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SHAREHOLDER LOANS

This issue of the Legal Business Report provides current information on shareholder loans and case law developments relating to shareholder loans. Alpert Law Firm is experienced in providing legal services to its clients in tax dispute resolution, tax litigation, tax and estate planning matters, corporate-commercial transactions and estate administration.

A. SUBSECTION 15(2) SHAREHOLDER DEBTS AND LOANS

1. Subsection 15(2) of the *Income Tax Act* (the "Act") prevents the tax-free distribution of corporate funds to, or for the benefit of, its shareholders through the use of loans or other indebtedness transactions. Where a "particular corporation" makes a loan to a shareholder or an individual "connected" with a shareholder, the general rule pursuant to subsection 15(2) of the Act is that the amount of the loan must be included in the net income of the shareholder of the loan in the year in which the loan is made.

2. Subsection 15(2) of the Act applies where the lender or creditor is: (i) the particular corporation; (ii) a corporation related to the "particular corporation"; or (iii) a partnership of which the "particular corporation" or a corporation related to the "particular corporation" is a member.

3. The identity of the borrower is equally important. Subsection 15(2) of the Act may apply if the borrower is: (i) a shareholder of a "particular corporation"; (ii) "connected" with a shareholder of a particular corporation; or (iii) a member of a partnership, or a beneficiary of a trust, that is a shareholder of a "particular corporation". A person is "connected" with a shareholder of a "particular corporation" if that person does not deal at arm's length with the shareholder and if that person is a person other than: (i) a foreign affiliate of the particular corporation; or (ii) a foreign affiliate of a person resident in Canada with which the "particular corporation" does not deal at arm's length.

4. Subsection 15(2) of the Act will not apply to a loan made to an individual or a related person if the individual was not a shareholder at the time the loan was made.

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B. EXISTENCE OF LOAN OR OTHER INDEBTEDNESS TRANSACTION

1. For subsection 15(2) of the Act to apply, a loan or other indebtedness transaction must exist. A loan or indebtedness is said to exist if there is a debtor-creditor relationship between the parties, regardless of how the parties label the transaction. A court will often consider all of the facts of each case to determine whether a debtor-creditor relationship exists.

2. Pursuant to Information Bulletin IT-119R4, the CRA states that a written agreement is not necessary to establish that a loan exists. However, the CRA states that there must be convincing evidence such as a corporate resolution setting out the loan and the terms of repayment to prove that the loan exists.

RELEVANT CASE LAW

1. *Tick v. M.N.R.*, 72 DTC 6135

In this Federal Court decision, the taxpayer was the sole beneficial shareholder of five corporations that carried on the business of constructing, dealing in, managing and operating apartment and commercial buildings. Between 1961 and 1965, the taxpayer built five different apartment blocks, which were owned by the above-mentioned five corporations. By 1971, the apartment blocks were sold to third parties and the five corporations became dormant. At the end of the 1966 taxation year, the taxpayer owed various amounts to four of the above-mentioned corporations. The loan amounts were reflected in each of the five corporation's 1966 income tax return. Following a reassessment, the Minister included the loan amounts in the taxpayer's income as a deemed dividend. The taxpayer argued that the corporations did not loan any money to the taxpayer; rather the amounts in question were balancing entries for receipts and disbursements of the **taxpayer's** account. He argued that the account was a control or clearing account that simply showed whether the company was in a debit or credit position at year end.

The Federal Court dismissed the taxpayer's appeal and held that the amount in question was a shareholder's loan **pursuant to subsection 15(2)** after considering the true nature and substance of the transactions. After conducting an analysis of the financial statements of the corporation, the Federal Court found sufficient evidence to conclude that there was a loan owing by the taxpayer to four of the corporations. Even with the lack of written documentation evidencing the loan, the disclosure in the financial statements was considered sufficient to establish the existence of a shareholder loan transaction.

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2. *Haynes v. The Queen*, 94 DTC 1906

In this Tax Court of Canada decision, the taxpayer was the sole shareholder, director and officer of a corporation. He borrowed a sum of money from the corporation on an interest-free basis, without any written documentation or corporate resolution, to finance the purchase of a larger residence. The Minister included the amount of money borrowed in the taxpayer's income as a shareholder's loan.

The Tax Court of Canada dismissed the taxpayer's appeal and held that the amount was an appropriation, not a shareholder's loan. The Tax Court held that a written agreement was not necessary for finding that a loan exists; however, there must be cogent evidence presented to satisfy the Court regarding the existence of a loan and terms of that loan. While a written record of a loan or indebtedness is not required, mere statements alleging that a loan or indebtedness exists will not suffice. The amounts were held to be the subject of an appropriation, not a loan.

