



Thinking About Loaning Yourself Money From Your Corporation? Read This First.

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“How can I pay the least amount of tax possible on my income?” It’s probably the most fundamental tax planning question, and in the case of distributing funds from your corporation the answer is far from simple. Normally, you might pay a dividend from your corporation, or you might pay yourself a salary. Both are taxable to you personally, though your corporation can deduct your salary from its income for tax purposes. Another avenue that people have attempted over the years (with mixed results) is loaning themselves money from their corporation. Since the loan you receive would not normally be taxable to

you like a dividend or salary, it would seem that you have outmaneuvered the taxman. However, this has, of course, been anticipated and thus there are traps that could eliminate the tax advantages of such a strategy. This article discusses these rules and describes, basically, what you can and cannot do.

Overview

The federal Income Tax Act contains two main rules that are intended to prevent shareholders and employees of a corporation from avoiding tax on a distribution from a corporation by receiving the funds via a loan or advance from the corporation.

First, if as a shareholder of a corporation you receive a loan or advance from the corporation, the amount of the debt may be included in your income for tax purposes—this obviously eliminates the tax burden you would have avoided. However, there are rules and exceptions to be aware of that are discussed below.

Second, if the above rule does not apply, if you received a loan or advance as either a shareholder or employee of the corporation, you may be required to pay personal income tax on a taxable benefit that represents interest on the loan from the corporation. This rule is also discussed below.

Loan Amount Included in Income

Where you become indebted to a particular corporation, a related corporation, or a partnership of which a corporation is a member, the amount of the loan may be included in your income. For the rule to apply, you must be:

- a shareholder of the particular corporation,
- “connected” with a shareholder of the particular corporation, or
- a member of a partnership or beneficiary of a trust that is a shareholder of the particular corporation.

If you receive a loan or advance from any of the above entities, the amount of the indebtedness will be included in your income and you will be required to pay tax on that income. This can apply not only to common forms of debt such as a loan in cash, but also to other indebtedness such as an unpaid purchase price for goods and services received.

Exceptions

There are several exceptions to the above rule:

- **Ordinary course of business.** An exception arises where the indebtedness arose in the ordinary course of the creditor’s business, or a loan was made in the ordinary course of the lender’s ordinary business of lending money, if arrangements were made at the time the indebtedness arose for repayment within a reasonable time.
- **Employee situations.** An exception arises in certain employee situations: where the employee is not a “specified employee” (basically this depends on whether less than 10% of the shares of any class are held); or in situations pertaining to the acquisition of a dwelling/treasury shares/motor vehicle. In all of these instances, the loan must be made in the person’s capacity as an employee.
- **Repayment within one year.** An exception is provided where indebtedness is repaid one year after the end of taxation year of the creditor in which the indebtedness arose. However, the repayment must not be part of a series of loans and repayments. This prevents you from repaying the

amount within one year, and then immediately borrowing the amount back to restart the clock.

Note that even if the principal amount of the loan is not included in income, you may still be liable to pay tax on an interest benefit, which is discussed further below.

Subsequent Repayment

If the amount of a loan is included in your income per the rules discussed above and you subsequently repay the loan, you can deduct the amount of the repayment from your income for tax purposes in the year in which the repayment is made. However, you cannot make such a deduction if it is established by subsequent events or otherwise that the repayment was made as part of a series of loans or other transactions and repayments. For example, the deduction may be denied when a repayment is of a temporary 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.

Loan Forgiveness

Where your shareholder loan is settled or extinguished by payment of less than the amount of the outstanding obligation, the forgiven amount of the loan is included in your income.

Imputed Interest Benefit

As mentioned previously, even if the amount of the loan is not included in your income, the Income Tax Act contains rules that apply an imputed taxable interest benefit to you personally. This rule applies to loans received by you as shareholder, but it can also apply to loans received by a person in their capacity as an employee as well. For the purposes of this article, only the rules for shareholder loans are discussed.

This rule applies to indebtedness incurred by you by virtue of your shareholder status in a corporation. The amount of the benefit is included in your income for tax purposes. Like the first rule discussed above, the imputed interest benefit may apply if you are:

- a shareholder of the corporation;
- “connected” with a shareholder of the corporation; or

- a member of a partnership, or beneficiary of a trust, that was a shareholder of the corporation.

The taxable benefit is determined by applying imputed interest at the rate prescribed to the principal balance. The resulting amount is reduced by any interest you paid on the debt and reimbursements made within 30 days after the end of the year. Of course, this taxable benefit will be included in your income every year in which a debt is outstanding.

The prescribed rates are adjusted quarterly in response to the average rate of 90-day Treasury Bills during the first month of the preceding quarter. Predictably, due to the current environment of rising interest rates, the prescribed rate for this rule has also been increasing lately. At the beginning of 2022, the rate was 1%, but it has so far increased to 3%. Thus, the tax cost of maintaining such a loan is becoming more expensive.

Offsetting Deduction for Income-Producing Loan

To the extent that there has been an imputed taxable benefit you may be eligible for an offsetting deduction where the proceeds have been used for income-earning purposes.

In a general sense, interest on borrowed money used for the purpose of earning income from a business or property or to acquire certain annuities may be

deducted in certain circumstances. Therefore, if you are deemed to have received an imputed benefit in respect of a loan or debt and can demonstrate that the loan or debt has been used for income-producing purposes, you can make an offsetting deduction equal to the amount of the benefit.

Effect on Your Other Compensation

Since this rule applies to all forms of indebtedness, it could have direct consequences on the common practice drawing funds out of the corporation through the shareholders' advance accounts, with a subsequent close-out to salary or dividends. If the advances remain on the books, the imputed interest benefit may be a valid concern. Thus, it is important that the dividend or salary is made legally official in a timely manner in order to close out the advance account.

Final Thoughts

There is no way to distribute funds from a corporation that would be the most optimal from an income tax perspective. As is evident, loaning the money could invoke rules that would reduce or eliminate any tax advantages that such a strategy would otherwise create. The remaining options are generally paying a dividend or salary. Distinguishing between the two options is also often a complicated decision that will depend on your unique circumstances.