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The clock is ticking on the low one per cent prescribed-rate loan strategy

Lock in and save

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A couple of years ago, I wrote about a simple tax strategy that would allow you to income split with low tax-rate family members without tripping over the attribution rules (where income will still be taxed at your own higher rate).

The prescribed loan strategy allows you to loan money (or assets) to a spouse or minor child at a prescribed interest rate and any income arising from the use of such funds or assets could be taxed in the hands of those family members.

This interest rate has been at an historic low of one per cent for the last couple of years – hence the popularity of the prescribed loan regime.

The prescribed rate as set by the government is determined by using the simple average of the three-month treasury bills for the first month of the preceding quarter, rounded up to the next highest percentage point.

However, the average yield on 90 day treasury bills during April, 2012, was 0.99 per cent.

So although the prescribed rate for the third quarter of 2012 will remain at one per cent, it appears highly likely that the rate will increase to two per cent on October 1, 2012.

This may motivate you to finally implement the prescribed loan strategy; doing so now will allow you to lock into the one per cent rate for the lifetime of the loan.

On that note, I thought it would be worthwhile to set out a refresher on the "ABCs" of the strategy.

You, as the lender, can loan after-tax money to a spouse, minor child, or a family trust for the benefit of your spouse and minor children at the prescribed rate in place at the time of the loan.

Such funds would then be invested, and any income arising from such investment can be taxed in the hands of those family members (and assuming they are in lower tax-brackets, tax savings would thereby result).

Alternatively, you can transfer property-in-kind instead of cash, and take back a promissory note bearing the prescribed rate of interest; however, such a transfer could potentially trigger any accrued capital gains in your hands (and you should therefore speak with your tax advisor as to the potential downside of loaning assets rather than cash).

In order to qualify for this tax break, the interest on the loan for each year must be paid no later than January 30th after the year end.

Otherwise, the attribution rules will apply and the profits will be taxable in your hands. Furthermore, if you miss even one January 30th deadline, the attribution rules will apply on the particular investment forevermore.

In earlier years, when the prescribed interest rate was at the higher range, the ability to take advantage of this manoeuvre was limited since you, as the lender, would have to pay tax on the receipt of such interest.

Therefore, you really needed

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a lucrative investment in mind if you wanted to take advantage of the loan manoeuvre in earlier years; one obvious example would have been a stock which you expected to appreciate (that is, if you're lucky enough to find one in this current market).

With the low one per cent rate, taking the interest into income has not required such an analysis since the interest income would not have been too high.

If the loan is made for the purpose of earning income (i.e. your spouse, child or trust were to borrow the money to make an investment), then the interest paid to you will normally be deductible by the payor.

However, if your investment turns out to be a loser, you might want to purposely trigger the attribution rules by missing an interest payment.

That way, for tax purposes, the loss will probably be treated as yours. So you can actually take advantage of the attribution rules and turn them in your favour.

Remember, though, that if you do flip this strategy in such a manner, and the investment then turns around, there is no way to reverse the attribution unless the loan was repaid and you put in place a new prescribed loan strategy.

Another scenario may involve you having already put in place the prescribed loan strategy, but at a time when the prescribed rate was at a higher amount.

Unfortunately, you are locked in at that higher rate because the income tax rules provide that the prescribed rate must be the one in place at the time the initial loan was made.

Accordingly, you may want to consider restarting the clock by having the prescribed loan repaid in full by your spouse, child or trust.

Then you can put in place a new loan now and lock into the low, one per cent prescribed rate. And the good news is that you will be locked into this low rate for as long as the loan is in place, even if the prescribed rate increases in the future.

I mentioned earlier the ability to make such a loan to a discretionary family trust set up for the benefit of a spouse and minor children. This would allow you some flexibility as to the ultimate ownership of the investment assets.

However, if you are using a family trust as part of your tax strategy, you should be aware that certain "compliance" matters should be attended to in order to avoid any unnecessary issues being raised by the CRA. Over the course of the last few years, the CRA were apparently reviewing certain transactions as they pertain to family trusts, notably:

- distributions out of a trust to family members paid with promissory notes that may be unenforceable under limitation rules;
- diversion of cash for the trustees (or parents) own use;
- the absence of proper accounting records or trustees' minutes and the inability to locate the original settlement property for the trust; and,
- monitoring of compliance with the deemed disposition upon the 21st anniversary of the family trust.

So what does this mean for you if you have a prescribed loan with a family trust, or are thinking of putting this strategy in place?

✓ Make sure that the trust is properly settled and that each party knows their responsibilities.

This would mean ensuring that the settlor understands his or her role in formally establishing the trust and the trustees have an understanding of the assets held by the trust and their role as a trustee with respect to same.

✓ Trustees should meet at least annually and minutes or meeting notes should be prepared, even if no actions were taken by the trustees.

✓ Written trustee resolutions should be prepared where income is to be allocated and/or distributed to beneficiaries.

✓ Ensure that income allocated to beneficiaries is evidenced by promissory notes if not paid before the year-end.

✓ Distributions to the beneficiaries should be for the beneficiaries' own use (and not scooped by the parents). It is recommended that bank accounts be opened for each beneficiary and any distributions of income be actually paid to them and deposited into their respective bank account.

✓ File a tax return for the family trust each year.

✓ Ensure all steps of the plan are carefully executed and documented.

The prescribed loan strategy is still worthwhile, what with the low prescribed rate of interest in place. However, the clock is ticking on the one per cent rate so ensure your plan and documents are all implemented prior to October 1, 2012, when the rate may increase to two per cent. ❐

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