3. *Trout v. M.N.R.*, 52 DTC 388

In this Tax Appeal Board decision, the taxpayer was one of three shareholders and directors of a corporation. During the course of his duties as a director, the taxpayer attended all Directors' meetings, approved the balance sheet, and signed the financial statements of the corporation, thereby acknowledging that he was indebted to the corporation. The Minister included the amount of indebtedness in the taxpayer's income. The taxpayer appealed the Minister's decision arguing that he had never borrowed any money from the company.

The Tax Appeal Board dismissed the taxpayer's appeal and held that the amount in question was a shareholder's loan. The Board found that the taxpayer was a sophisticated Director and successful businessman with certain experience who should have been aware of the error. By signing the financial statements, the taxpayer took full responsibility of the debt owed to the corporation. The taxpayer failed to displace the onus placed on him to prove that the Minister's assessment was not valid.

4. *Tremblay v. M.N.R.*, 63 DTC 136

In this Tax Appeal Board decision, two taxpayers started their own construction business, Star Home. A year later, the taxpayers decided to dissolve the company, and start up two separate businesses with each one incorporating his own business over which he would have absolute control. Since their capital was tied up in Star Home, the

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taxpayers withdrew the amount in the form of advances. The Minister included the amount of the advances in the taxpayers' incomes. The taxpayers appealed the Minister's decision and claimed that the amounts were not loans, but merely a recovery of capital.

The Tax Appeal Board allowed the taxpayers' appeal and held that the amount constituted a recovery of capital advances rather than loans. The Board defined "loan" as a contract by which a lender gives the borrower a thing to be used gratuitously for a time, which the borrower then returns back to the lender. Therefore, the Board found that if there is no promise to repay or it could be proved that the borrower will never have to make repayment, then the amount will not longer be considered a loan. Furthermore, the Board held that the name given to a transaction by the parties does not necessarily decide the nature of the transaction. The question always is what is the real character of the payment, not what the parties call it.

5. ***Erb v. The Queen*, 2000 DTC 1401**

In this Tax Court of Canada decision, the individual taxpayers, D and G, were both shareholders in one of the family corporations, Enterprises. The taxpayers and Enterprises were also partners in Erb Enterprises Partnership ("the Partnership"). In 1992, 1993 and 1994, D and G received draw amounts from the Partnership in excess of their allocated share of partnership income, which resulted in a deficit in their respective shareholder's loan accounts. The Minister included the amount of the deficit in the taxpayer's incomes alleging that the deficit was a loan received from Enterprise. The taxpayers appealed.

The Tax Court allowed the taxpayers appeals and referred the matter back to the Minister for reconsideration. The Tax Court found that the first step to determine whether subsection 15(2) of the Act is applicable is a consideration of whether indebtedness existed. The Tax Court held that where a partner's capital account falls into a deficit position, no indebtedness is created. To introduce into the Act a presumption of indebtedness whenever a partner's capital account falls into deficit, with the subsequent application of subsection 15(2) of the Act, was found by the Tax Court to be contrary to the scheme of the Act.

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C. NON-RESIDENTS EXCEPTION

Subsection 15(2) of the Act does not apply to a loan or indebtedness where the debtor and creditor are both non-residents of Canada. In such a case, the principal amount of the loan would not be included in income.

D. ORDINARY COURSE OF BUSINESS EXCEPTION

1. Subsection 15(2) of the Act does not apply to a debt that arose in the ordinary course of the creditor's business or a loan made in the ordinary course of the lender's ordinary business of lending money where, at the time the indebtedness arose or the loan was made, *bona fide* arrangements were made for repayment of the debt or loan within a reasonable time.

2. This exception applies to loans made to borrowers regardless of whether they are employees of the corporation. Furthermore, there is no additional requirement that the borrowed funds be used for a particular purpose.

3. Revolving debts, such as line of credit or charge cards, will not be subject to subsection 15(2) of the Act if the terms and conditions attached to debt are the same for the individuals as the public at large who do not own shares in the institution.

4. It is not necessary that the repayment of the debt or loan be made within a reasonable time as long as the *bona fide arrangements* for such repayment are made within a reasonable time.

5. To determine whether the repayment was *bona fide*, certain factors set out in Information Bulletin IT-119R4 need to be considered, namely: (i) the extent to which the arrangements have been carried out by the borrower; (ii) if the borrower is in default; and (iii) any unusual circumstances that might have hindered the arrangements from being carried out.

