LEGAL BUSINESS REPORT
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SHAREHOLDER LOANS – PART I

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 in Taxation Law, and also as a Specialist in Corporate and Commercial Law.

A. SUBSECTION 15(2) SHAREHOLDER DEBTS AND LOANS

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.

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.

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.

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

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.

Pursuant to Information Bulletin IT-119R4 released on August 7, 1998, 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.

C. NON-RESIDENTS EXCEPTION

Subsection 15(2.2) of the Act provides that 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. PERTINENT LOAN OR INDEBTNESS EXCEPTION

Subsection 15(2.11) of the Act provides that where a non-resident corporation becomes indebted to a resident corporation that it controls, the two corporations can jointly elect the debt to be a *pertinent loan or indebtedness* (“PLOI”). A PLOI is exempt from the subsection 15(2) shareholder loan rules and is subject to the deemed interest imputation rules under section 17.1 of the Act instead.

E. ORDINARY COURSE OF BUSINESS EXCEPTION

Subsection 15(2.3) of the Act provides that 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.

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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. 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 borrower as the public at large, who do not own shares in the corporation.

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. 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) whether the borrower is in default; and (iii) any unusual circumstances that might have hindered the arrangements from being carried out.

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.

F. EXCEPTIONS FOR LOANS MADE TO EMPLOYEES

There are additional exceptions for loans made to a borrower who is an employee of the lender or creditor. Subsection 15(2.4) of the Act provides that 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;

(iii) an employee of the lender or creditor corporation ("particular corporation") to enable or assist the employee to acquire from the particular corporation, or from another corporation related to the particular corporation, previously unissued fully paid shares of the capital stock of the particular corporation

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or the related corporation to be held by the employee for his or her own benefit; or

(iv) 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.

For these particular exceptions to apply, *bona fide* arrangements for repayment within a reasonable time must be made at the time the loan was made or the debt incurred. In addition, 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 their shareholdings.

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 employee *qua* employee. Subsection 15(2.4) of the Act will generally apply to loans made under these circumstances.

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. Subsection 15(2.4) of the Act will not apply to loans made under these circumstances.

Pursuant to Information Circular IC 70-6R5, 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 by the employee *qua* employee, if it is reasonable to conclude that the loan is part of a remuneration package.

G. NON-SPECIFIED EMPLOYEE EXCEPTION

Paragraph 15(2.4)(a) of the Act provides that 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) is a "specified shareholder" owning more than 10% of the issued shares of any class of the corporation; or (ii) does not deal at arm's length with the corporation.

H. HABITATION OR DWELLING EXCEPTION

Paragraph 15(2.4)(b) of the Act provides that 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. 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 as a shareholder.

"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. 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.

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. 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.

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

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which they will both inhabit. 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.

I. SHARE ACQUISITION LOAN EXCEPTION

Paragraph 15(2.4)(c) of the Act provides that subsection 15(2) of the Act does not apply to a loan or a debt if it was made to enable or assist an employee of the lender or creditor corporation ("particular corporation") to acquire from the particular corporation, or from another corporation related to the particular corporation, previously unissued fully paid shares of the capital stock of the particular corporation or the related corporation, to be held by the employee for his or her own benefit.

Pursuant to Interpretation Bulletin IT-119R4, a subsequent disposition of the shares before the loan is repaid will generally be indicative of a purpose for the acquisition of shares other than to be held by the employee for his or her own benefit.

J. MOTOR VEHICLE FOR EMPLOYMENT USE EXCEPTION

Paragraph 15(2.4)(d) of the Act provides that 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.

K. TRUST EXCEPTION

Subsection 15(2.5) of the Act provides that subsection 15(2) of the Act does not apply to a loan made or a debt that arose in respect of a trust where all the following conditions are met: (i) the lender or creditor is a private corporation; (ii) the corporation is the settlor and sole beneficiary of the trust; (iii) the sole purpose of the trust is to facilitate the purchase and sale of the corporation's shares or those of another corporation related to it at their fair market value from or to the employees of the corporation or the related corporation (excluding "specified employees"); and (iv) *bona fide* arrangements for repayment within a reasonable time were made at the time the loan was made.

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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.