length of time the prescribed rate loan is in place, as long as any interest which is due and payable is paid annually before January 30th of the following year.

What needs to be included in a Prescribed Rate Loan?

- A prescribed rate loan would generally have the following features:
 - Be evidenced in writing by either a loan agreement or a promissory note;
 - Provide the names of the borrower and lender;
 - Stipulate the amount loaned (principal);
 - Stipulate the interest rate charged (generally, the lowest rate that can be used for the prescribed rate loan is the CRA's prescribed rate at the time the loan is put in place);
 - Stipulate that interest for the year is due and payable on or before January 30th of the following year; and
 - Be properly signed and dated.

Do we need to actually transfer funds? Can we just report the loan amount in the borrowing spouse's name once the borrower signs the promissory note?

- Once the loan is in place, the lending spouse must transfer the funds to the borrowing spouse in accordance with the promissory note.
- The loan should be properly documented, payments of interest should be properly recorded, and appropriate bank records should be retained in order to indicate compliance with CRA rules.
- The onus is on the parties to prove to the CRA that the loan exists and that interest payments have been made.

- While it is not mandatory to set up a new account (in the case where spouses have joint accounts) when making the loan transfer, it is generally recommended that spouses have separate accounts to help keep track of the investment income generated from the loan so that the paper trail is easily traceable.

As the borrower, do I need to invest the borrowed funds?

- Borrowed funds do not necessarily need to be invested and can be used for other purposes; however, income splitting and tax minimization can only be achieved if the funds borrowed are used for investment purposes and generate investment income. If the funds are used for investment purposes, the annual interest on the borrowed funds can be deducted as an expense against the earned income.

What happens if I do not pay the interest on time?

- If interest payments on the prescribed rate loan are not made at least annually on or before January 30th of the following year, the attribution rules will apply in that particular year and in every subsequent year in which the borrower receives income from the loaned property. To establish a new prescribed rate loan, the old loan should be repaid by the borrower (with care taken regarding the source of the funds to avoid attribution rules), and a new prescribed rate loan agreement should be drafted.

If the CRA's prescribed interest rate drops, can the loan be refinanced?

- To refinance an existing prescribed rate loan to provide for a lower prescribed interest rate, the borrower must dispose of the acquired property and use the proceeds to repay the original loan. This disposition will generally result in income tax implications to the borrower. A new loan at the lower prescribed rate could then be advanced to the borrower to allow the borrower to acquire an income-producing property.

What happens if the CRA's prescribed interest rate changes?

- The prescribed interest rate is locked in at the time the prescribed rate loan is implemented. For example, if a loan is put in place when the prescribed interest rate is 2%, this rate is locked in for as long as that loan is in existence, regardless of any changes in the prescribed interest rate announced by the CRA thereafter.

Can I loan property such as stocks in-kind?

- If property other than cash is loaned, there may be tax implications associated with the loan.

I want to increase the loan amount. Can I add to the outstanding loan balance at the current rate?

- To ensure attribution rules do not apply, a new loan agreement must be drafted at the prevailing prescribed rate for any additional loaned funds.

Does the Prescribed Rate Loan strategy work if one spouse is a U.S. Person?

- Careful consideration must be taken where one spouse (lender or borrower) is a U.S. person (which includes a U.S. citizen, resident or green-card holder). You should speak to your tax advisor about the implications of a prescribed rate loan where one spouse is a U.S. person prior to implementing such a strategy as there may be consequences such as additional U.S. filing requirements, U.S. income tax, gift tax, and/or estate tax.

Can I forgive the loan amount?

- It is possible to forgive the loan, however there may be adverse tax consequences in doing so. For example, the debt forgiveness rules would be applied to the borrowing spouse who could potentially have an income inclusion of the forgiven amount. You should speak to your tax advisor.



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Family Income Splitting

Using a Prescribed Rate Loan



Canada has a progressive tax rate system which means that an individual's marginal rate of tax increases as their income surpasses various brackets. To mitigate the effect of being in a higher tax bracket, individuals may look for ways to split income with family members such as spouses/common-law partners, adult and minor children/grandchildren.

Income splitting between family members typically involves shifting taxable income from a high-income earner to a lower-income earner, with the objective of having the income taxed at a lower rate in the hands of the lower-income taxpayer. This may provide a family with more after-tax money for investment purposes.

While income splitting is appealing, Canada has "attribution rules" designed to prevent taxpayers from attempting to income split with related taxpayers. Without these rules, a taxpayer could derive a tax benefit by transferring the income-earning investment property to a low-income spouse, common-law partner or child.

However a Prescribed Rate Loan (PRL) arrangement enables income splitting without application of the attribution rules. This arrangement involves transferring funds, using a formal loan agreement, to a lower income family member for investment.

In order for the attribution rules not to apply, the following criteria should be met:

- there is a written loan agreement;
- at the time the loan is made, the rate of interest charged is at least equal to the lesser of:
 - the federal prescribed rate of interest, and
 - an arm’s length rate (e.g., a commercial rate); and
- the loan interest for the current calendar year must be paid on or before January 30th of the following year. If the interest payments are not made when required, the attribution rules will apply for the current and all future years.

If the funds are used for investment purposes in a non-registered account, the lower income family member may be able to deduct the interest paid on the loan against any investment income earned. Any income in excess of the interest paid would be taxable in the hands of the lower income earner. The interest paid is considered to be income to, and taxable to, the higher income earner.