6. Normal commercial practices that prevail in a similar situation are one of the considerations to determine the "reasonable time" for repayment. Payment within a “reasonable time” is a question of fact.

RELEVANT CASE LAW

1. *Davidson v. The Queen*, 99 DTC 933

In this Tax Court of Canada decision, the taxpayer was an employee and shareholder of a corporation. The taxpayer received an interest-free loan from the corporation to acquire a personal residence in return for two promissory notes as security. The taxpayer's husband, who was the sole director of the corporation, passed a written resolution approving the making of the loan. The taxpayer testified that he had agreed to repay the loan within a 5 year period. The Minister included the amount in the taxpayer's income and claimed that no *bona fide* arrangements were made within a reasonable time, pursuant to the requirements of the Act.

The Tax Court of Canada allowed the taxpayer's appeal and held that the housing loan was a *bona fide* arrangement that had to be repaid in five years. The Tax Court found that five years, in this particular context, was a reasonable time and was sufficient to meet the requirements of the subsection. Citing ***Silden v. M.N.R***, the Tax Court held that the real question is not whether the arrangements relating to repayment of the loan were reasonable, but whether, pursuant to those arrangements, the loan was to be reimbursed within a reasonable time.

The Tax Court held that there was no additional requirement for the arrangement for repayment to be made in writing, pursuant to the words of paragraph 15(2)(a) of the Act. If the Parliament wanted to impose a written requirement, they would have specific clearly in the subsection. Furthermore, the words "*bona fide* arrangements" clearly was not intended to be contractually binding. The proper meaning of "arrangement" within the context of the subsection was something less than a binding contract or agreement or an understanding or plan arranged between two parties which may not be enforceable at law.

2. *Perlingieri v. M.N.R.*, 93 DTC 158

In this Tax Court of Canada decision, the taxpayer was a significant shareholder of a corporation. In 1985, the taxpayer's shareholder loan account with the corporation was credited with the amount of a loan. The loan was payable on demand without interest and no payments were made by the taxpayer in 1985 and 1986. The Minister included the amount of the loan in the taxpayer's income in 1985.

The Tax Court of Canada rejected the taxpayers appeal and held that no *bona fide* arrangements were made at the time of the demand loan for repayment. The Tax

Court found that a demand loan provides for the possible requirement for the debtor to repay his loan at once, however, this did not meet the requirements of an "arrangement". The Tax Court held that a *bona fide* arrangement must meet certain requirements: (i) the arrangement must be made in good faith at the time the loan was made; (ii) at the time the loan was made, the creditor and the debtor must be aware of the arrangements made between them for repayment; and (iii) the debtor must know when he must repay the loan at the time the loan is made. In light of these considerations, a demand letter was found to be open ended with respect to repayment since a creditor may or may not know when he will demand payment and the debtor will not know when has to make the payment. In such a case, no arrangement, *bona fide* or otherwise, has been made at the time of the demand loan for its repayment.

E. EXCEPTIONS FOR LOANS MADE FOR SPECIFIC PURPOSES

Subsection 15(2) of the Act does not apply to a loan made or a debt that arose in respect of: (i) an individual who is an employee of the lender or creditor but not a "specified employee" of the lender or creditor pursuant to the provisions of section 248(1) of the Act; (ii) an individual who is an employee of the lender or creditor or who is the spouse or common- law partner of an employee of the lender or creditor to enable or assist the individual to acquire a dwelling; or (iii) an employee of the lender or creditor to enable or assist the employee to acquire a motor vehicle to be used by the employee in the performance of the duties of the employee's office or employment. These exceptions apply provided that at the time of making the loan or when the indebtedness is incurred, *bona fide* arrangements are made for repayment within a reasonable time.

(I) EMPLOYEE REQUIREMENT

1. In addition to *bona fide* arrangements made within a reasonable time, for these particular exceptions to apply, it must be reasonable to conclude that the employee or the employee's spouse received the loan or became indebted because of the employee's employment and not because of his shareholdings.

2. Pursuant to the Interpretation Bulletin IT-119R4, when a public corporation makes a loan to a shareholder on the same terms and conditions as to a loan made to other employees who are not shareholders, the loan is normally considered to be a loan received in the capacity of an (*qua*) employee. On the other hand, when the opportunity to borrow funds is only made available to shareholders or when the terms and conditions of the loan are more favourable to shareholders than employees, then the

loan will be considered to have been made to the shareholder-employee in his capacity as a shareholder, unless the facts clearly indicate otherwise.

