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SHAREHOLDER LOANS – PART II

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 and tax litigation, tax and estate planning matters, corporate-commercial transactions and estate administration. Howard Alpert has been certified by the Law Society as a Specialist in Estates and Trusts Law, and also as a Specialist in Corporate and Commercial Law.

A. SHAREHOLDER LOAN REPAYMENT EXCEPTION

1. Subsection 15(2.6) of the *Income Tax Act* (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.

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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.

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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 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.

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 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 interrelated 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*, [1998] F.C.J. No. 422**

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 its 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,* [1994] T.C.J. No. 199

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.*, [1992] T.C.J. No. 9**

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, which 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 if: (i) 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) the repayment was made as part of a series of loans.

B. 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 that 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.

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 arm's length parties if: (i) the loan was not issued because of employment or shareholdings; and (ii) the business of the creditor was the lending of money.

RELEVANT CASE LAW

1. *Hansen v. The Queen*, 2011 TCC 194

In this Tax Court of Canada case, the taxpayer owned a corporation, OF, which operated a greenhouse and flower shop. The taxpayer was reassessed on the basis that a series of expenditures made by OF and recorded in its corporate account records as "Gerry's drawings" were interest free loans to the taxpayer. The Minister included

imputed interest on these amounts in the taxpayer's income pursuant to subsection 80.4(2) of the Act. The taxpayer appealed the assessment. According to the taxpayer, the Minister had disregarded the fact that the taxpayer had made loans to OF that more than offset the loans to the taxpayer. The taxpayer had borrowed $975,000 from the Bank of Montreal to finance the purchase of OF from his father. This loan was refinanced ten years later. At that time, the balance outstanding on the loan was $488,333 and was replaced by new bank financing totaling $960,000. The taxpayer stated that after the refinancing, he had loaned $472,000 of the money he had borrowed from the bank to OF. The Crown argued that the bank lent funds to both the taxpayer and OF at the time of the refinancing, while the taxpayer argued that he was the only borrower.

The taxpayer's appeal was denied. The Tax Court found that the evidence was conflicting. No loan documentation was entered into evidence. While some evidence indicated that the bank had lent funds to both the taxpayer and OF, other evidence indicated that the taxpayer was the only borrower. According to the Tax Court, since the taxpayer had failed to keep necessary documentation and had failed to call witnesses from the bank to clear up the confusion, he had failed to meet the burden of proof with regards to the $472,000 loan to OF. Therefore, the Minister's assessment was correct and the imputed interest was properly included in the taxpayer's income.

2. ***Desgagné v. The Queen*, 2012 TCC 63**

In this Tax Court of Canada decision, the taxpayer was a lawyer and a shareholder of a management corporation which paid her law firm's common operating costs. The Minister reassessed the taxpayer for two taxation years and added imputed interest on interest-free loans she owed to the management corporation to her income pursuant to subsection 80.4(2) of the Act. The taxpayer appealed the assessment.

The Tax Court dismissed the taxpayer's appeal. The Tax Court found that during the two taxation years in issue, the accounts receivable owed by the taxpayer as a shareholder of the management corporation to that corporation were over $15,000. No interest was charged on this debt. The Tax Court noted that it is not normal for a supplier to indefinitely refrain from charging interest on an account receivable. Therefore, this amounted to an interest free loan and the imputed interest was properly included in the taxpayer's income.

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