Loans to family members – The debt forgiveness rules

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Personal loans can be made to arm's length third parties, but, more often than not, they are made to family members. But what happens if you decide to forgive a loan you gave to a family member? The answer will depend on the purpose of the loan: is your family member using the funds for investment or business purposes, or are they using the loaned funds for personal use, such as to buy a home? This report will review some of the potential tax consequences of debt forgiveness for both types of loans.

Loan for personal use

With the cost of housing so high in various parts of Canada, it's becoming increasingly common for parents and other family members to provide funds towards a down payment on a home. For many reasons, including the protection of the loaned funds in the event of a matrimonial or relationship breakdown, this assistance may be structured as a loan rather than as an outright gift. In fact, you, as the lender may choose to register a (second) mortgage on title reflecting the amount of the loan.

If you later decide to forgive this loan, there would likely be no adverse tax consequences to the borrower provided that the borrowing was not incurred for the purpose of earning income such that any interest that the borrower paid (or would have paid if interest was charged) would not have been tax deductible. This test will be met if the home is used for personal use by the borrower, rather than being used as an income property, and rented out to earn income.

Loan for investment or business use

The tax consequences differ when a debt is forgiven where the funds borrowed by your family member are used to buy investments, or were used to invest in a business.[1] It's assumed that any interest charged in these circumstances would be tax deductible by the borrower. A common example of such a loan is prescribed rate loan planning where you loan funds as a high-income spouse or partner to your lower-income spouse or partner at the Canada Revenue Agency's prescribed interest rate to reduce your overall family tax burden.[2] But what if that loan is ultimately forgiven? The tax treatment will depend on whether the loan was forgiven during your lifetime, or upon your death.

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[1] In limited circumstances, where the loan was made for the purpose of earning income, the lender may be able to claim a loss on the loan forgiveness. The criteria that must be satisfied for a loss to be available are beyond the scope of this report and professional advice should be sought regarding the appropriate tax treatment in these circumstances.

[2] For more information on prescribed rate loan planning, see our report: https://www.cibc.com/content/dam/personal_banking/advice_centre/tax-savings/prescribed-rate-loans-en.pdf.

Forgiving the loan

During your lifetime

If the investment or business loan is forgiven during the lender's lifetime, the borrower will initially be required to reduce any losses that have been carried forward from previous years by the amount of debt that has been forgiven. Non-capital losses are reduced first, followed by net capital losses.

Once any loss carryforwards have been reduced, then the remaining balance of the loan amount is used to reduce the cost of certain property of the borrower. Personal use property, however, such as the borrower's personal residence, cottage, vehicles and boat, are not impacted by these rules. As for the ordering, first, the cost of depreciable property is reduced. This includes buildings, equipment and vehicles used to earn income. The next type of property to have its cost reduced is other capital property, such as shares or debt.

Should any amount of the loan forgiven still remain after the measures set out above, then 50% of the remaining amount would be included in the income of the borrower in the year the debt is forgiven.

At the time of your death

If, however, you forgive a debt upon your death, perhaps via your will, then there should not be any adverse tax consequences to the borrower.

This is a complex area of tax and estate planning and professional advice should be sought when dealing with the debt forgiveness rules.

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