3. The fact that an individual is the only employee of a corporation does not mean, in and of itself, that the loan is conferred *qua* employee. Where the shareholder is the only employee, the CRA will generally consider a loan to be received by virtue of employment where a shareholder-employee can show that employees with similar duties and responsibilities to another employer of similar size, but who are not shareholders of that other employer-corporation, receive loans of similar amounts under similar conditions as that granted to the shareholder-employee. Furthermore, a loan will be considered to be received *qua* employee, if it is reasonable to conclude that the loan is part of a remuneration package.

4. Pursuant to Information Circular IC 70-6R5, generally, a benefit will be considered to be conferred qua employee if it is reasonable to conclude that a benefit is conferred on an individual as part of a reasonable remuneration package. Where the shareholder is the only employee, the CRA will generally consider a loan to be received by virtue of employment where a shareholder-employee can show that employees with similar duties and responsibilities to another employer of similar size, but who are not shareholders of that other employer-corporation, receive loans of similar amounts under similar conditions as that granted to the shareholder-employee.

RELEVANT CASE LAW

1. *Silden v. M.N.R.*, 93 DTC 5362

In this Federal Court of Appeal decision, a Norwegian corporation incorporated a subsidiary in Canada. The taxpayer, who was an employee of the parent company, received a loan from the parent company to assist him to acquire a house in Canada upon relocation from Norway. The loan was to be repaid if the taxpayer left his employment or resold or transferred the property. The taxpayer also received one-third of the shares of the subsidiary as part of an employee incentive plan. The Minister included the amount of the loan in the taxpayer's income. The taxpayer's appeal to the Tax Court of Canada was unsuccessful, but his further appeal to the Federal Court Trial Division was successful. The Minister appealed to the Federal Court of Appeal.

The Federal Court of Appeal held that the real question is not whether the arrangements relating to the repayment of the loan were reasonable, but whether, pursuant to those arrangements, the loan was to be reimbursed within a reasonable

time. Since the arrangements did not specify when the loan had to be repaid, the *bona fide* arrangements requirement was not met.

(I) NON-SPECIFIED EMPLOYEE EXCEPTION

Subsection 15(2) of the Act does not apply to a loan made or a debt that arose in respect of an individual who is an employee of the lender or creditor, other than a specified employee of the lender or creditor. A "specified employee", defined under subsection 248(1) of the Act, is an employee who: (i) a "specified shareholder" owning more than 10% of the issued shares of any class of the corporation; or (ii) who does not deal at arm's length with the corporation.

(II) HABITATION OR DWELLING EXCEPTION

1. Subsection 15(2) of the Act does not apply if a loan or indebtedness is made to an employee, or the employee's spouse or common-law partner to enable or assist the individual to acquire a dwelling for the individual's habitation, and the individual is exempted from including the loan or indebtedness in income.

2. In order for this exception to apply, two threshold requirements must be met namely: (i) at the time the loan was made, *bona fide* arrangements for repayment within a reasonable time must be made and maintained; and (ii) the loan must be received by the shareholder in his capacity as an employee and not a shareholder.

3. "Dwelling", as defined broadly by the CRA, includes an ownership interest in a house, an apartment in a duplex or apartment building, a condominium, a cottage, a mobile home, a trailer, or a houseboat, but not any leasehold interest in such property, so long as the property was acquired for the purpose of habitation by the employee or his spouse.

4. There is no requirement for the dwelling to be located in Canada or for the property to be the principal residence of the employee or spouse of the employee. However, the employee or spouse who received the loan must inhabit the dwelling unless exceptional circumstances occur such as death, illness, fire, or transfer of employee or spouse to another locality.

5. Whether a loan or a debt is made to "enable or assist" an employee or an employee's spouse to acquire a dwelling is a question of fact. The CRA is of the position that a loan made for the purpose of refinancing an indebtedness that was incurred

earlier to acquire a dwelling will not qualify as a loan made to enable or assist an employee, or his spouse, in the acquisition of a dwelling.

6. Loans or indebtedness arising in respect of repairs, alternations, renovations or additions made to a dwelling are not considered to qualify for the exception. However, a loan used to build a new dwelling will qualify for the exception.

7. An individual will not qualify for this exception if he receives the loan, and gifts the proceeds of the loan to his spouse so that the spouse can acquire the dwelling which they will both inhabit.

8. If the facts support the requirements of this subsection, then the amount of the loan will not be required to be included in the shareholder's income. However, subsection 80.4(1) of the Act may deem the individual to have received a benefit equal to the imputed interest on such loan at the prescribed rate for the period it was outstanding, subject to the rules specified in section 80.4 of the Act.

