ADVANCED WEALTH PLANNING GROUP

Deadline Reminder: 2024 Prescribed Rate Loan Interest Payment

WELLINGTON-ALTUS

Clients who have implemented a prescribed rate loan should be reminded to pay the appropriate interest relating to the 2024 year **on or before January 30, 2025**.

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 loan to, and legitimately place income and gains earned from the loan proceeds in the hands of, their spouse, common-law partner or an *inter vivos* trust with beneficiaries who are taxed at lower marginal 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, 2025.
- The payment of interest is required even if the prescribed rate loan was issued during the year or additional funds were loaned or repaid. Where the loan balance has changed in the year (e.g. a payment was made to principal), the interest payable should be prorated based on the number of days in the year that each different balance was outstanding.

For example:

1. A $100,000 prescribed rate loan at 5% interest was established on December 1, 2024. The accrued interest for the period December 1 - 31 must be calculated and paid no later than January 30, 2025.
2. A $2 million prescribed rate loan at 5% interest was set up on July 1, 2024, half the loan principal ($1 million) was repaid on December 15, 2024. Interest for 2024 will be calculated as 5% on $2 million (July 1 - December 14) plus 5% on $1 million (December 15 - 31). Interest must be paid no later than January 30, 2025.

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.

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. The loan will be considered “tainted”.

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**
  Though they have begun coming down, prescribed rates rose sharply starting mid-2022. The prescribed rate has been set at 4% for the first quarter of 2025. Given the interest rate is “locked in” at the time a prescribed rate loan is established, missing an interest payment may taint 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 “tainted” 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.

To facilitate payment of interest on your prescribed rate loan and to understand how such loans may be an effective tax mitigating strategy for you and your family, contact your Wellington-Altus advisor.