CORPORATE Newsletter

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Loans and Advances to Shareholders

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There are tax rules that prevent shareholders from avoiding paying tax on dividends by instead extracting money from their corporations by means of lending money to themselves from the corporation. If you are a shareholder, directly or through a partnership or trust, or if you're a related shareholder of a corporation and you have obtained a loan from or otherwise incurred a debt to that particular corporation or a corporation related to it, or from a partnership of which either the particular corporation or the related corporation is a member, the loan or debt is treated as income received by you in the year of the loan or debt. Loans which meet the initial criteria for inclusion in income are referred to as "shareholder loans". A shareholder loan which is deemed to be income under this rule is not considered to be a dividend, and, therefore, is not eligible for the dividend tax credit.

The term "incurred a debt" refers to all forms of indebtedness, including for example, the unpaid purchase price of property purchased from the company or a note payable.

Fortunately, there are several exceptions to the shareholder loan inclusion rule, outlined below. However, where they do not apply, the imputed interest rules discussed below may apply if the loan or debt carries no interest or a rate of interest below the prescribed rate of interest. If the shareholder loan inclusion rule applies, there is an offsetting deduction in the year in which you repay the loan or debt. The CRA has stated that, in general, repayments are considered to apply first to the oldest loan or debt outstanding (first-in, first-out basis) "unless the facts clearly indicate otherwise".

Exceptions

As noted, there are various exceptions where a shareholder loan or debt is not included in income. They are summarized below.

Loan from Money-Lender

An exception applies where the loan was made in the ordinary course of business of a corporation whose business is the lending of money, or the debt arose in the ordinary course of the creditor's business, provided

however that *bona fide* arrangements for repayment within a reasonable time were made at the time the loan or debt arose.

Repayment within one year after year of loan

The rule does not apply if the loan or debt is repaid within one year from the end of the corporation's taxation year in which it was made. This exception does not apply where the loan is part of a series of loans and repayments. The CRA takes the position that genuine repayments of shareholder loans which are the result of the declaration of dividends, salaries, or bonuses should not be considered part of a series of loans or other transactions.

Loans between non-residents

The rule does not apply to the indebtedness between non-resident persons.

Loans to certain employees

Loans or debts to employees who are also shareholders are excluded from the shareholder loan rule provided two initial conditions are both met at the time the loan or debt is incurred. These initial conditions are:

1. a genuine arrangement has been made to repay the loan within a reasonable time; and
2. it is reasonable to conclude that the employee received the loan or became indebted because of the employment relationship and not because of shareholdings.

In its interpretation bulletin IT-119R4, the CRA comments on this condition: "Whether or not a loan made by a corporation to an individual is considered to have been received by that individual in his or her capacity as an employee or as a shareholder involves a finding of fact in each particular case. When a public corporation makes a loan to a shareholder on the same terms and conditions as to other employees who are not shareholders, the loan is normally considered to be a loan received by virtue of that individual's office or employment rather than his or her shareholdings. However, when the opportunity to borrow funds is only made available to shareholders or when the terms and conditions attached to loans to employee-shareholders are more favourable than those attached to loans to other employees, the loan will be considered to have been made to the employee-shareholder in his or her capacity as a shareholder unless the facts clearly indicate otherwise."

If the employee is not a "specified employee" and the two criteria above are met, the loan is not included in income.

Loans to "Specified Employees"

A specified employee is essentially one who owns directly or indirectly at any time in the year 10% or more of any class of shares of the corporation or a related corporation. The actual definition is far more elaborate and specific so that, for example, a taxpayer is deemed to own each share owned by a related person and a person who does not deal at arm's length with a specified employee is also a specified employee. Basically, if you own 100% of your corporation (or 10% or more for that matter), this rule applies to you.

If the loan is made in respect of a specified employee, there are three other exclusions from the shareholder loan rules, provided that the two conditions discussed above are met:

1. the loan is in respect of an employee (or the employee's spouse) of the lender/creditor to help the employee acquire a dwelling house (including a country house, a summer cottage, or a suite in an apartment block or unit in a duplex) which is for the employee's habitation;
2. the loan is in respect of an employee of a particular lender/creditor corporation (or a corporation related to the particular corporation) to enable or assist an employee to buy shares from the lender/creditor corporation or from a corporation related to the lender/creditor corporation to be held for the employee's own benefit; or
3. the loan is in respect of an employee of the lender/creditor to enable or assist the employee to acquire a motor vehicle to be used by the employee in the performance of the employee's duties.

Imputed Interest on Shareholder and Employee Loans

Shareholder Loan

Even where a loan is not included in your income because you meet one of the exceptions discussed above, you may be deemed to include a taxable benefit in your income with respect to an imputed interest benefit.

If you are a shareholder of a corporation and received a loan or incurred other forms of debt by virtue of the shareholding from the corporation or a related corporation, you will be deemed to have received a taxable interest benefit, computing similarly to that noted above for employee loans. The benefit will be the difference between the interest on the loan or debt computed at the prescribed rate and the interest for the year actually paid within 30 days of the end of the year.

There is no deemed interest benefit for shareholders or employees where the interest rate on the loan is equal to or greater than the interest rate that would have been negotiated between arm's length parties at the time the loan was made, having regard to all the circumstances, including the terms and conditions of the loan. Note however, that this interest benefit does not apply to the portion of any loan or debt that has been included in your income due to the shareholder loan benefit rule discussed above.

Both Employee and Shareholder

Where you are both a shareholder and an employee of the same company (or related companies), and you receive a loan, it is important to determine whether the loan is received in your capacity as shareholder or employee. This is a question of fact in each case, and will depend on such things as whether others who are not both shareholders and employees can receive such loans as one or the other. If your loan is received as a shareholder, it may be subject to income inclusion if not repaid within two years (discussed above) and may in any case be subject to the imputed interest rules if interest is charged at less than prescribed rates (also discussed above). If the loan is received as an employee, it may escape inclusion in income if it meets the exceptions.

Offsetting deduction for imputed interest expense

If you are required to include in your income a taxable imputed interest benefit in respect of a loan or debt, and the loan or debt has been used for the purpose of earning income from a business or property, you will be entitled to an offsetting deduction equal to the amount of the benefit. However, where the loan or debt is deemed to have been received or incurred by another person you will be denied the deduction.

For example, if your spouse receives an interest-free loan from your employer to purchase shares, you will be deemed to have received a taxable benefit, however, you are not entitled to the deduction as the loan was not used by you. It appears, however, that your spouse may be entitled to the interest deduction.

If you are required to include in your income a taxable benefit as a result of receiving an interest-free or low-interest loan, by virtue of your employment, for the purpose of purchasing an automobile, and you are eligible to deduct expenses under either the salespersons's or travel expense rules, you will also be entitled to an offsetting deduction.