LEGAL BUSINESS REPORT | ALPERT LAW FIRM
THE TAX LAW PROFESSIONALS

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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

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 lender or 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

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.

Pursuant to Interpretation Bulletin IT-119R4 released on August 7, 1998, a promissory note does not constitute repayment of the loan. Furthermore, the transfer of property constitutes repayment only to the extent of the fair market value of the transferred property at time of that transfer. Repayments are considered to apply first to the oldest loan or debt outstanding ("first-in, first-out"), unless the facts clearly indicate otherwise.

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.

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

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(ii) SERIES OF LOANS AND REPAYMENTS

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.

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.

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

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

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.

No deduction is allowed if: (i) the amount of the loan or indebtedness was deductible from the taxpayer's 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 or other transactions and repayments.

B. INTEREST FREE OR LOW INTEREST LOANS

Shareholder loans that are not included in income pursuant to subsection 15(2) of the Act may still be included under subsection 15(9) of the Act. Subsection 15(9) of the Act provides that the loan will be included in income if a shareholder receives a loan that is deemed to be a benefit under section 80.4 of the Act. Section 80.4 of the Act applies

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when the loan is acquired in the course of office or employment and the interest on the loan is nil or less than the prescribed rate.

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.

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.

Pursuant to Interpretation Bulletin IT-421R2 released on September 9, 1992, whether a loan received by an employee from someone other than the employer is received "by virtue of office or employment" is a question of fact. Where a loan is being negotiated and the employer provides documentation to the lender to support the employee's loan application, the loan will generally be considered to have been received by virtue of office or employment. On the other hand, if an employee negotiates a loan agreement with the third party without any involvement by the employer, the fact that the employer may at some subsequent date subsidize the employee's interest cost will not cause the loan to be considered as received by virtue of office of employment.

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 the 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.

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.

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

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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.

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.

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.

This issue of the Legal Business Report is designed to provide information of a general nature only and is not intended to provide professional legal advice. The information contained in this Legal Business Report should not be acted upon without further consultation with professional advisers.

Please contact Howard Alpert directly at (416) 923-0809 if you require assistance with tax and estate planning matters, tax dispute resolution, tax litigation, corporate-commercial transactions or estate administration.