When considering a PRL arrangement, individuals should consider:

- the tax rates of the borrower and lender;
- the rate of interest tied to the PRL; and
- the anticipated rate of return generated from the borrowed funds.

PRL Example

Alex lends \$100,000 to his common-law partner Tyler at a time when the prescribed rate is 2%. Assume that Alex is in a 40% marginal tax bracket, and Tyler is in a 25% marginal tax bracket.

If Alex had kept and invested \$100,000 for himself and earned interest at 5%, the full \$5,000 of interest income would have been taxed in his hands, yielding an after-tax income of \$3,000 which is lower than the \$3,450 generated where a PRL is implemented.

Alex	Income for Alex	Income for Tyler	Tyler
Lends to Tyler \$100,000			Invests the \$100,000
Earns 2% Interest (from Tyler)	\$2,000	\$5,000	Earns 5% interest (from his investment)
Alex’s Taxable Income	\$2,000	\$3,000	Tyler’s Taxable Income (net of \$2,000 interest paid to Alex)
Tax @ 40%	\$800	\$750	Tax @ 25%
After-Tax Income	\$1,200	\$2,250	After-Tax Income
Total Income (After-Tax)	\$3,450		

Generally speaking, in order for a PRL arrangement to be worthwhile, the borrower (e.g., Tyler) would typically need to remain in a lower tax bracket than the lender, (e.g., Alex) and be able to make the corresponding interest payments. In addition, the invested funds would need to generate a return that is greater than the interest on the loan and any associated administrative costs.

The invested funds would need to generate a return that is greater than the interest on the loan.

PRLs and estate planning issues

As previously discussed, with a PRL, a written loan agreement would be in place, often in the form of a promissory note, outlining the terms of the loan agreement. One of the important issues to address when entering into a PRL arrangement is the possibility that either the borrowing or lending partner passes away before the loan is repaid.

Upon the *death of the borrower*, a PRL arrangement would typically be treated like any other outstanding debt, unless the lender forgives the debt. When this occurs, the debt forgiveness rules within the *Income Tax Act (ITA)* may apply. If the debt is not forgiven, the borrower's estate would be required to repay the outstanding loan amount.

If the *lender's death* occurs before the loan is repaid, his or her executor will need to work with the borrower to ensure the loan is repaid, unless there is documentation summarizing that the lender forgives the loan on death. The *ITA* debt forgiveness rules do not apply to loans forgiven by way of bequest or inheritance.

Forgiving a loan can be complex and may impact the distribution of an estate. Therefore a discussion with an estate lawyer, as part of the PRL process, and overall estate planning is recommended.

Additional Information

- The Canada Revenue Agency (CRA) announces the prescribed interest rate on a quarterly basis.
- The prescribed interest rate is locked in under a PRL. For example, if the current prescribed interest rate is 2%, this rate is locked in for as long as the loan is in existence, regardless of any subsequent changes in the prescribed interest rate.
- In some instances, individuals may use a family trust as part of their PRL arrangement. The family trust would act as the borrower and would be required to pay interest to the lender based on the criteria previously outlined above.
- There will be legal costs associated with having a loan document properly prepared outlining the terms of the PRL. In addition, where a family trust is used as part of a PRL arrangement, there may be costs associated with establishing and maintaining the family trust structure, such as legal fees and annual accounting and tax filing fees for the family trust.
- There is no limit on the PRL amount, or the length of time for which the PRL remains in place.

Consider:

Prior to the implementation of a PRL arrangement, consider seeking the advice of a tax advisor and lawyer to ensure that this planning strategy is appropriate to your particular circumstances.



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DEMAND PROMISSORY NOTE
(PRESCRIBED RATE LOAN)

\$ _____ Canadian

Dated: _____

FOR VALUE RECEIVED, the undersigned, _____ (the "Borrower") promises to pay to or to the order of _____ (the "Lender") on the first day following demand for payment hereunder, the principal sum of \$ _____ (the "Principal Amount") in lawful money of Canada, together with interest thereon calculated from the date of receipt of the Principal Amount at the rate of _____% per annum ("Interest"), being the prescribed rate of interest on the date hereof for the purposes of subsection 74.5(2) of the *Income Tax Act* (Canada).

Interest shall be calculated annually in arrears and shall accrue on the Principal Amount outstanding from time to time during the year at the above rate both before and after default and/or judgment, if any, until payment thereof. Interest shall be paid by the Borrower to the Lender by January 30th of the year following the year in which such Interest accrued.

The Borrower shall be entitled to repay the whole or any part of the Principal Amount at any time without penalty or bonus.

No delay or failure by the Lender in the enforcement of any obligation of the Borrower hereunder shall constitute or be deemed to constitute a waiver of such obligation. No single or partial exercise of any of the Lender's rights hereunder shall preclude other and further exercise thereof, or the exercise of any other right.

This Demand Promissory Note will ensure to the benefit of and be binding upon the respective heirs, executors, administrators, successors and legal personal representatives, as the case may be, of the Borrower and the Lender.

This Demand Promissory Note shall be governed by the laws of the Province of _____ and the laws of Canada applicable therein.

All payments hereunder will be made without days of grace, presentment, protest, notice of dishonour or any other notice whatsoever, all of which are hereby expressly waived by the Borrower and each endorser hereof.

Sign: _____
Print Name: _____