RELEVANT CASE LAW

1. *Charabin v. M.N.R.*, 88 DTC 1284

In this Tax Court of Canada decision, the taxpayer made architectural plans and specifications for the construction of a residence for himself in 1971. The taxpayer and his family moved into the home in December 1971. In 1974, the taxpayer incorporated his business and received a loan from the corporation in 1980. The rumpus room, office and swimming pool was installed in 1979. The Minister included the amount of the loan in the taxpayer's income for the 1980 taxation year.

The Tax Court of Canada dismissed the taxpayer's appeal and held that the house became a "dwelling", pursuant to the subsection, when the taxpayer and his family moved into the home. The rumpus room, office and swimming pool alone could not reasonably be considered the acquisition of a dwelling. The Tax Court held that once a house is built and is treated as a dwelling by the taxpayer, notwithstanding the fact that the house has not been completed in accordance with original plans and specifications, any structure attached to the dwelling years later is not an "acquisition of a dwelling" since the individual already possesses the dwelling. The loan was received by the taxpayer when he already owned a dwelling. The taxpayer did not acquire a dwelling, therefore, he did not meet the requirements of subsection 15(2) of the Act.

2. *Blize v. Canada*, 95 DTC 345

In this Tax Court of Canada decision, the taxpayer was a shareholder and director of a corporation. In 1984, the taxpayer bought land and started construction of a new home. In 1986, the house was still not habitable. However, at this time, the taxpayer entered into an oral agreement with the corporation and received a loan in order to acquire a new residence. The taxpayer moved into the house in September 1986. There were no provisions for payment of interest on the loan. Furthermore, no written agreement was entered into between the taxpayer and the corporation. The Minister included the amount of the loan in the taxpayer's income and held that it did not meet the requirements for the exception pursuant to subsection 15(2.4)(b) of the Act. The taxpayer appealed claiming that there was a *bona fide* oral agreement for the corporation to loan money to the taxpayer for a residence, and an oral agreement is valid and enforceable.

The Tax Court of Canada allowed the taxpayer's appeal and held that the loan was advanced to assist the taxpayer to acquire a dwelling for his habitation and at the time the loan was made, *bona fide* arrangements for repayment were made within a reasonable time. The Tax Court found that the evidence provided by the taxpayer, that is, a corporate tax return that set out the loan amount and repayment structure, was sufficient evidence to show "*bona fide*" arrangements. The Tax Court was also satisfied that the money was advanced to enable or assist the taxpayer to acquire a dwelling for his habitation based on a finding of fact that the money was advanced during the construction process over a period of more than one year. The appeal was allowed and the taxpayer was subject to imputed interest pursuant to subsection 80.4(1) of the Act.

(III) MOTOR VEHICLE FOR EMPLOYMENT USE EXCEPTION

Subsection 15(2) of the Act does not apply to a loan made or a debt that arose in respect of an employee of the lender or creditor to enable or assist the employee to acquire a motor vehicle to be used by the employee in the performance of the duties of the employee's office or employment.

F. REPAYMENT EXCEPTION

1. Subsection 15(2.6) of the Act provides that a loan or indebtedness to a shareholder is not required to be included in the shareholder's income under subsection 15(2) of the Act if two requirements are met: (i) the loan or indebtedness must be repaid within one year after the end of the taxation year of the creditor in which the loan was

made or indebtedness arose; and (ii) the repayment must not be part of a series of loans or other transactions and repayments.

(I) REPAYMENT WITHIN ONE YEAR

1. The first requirement for the subsection 15(2.6) exception to apply is that a loan or indebtedness must be repaid within one year after the end of the taxation year in which the loan was made or indebtedness arose.

2. Pursuant to Interpretation Bulletin IT-119R4, providing a promissory note does not constitute repayment of the loan. Furthermore, transfer of property constitutes repayment only to the extent of the fair market value of the transferred property at time of that transfer.

3. The expression “year” means any period of twelve consecutive months. Therefore, if a corporation makes a loan to a shareholder early in its taxation year, the shareholder is not obligated to repay the loan for almost two years without being included in the shareholder's income.

4. What constitutes a repayment is a question of fact and has been considered in several cases.

RELEVANT CASE LAW

1. *Bass v. M.N.R.*, 67 DTC 49

In this Tax Appeal Board decision, the taxpayer was the controlling shareholder of a corporation. The corporation made several loans to the taxpayer over the taxation year which remained unpaid at the end of the year. The Minister included these amounts in the taxpayers income as deemed dividends. The taxpayer appealed this decision and argued that the repayment was effected by the giving of a promissory note by a third party corporation, also controlled by the taxpayer.

