Tax Insights
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# Taxable benefit rate declining to 1%: Don't act until January 1, 2014

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## In brief

The federal prescribed interest rate for taxable benefits will decrease to 1% on January 1, 2014. The rate – which is subject to change every quarter – is currently 2%. To lock in the 1% rate and save tax, you must not act until January 1, 2014.

## In detail

A low prescribed interest rate for taxable benefits can provide tax saving opportunities for you or your family, if you will be:

- participating in or refinancing a family income-splitting loan arrangement, or
- taking out or replacing an employee home purchase loan

### Family income-splitting loan arrangements

The drop in the prescribed rate means that you should wait until 2014 to make a loan to a low-income spouse and/or other adult family member who will invest the funds.

If you make the loan in 2013, it must bear at least 2% interest to avoid the attribution of income rules described below. The rate is reduced to 1% if the loan is made from January 1, 2014, to March 31, 2014 (or later, if the prescribed rate remains 1% after the first quarter of 2014).

*How this strategy works*

The loan splits income, because income earned on the investment of the loaned funds, in excess of the 1% interest charge, can be taxable to the low-income family member at his or her lower tax rate.

For example, if $300,000 is borrowed and invested at 2.5% for the year, $4,500 of income (i.e. $300,000 x [2.5% - 1%]) will be taxable to the borrower, at his or her low marginal tax rate, rather than to the family lender.

Normally, this income (including interest, dividends and certain other types of investment income, and capital gains in the case of a spousal loan) would be 'attributed' to the lender and included in his or her income, rather than the borrower's income, for tax purposes.

An exemption from the attribution rules can apply, though, if:

- the borrowed money bears interest at a rate at least equal to the prescribed rate in effect when the loan is made, and
- the interest is paid each year within 30 days of the end of the year

Because the 1% rate on the family loan is locked in, significant tax savings can arise in future years, if market rates increase and investment returns improve, to the extent the income would have otherwise been taxable to the lender at higher marginal tax rates.

### *Making this strategy work*

For this strategy to work:

- the loan must, among other requirements:
  - be entered into after December 31, 2013, and before April 1, 2014, and
  - bear interest at 1%, which must be paid by January 30, 2015 (and by January 30 following the end of every subsequent year during which the loan remains outstanding), and
- the borrower's return on the investment must exceed 1%

Careful adherence to the interest payment requirements is essential, because if a payment is even one day late for any year, the exemption from the attribution rules will be lost for that year and all subsequent years until the family member no longer holds the invested funds or any 'substituted property' (property for which the original loan proceeds have been exchanged in one or more transactions).

### *Using a family trust*

A discretionary family trust can also be used to implement this family income-splitting loan arrangement. The same loan and interest payment requirements described above must be met.

Provided the trust has been properly established, any income or capital gains the trust earns exceeding the 1% interest the trust pays the lender can be allocated and made payable to, and therefore be taxable to, beneficiaries of the trust, who could include any of the lender's lower-income family members, including minors.

This strategy allows the trustees of the trust to determine the allocation to each family member each year, optimizing the use of personal tax credits and marginal tax rates when levels of other income, expenses or credits vary. Further, it involves only one loan.

### *Refinancing a family loan*

If you have already lent funds to a family member or trust at a higher interest rate, you can still benefit from the 1% prescribed rate. However, you cannot simply reduce the interest rate on the loan to 1%, because the attribution rules would begin to apply and any income (and capital gains on loans to a spouse or to a trust that allocates the gains to the spouse) subsequently earned on the funds would be taxable to you.

Similarly, making a new loan at 1% that is used to repay the existing loan might potentially trigger the attribution rules. Taking into account Canada Revenue Agency (CRA) pronouncements, the attribution rules should not apply if the existing loan is repaid and a new loan is advanced in separate transactions. This could be achieved, for example, if:

1. the borrower sells the investments and uses the proceeds to repay the existing loan
2. you extend a new loan using funds other than funds received from the repaid loan
3. the amount and terms of the new loan differ from those of the former loan, and
4. all transactions are supported by appropriate documentation

Current market conditions may make it undesirable to sell investments. Instead of point 1, it appears from comments made by the CRA that the debtor may be able to borrow from an arm's length party, such as a bank, to repay your existing loan (but you must not guarantee, or otherwise allow your property to be used as security for, the bank loan).

You would then make a new loan to the low-income family member or trust who would use the loan proceeds to repay the bank. Points 2, 3 and 4 would still apply.

Although the above refinancing approaches appear supportable based on CRA commentary, the CRA has not addressed them specifically. The rules that apply to these situations are not clear, so professional advice should be obtained before implementing any refinancing of a family loan.

## ***Employee home purchase loans***

Employees can take advantage of the low prescribed interest rate by taking out or replacing an employee home purchase loan after December 31, 2013, and before April 1, 2014. This will ensure that the employee's interest rate benefit will be calculated using a rate of 1% for the next five years.

A home purchase loan must be used to acquire (or repay or replace a loan used to acquire) a home for the employee or a relative of the employee. Unlike other employer-provided loans, the interest rate used to calculate the employment benefit will not exceed the rate in effect when the loan was made. Therefore, increases in the prescribed interest rate after the loan is made will not affect the calculation of the benefit.

A home purchase loan is considered a new loan on each fifth anniversary and the prescribed rate at that time applies for the next five years.

## *Let's talk*

For a deeper discussion on structuring these loan arrangements, please contact:

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