Deadline Reminder: 2022 Prescribed Rate Loan Interest Payment

Advanced Wealth Planning Group

Clients who have implemented a prescribed rate loan should be reminded to pay the appropriate interest relating to the 2022 year **on or before January 30, 2023.**

What is a prescribed rate loan?

A prescribed rate loan is one of the few income-splitting opportunities provided to Canadians that does not contravene the various "attribution rules" found in Canada's Income Tax Act.

A prescribed rate loan strategy allows Canadians to legitimately loan capital and the income and gains earned from such into the hands of their spouse or common-law partner or an *inter-vivos* Trust and beneficiaries, who pay tax at lower marginal income tax rates. When structured properly, the family unit will pay less income tax on a combined basis on such income and gains.

When is the interest due?

Interest on a prescribed rate loan must be *"paid not later than 30 days after the end of the particular year."* As *"particular year"* in most instances refers to a calendar year, the year-end is December 31. To ensure that any outstanding prescribed rate loans remain valid, the borrower must ensure that the required interest is paid to the lender **on or before January 30, 2023.**

The payment of interest is required even if the prescribed rate loan was issued during the year or additional funds were loaned.

For example:
A prescribed rate loan was established on December 1, 2022. The accrued interest for the period December 1– 31 must be calculated and paid no later than January 30, 2023.

How should interest be paid?

It is best practice for the borrower to pay the required interest from their own separate account. Using joint chequing or investment accounts to make the interest payments should be avoided. Where a prescribed rate loan is in place between spouses or common-law partners, the borrower often pays the interest from their investment account to the lender's investment account.

Interest payments should be documented to provide support should the Canada Revenue Agency request evidence. As with other supporting tax information, it is generally recommended to retain this documentation for a period of at least six years.

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What happens if the interest is not paid?

If the interest is not paid on time, then the “attribution rules” will apply and the tax benefits of the prescribed rate loan strategy will be lost.

While a new prescribed rate loan can be established to regain the tax benefits, there are several negative outcomes that can arise if the interest payment is not made on time:

- **Professional Fees:** Establishing a prescribed rate loan generally comes with professional fees. For example, a lawyer would have to be engaged to draft a new loan agreement to document the new prescribed rate loan. Additionally, professional fees from accountants and/or tax advisors may also be required.
- **Lost access to lower interest rates:** Prescribed rates have risen sharply over the past year, and have been set at 4% for the first quarter of 2023. Given the interest rate is “locked in” at the time a prescribed rate loan is established, missing an interest payment may nullify a prescribed rate loan that is locked in at a lower interest rate (many have been established at 1%). Generally, the lower the prescribed rate attached to the loan, the greater the tax benefits.
- **Liquidation of Portfolio:** Where the prescribed rate loan was used by the borrower to purchase marketable securities, it is generally best practice to liquidate the portfolio, settle the “invalid” prescribed rate loan, establish a new prescribed rate loan and invest. If the original investments are disposed of at a loss and are subsequently repurchased, the superficial loss rules should be considered.

Note: Professional tax advice should be obtained if a prescribed rate loan is offside due to missed interest payments.

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