The Tax Appeal Board dismissed the taxpayer’s appeal and held that giving a promissory note did not constitute repayment of the loan. The Board found that a promissory note operates as a conditional payment only and not as a satisfaction of the debt, unless the parties agree to treat it as such. The original debt remains, the remedy is merely suspended during the currency of the note, whether it is given by the debtor or

by a third party. If the note is ultimately paid, the payment of the debt becomes absolute as of the date of taking of the note.

2. ***Johnston Estate v. M.N.R.*, 64 DTC 204**

In this Tax Appeal Board decision, the taxpayer was the president and sole beneficial shareholder of a corporation that loaned him various amounts over the year. At the end of the year, the taxpayer gave the company a mortgage on his house. Upon his death, the estate of the taxpayer claimed that the mortgage constituted repayment of the loan. The Minister added the amount of the loans to the taxpayer's income.

The Tax Appeal Board dismissed the taxpayer's appeal and held that the giving of the mortgage did not extinguish the loan. The Board held that the Act requires repayment in money or money's worth. Where the repayment is being made in money's worth, the burden is on the taxpayer to prove the sufficiency in all respects of such repayment. The taxpayer did not provide sufficient evidence to displace this burden. The Board held that the delivery of the mortgage did not change the position of the taxpayer except the corporation now held a secured obligation instead of a simple contract debt. Furthermore, the mortgage was not considered a negotiable asset in the hands of the corporation because the taxpayer and creditor company were not dealing with one another as independent entities.

3. ***Gauthier v. M.N.R.*, 58 DTC 425**

In this Tax Appeal Board decision, the taxpayer was the controlling shareholder of Rogers Motor Products ("RMP"), which was the controlling shareholder of another corporation, Rogers Motor. RMP made a loan to the taxpayer in 1952 to assist him to purchase a residence. In December of 1953, RMP assigned the taxpayer's loan to the related corporation, Rogers Motor and agreed that the taxpayer's indebtedness had been fully repaid. The Minister added the amount of loan to the taxpayer's income as deemed dividend. The issue before the Board was whether the loan was repaid within one year from the end of the taxation year in which it was made.

The Tax Appeal Board dismissed the taxpayer's appeal and held that the loan was not "repaid" within the meaning of the term pursuant to the subsection. The Board held that the assignment of a loan by a creditor company, which was controlled by the shareholder, to another company, which was controlled by the creditor company, did not constitute repayment of the loan.

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4. ***New v. M.N.R.*, 75 DTC 206**

In this Tax Review Board decision, the taxpayer was a shareholder of a corporation controlled by the New family. From 1968 to 1970, the taxpayer and a personal corporation, both borrowed sums of money from one of the four corporations owned by New family. To repay the loan, the corporation assigned to the creditor corporation a receivable which it had acquired as a result of the sale of assets to another of the four companies. The Minister included the loan amounts in the taxpayer's income.

The Tax Review Board allowed the appeal and held that the assignment of receivables by the taxpayers by the taxpayer to their creditor constitutes repayment of the loans, even though the receivables were from a related company to the creditor company. The Board distinguished this case from the *Gauthier* decision. The Board found that in this case, the borrower gave up and assigned to the lender a value, which was a *bona fide* assignment of receivables, unlike the *Gauthier* decision, where a debt was assigned from one company to another without any real value being transferred.

Essentially, the Board held that the assignment of debt from one company to another without the debtor giving up anything in satisfaction of the debt, though legal and accepted in accounting practice, does not constitute repayment of the debt. However, the assignment of *bona fide* receivables from a financially sound company to which receivables the borrowers gave up their rights and which transferred legal consideration of the loans to the creditor, was found to be a repayment of a loan, The fact that the companies were inter-related was irrelevant because: (i) the companies were still distinct legal entities; and (ii) the fact that the transaction was completed without any sham or fraud.

5. ***Wallace v. The Queen*, 98 DTC 6236**

In this Federal Court of Appeal decision, the taxpayer was a shareholder of a corporation that guaranteed a loan made by a bank to the taxpayer personally. The taxpayer was unable to pay the loan, and the bank called in the guarantee resulting in the taxpayer being indebted to the corporation. The Minister included the amount in the taxpayer's income. The taxpayer appealed the decision. The Tax Court of Canada dismissed the appeal. The taxpayer appealed to the Federal Court of Appeal for a judicial review of the Tax Court decision.

