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Refinancing Prescribed-Rate Loans Used for Income Splitting

By: Minden Gross LLP Tax lawyer Michael Goldberg and Vincent Didkovsky (Newport Private Wealth) in *Canadian Tax Focus*

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The prescribed interest rate for the purpose of attributing income on low- and no-interest loans has fallen to 1 percent for the third quarter of 2020. This compares to the previous rate of 2 percent, which has prevailed since April 1, 2018. The new rate of 1 percent is the lowest the rate can possibly go under regulation 4301 (unless the yield on government of Canada treasury bills becomes zero or negative). Accordingly, many practitioners are likely to consider whether loans in place at higher prescribed interest rates can be refinanced and locked in at the lower 1 percent prescribed rate. Unfortunately, the process required to make a refinancing strategy effective may be complex and costly and would also likely require a disposition of the income-producing property acquired with the loan. As a result, the tax benefits of the lower-prescribed-rate loan should be weighed against the aggravation and costs of refinancing, including any potential tax on capital gains.

Generally, transfers of loans to a spouse or minor children will attract the attribution rules for income (section 74.1) and/or capital gains (section 74.2—spouses only). However, subsections 74.5(1) and 74.5(2) (collectively, the saving provisions) provide that sections 74.1 and 74.2 will not apply to any income, gain, or loss derived from transferred or loaned property where the interest rate on the indebtedness is at least the prescribed rate. Since these provisions do not impose a term limit on the loan, the loan can (barring legislative change) remain outstanding forever at the prescribed rate that was in place at the time it was made, without triggering the attribution rules (as long as the loan continues to satisfy the requirements of an applicable saving provision). Consequently, if it is possible to restructure an existing prescribed-rate loan so that the applicable prescribed rate is reduced to 1 percent, the tax benefit from having a low amount of imputed interest will be as high as it ever can be and will continue indefinitely. This is an attractive combination of attributes.

Two ineffective strategies for refinancing an existing loan are described below:

- *Amending the terms of an existing prescribed-rate loan*. For the saving provisions to apply, the loan must be made at the prescribed rate that was in place at the time the loan was made. For this reason, amending the terms of an existing loan to reduce the interest rate to the new, lower prescribed rate does not comply with the saving provisions.
- *Refinancing an existing prescribed-rate loan*. CRA commentary suggests that repaying the original loan with the proceeds from a new, lower-prescribed-rate loan does not

effectively refinance an existing prescribed-rate loan. According to CRA document no. 9336625 (April 29, 1994), the new loan would not be used for an income-producing purpose, but rather for the purpose of extinguishing the original loan. As a result, the CRA's published position is that the new loan would not qualify for the saving provision in subsection 74.5(2) and would therefore be subject to the attribution rules in subsection 74.1(3).

However, it may be worth considering whether the CRA's position that a refinancing strategy is ineffective is correct, since it does not reference subsection 20(3). Under subsection 20(3), subject to limited exceptions, borrowed money used to "repay money previously borrowed or to pay an amount payable for property described in subparagraph [20](1)(c)(ii) previously acquired . . . is deemed to be used for the purpose for which the previous indebtedness was used or incurred, or was deemed by this subsection to have been used or incurred."

To minimize the risk of a CRA challenge, a prudent method of refinancing an existing prescribed-rate loan with a lower-prescribed-rate loan is for the borrower to dispose of the income-producing property and use the proceeds to repay the original loan. Once the original loan has been repaid, a new, lower-prescribed-rate loan may then be advanced, and the proceeds could be used to acquire income-producing property. To minimize the possibility that subsection 74.1(3) could apply to the new loan, the terms of the new loan should be sufficiently different from the terms of the original loan. Examples of differences might include ensuring that the amount and term of the loan differ and that, if possible, funds other than the proceeds received on repayment of the original loan are used to make the new prescribed-rate loan.

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