The Federal Court of Appeal dismissed the taxpayer's application and held that the Tax Court did not err in their decision. The taxpayer argued that the amount was

repaid within one year since the debt was written off by the company as uncollectible. The Federal Court of Appeal disagreed with the taxpayer and held that a write-off is not equivalent to a repayment of the debt by the taxpayer.

6. ***Fahey v. The Queen*, 2010 TCC 407**

In this Tax Court of Canada decision, the taxpayer was the owner, manager, sole Director and sole shareholder of a corporation ("HB") that built houses. In 2002, the taxpayer entered into a joint venture with HB to build a house in St. John's that was not sold until 2005. The taxpayer suffered some financial difficulty as he was required to put in his own money to pay the trades and subcontractors. After closing, the suppliers, trades and subcontractors were paid. However, the taxpayer was still owed $49,000 by HB. The amount was repaid to the taxpayer from the income of another wholly-owned corporation ("HF"), which was then amalgamated with HB. The Minister argued that the taxpayer engaged in an unsuccessful loan utilization plan which resulted in a shareholder loan or benefit being conferred on the taxpayer by HF. The Minister included the $49,000 amount in the taxpayer's income as a shareholder loan.

The Tax Court of Canada allowed the taxpayer's appeal and held that there was no shareholder loan or benefit made to the taxpayer. The Tax Court found: (i) that there was no evidence of any liquidation of HF's business assets, (ii) that the direct transfer of debt was not properly and effectively done; and (iii) that the accounting entries did not correctly reflect what happened. The Tax Court held that the taxpayer agreed to treat payments to him by HF as repayments of the amount of money owed to him by HB. Based on this conclusion, the Tax Court held that HF did not make a shareholder's loan to the taxpayer. Furthermore, since the taxpayer's efforts were the contributing source to the reorganization, as well as, to HF earning the income from which the taxpayer was repaid, the Tax Court held that HF did not confer a shareholder's benefit on the taxpayer.

(II) SERIES OF LOANS AND REPAYMENTS

1. The second requirement for the subsection 15(2.6) exception to apply is that it must be established that the repayment was not made as part of a series of loans or other transactions and repayments. There is no requirement that the repayment be made within a reasonable time, however, the *bona fide* arrangements for such repayment should be made at the time of the making of the loan or when indebtedness arose. It is a question of fact whether or not a repayment of loan is part of a series of loans or other transactions and repayments.

2. One loan and one repayment transaction in each taxation year of the lender or creditor may still be considered a "series" of loan and repayments, if the repayment is temporary in nature, such as a loan that is repaid shortly before the end of the year and the same amount or substantially the same amount is borrowed shortly after the end of the year.

3. However, if a current loan account is maintained in the corporation for a shareholder during a tax year and the year-end balance is repaid from salary or declared dividends the CRA will generally not consider these transactions as a series of loans or repayments. *Bona fide* repayments of shareholder loan that result from, for example, the payment of dividends, salaries, or bonuses, are not part of a series of loans or other transactions and repayments

RELEVANT CASE LAW

1. *Meeuse v. The Queen*, 94 DTC 1397

In this Tax Court of Canada decision, in February 1987, the taxpayer borrowed a sum of money from a corporation in which her husband was the sole shareholder. The taxpayer sold her house in 1988 and repaid the entire loan amount to the corporation from the proceeds. In 1989, the taxpayer borrowed a further sum of money to purchase a franchise for the business and eventually paid it back. The Minister included the amount in the taxpayer's income claiming that the amount was not a *bona fide* repayment or that it was part of a series of loan pursuant to subsection 15(2) of the Act.

The Tax Court of Canada allowed the taxpayer's appeal and held that the loans were *bona fide* loans as they were used for genuine business purposes. The loans were paid back from the taxpayer's own funds derived from a source that was wholly independent of the corporation, that is, the sale of her house.

In considering whether the repayment was part of a series, the Tax Court held that a mere succession of loans is not sufficient to constitute a series. A further consideration of the purpose of the subsection is essential to avoid a mechanical or simplistic interpretation of the term. The purpose of the subsection was found to be the prevention of corporate funds to be paid out to shareholders or persons connected with them, otherwise than by way of dividend. The Tax Court adopted a narrow interpretation of the term "series" with the benefit of the doubt going to the taxpayer.

2. *Attis v. M.N.R.*, 92 DTC 1128

In this Tax Court of Canada decision, during all relevant times the taxpayer was the President, employee and sole director and shareholder of a corporation that owned a nightclub. The taxpayer did not enter into a written employment contract with the corporation and never received a salary. He loaned money to the corporation and took money out of the corporation as advances against his earnings on an irregular basis. The Minister included the amount owed to the corporation in the taxpayer's income. The taxpayer appealed.

The Tax Court of Canada allowed the taxpayer's appeal. The Tax Court considered the detailed evidence outlining the inflows and outflows of funds between the taxpayer and the corporation and held that the taxpayer had established on a balance of probabilities that the taxpayer had paid off the debt within one year from end of the relevant tax year in which the indebtedness arose. The Tax Court also held that the payments made through bonuses and dividends were not made as part of a series of loans or other transactions and repayments because the bonuses and dividends were already included in the taxpayer's income. As such, the Tax Court concluded that the Parliament could not have intended to include them twice in income.

Following this decision, the CRA amended Interpretation Bulletin IT-119R4 to include paragraph 29 that states that payments of dividends, salaries and bonuses used to repay a shareholder's loan account at the end of a year will be considered *bona fide* repayments and will not be considered part of a series of loans or other transactions and repayments.

(III) DEDUCTION OF REPAYMENT IF NOT PART OF SERIES OF LOANS

1. If a loan or indebtedness is included in the taxpayer's income under subsection 15(2) of the Act, then a taxpayer can claim a deduction of the amount of the loan if the taxpayer subsequently repays the amount pursuant to paragraph 20(1)(j) of the Act.

2. No deduction is allowed: (i) if the borrower was a corporation, to the extent that the amount of the loan was deductible from its income for the purpose of calculating taxable income in the year the loan was made; or (ii) if the repayment was made as part of a series of loans.

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G. INTEREST FREE OR LOW INTEREST LOANS

1. Loans that are not subject to subsection 15(2) of the Act may still be included in income pursuant to subsection 15(9) of the Act if no interest or a low rate of interest is charged. If the taxpayer receives a loan from his employer that bears a lower than prescribed interest rate or no interest at all, then section 80.4 of the Act will be applicable and a benefit may be assessed which is required to be included income.

2. Subsection 80.4(1) of the Act deems a benefit to have been received by: (i) an individual where a loan has been received by a person or partnership by reason of or as a consequence of a previous, current or intended office or employment of the individual; or (ii) a corporation carrying on a personal services business where the loan was received because of the services performed or to be performed by that corporation.

3. To determine whether the loan was received by virtue of an individual's employment, a strict "but-for" test has been utilized. The question to be considered is whether it is reasonable to conclude that, *but for* the individual's previous, current or intended office or employment, the terms of the loan would have been different or the loan would not have been received.

4. The Act also deems a benefit to have been received if a person or partnership, which is or is connected to a shareholder of the company, receives a loan by virtue of his shareholdings in a corporation or a related corporation, pursuant to subsection 80.4(2) of the Act. This subsection does not apply to a corporate borrower or debtor that is a resident in Canada or a partnership each member of which is a corporation resident in Canada.

5. Whether a loan has been received by virtue of an individual's shareholdings is a question of fact. Factors such as: (i) existence of a *bona fide* business transaction; (ii) terms and conditions of the loan including interest rate and terms of repayment; and (iii) whether the business of the lender includes the lending of money, are relevant considerations in determining whether the loan was received because of an individual's shareholdings.

6. If a person is both an employee and a shareholder, then it is always a question of fact whether the loan arose as a result of employment or shareholdings. Where subsection 80.4(1) of the Act applies, the benefit is always taxed in the hands of the employee, even if some third party, such as employee's spouse is the actual debtor or recipient of the loan. On the other hand, benefits arising pursuant to subsection 80.4(2) of the Act are taxed in the hands of the actual debtor.

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7. Pursuant to Information Bulletin IT-421R2, section 80.4 of the Act will be applicable to any loans that meet the requirements for as long as the amount remains unpaid, notwithstanding any subsequent changes to the relationship of the parties or the conditions of the loan. For example, if a loan was received by reason of employment, then section 80.4 of the Act will continue to apply to the outstanding balance of the loan even after the resignation, dismissal or retirement of the employee.

8. If the loans are subject to a rate of interest equivalent to a commercial rate of interest at the time the loan was received, taking into account all the circumstances including the terms and conditions of the loan, then the loan amount will not be taxed under section 80.4 of the Act. The commercial rate of interest is the rate that would have been agreed upon between arms length parties if: (i) the loan was not issued because of employment or shareholdings; and (ii) if the business of the creditor was the lending of money.

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