TAX NEWSLETTER

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SHAREHOLDER BENEFITS AND LOANS

There are various provisions in the Income Tax Act that prevent you from taking money or property of a corporation on a tax-free basis. Two of the main provisions are discussed below. One applies to shareholder benefits, and the other to certain shareholder loans.

Shareholder benefit

If you are a shareholder of a corporation and receive a benefit from the corporation, the value of the benefit is included in your income. For example, if your corporation pays for your personal-use car, or a vacation property or renovations on your home, you will be required to recognize this benefit for income tax purposes.

This rule also provides that a person who receives a benefit from a corporation in *contemplation* of being a shareholder must also include the benefit in income. So the rule can catch prospective shareholders, and not only current shareholders.

There are some exceptions to the shareholder benefit rule. For example, a dividend is not a shareholder benefit, and is taxed more lightly to the recipient shareholder than regular income, due to the dividend tax credit. Also, if the corporation grants a right to all common shareholders to acquire additional shares, the grant of the rights is not normally a taxable benefit.

One of the main problems with the shareholder benefit rule is that the corporation cannot deduct the benefit in computing its income. This means that there is an element of double taxation.

If you are both a shareholder and an employee of the corporation, the payment of salary, wages and employment benefits is included as employment income and not shareholder benefits. The distinction is quite important, since the corporation can normally deduct these amounts, but not shareholder benefits.

Shareholder loans

There is a fairly onerous rule that provides that if a shareholder of a corporation, or a person "connected" with that shareholder, receives a loan from the corporation, the *full amount of the loan* is included in the person's income. As with the shareholder benefit rules, the corporation cannot deduct the loan in computing its income. However, as discussed below, the shareholder or connected person can claim a deduction when the loan is repaid.

For these purposes, a person is considered "connected" with a shareholder if the person does not deal at arm's length with the shareholder or is affiliated with the shareholder. The "arm's length" and "affiliated" rules are quite complex, but they include the following persons (among others):

- Individuals related to the shareholder for tax purposes, which include lineal descendants and ascendants (e.g. parents, grandparents, children, and grandchildren), spouses and common-law partners, siblings and siblings-in-law, step-

parents and step-children and parents-in-law. Interestingly, they do not include uncles, aunts, nieces, nephews, and cousins;

- Corporations that are controlled by the shareholder;
- Corporations that are controlled by a person related to the shareholder; and
- A trust of which the shareholder is a beneficiary.

Exceptions to the shareholder loan rule

Fortunately, there are several exceptions, as discussed below. Where an exception applies, the principal amount of the loan is not included in the shareholder's income.

- The shareholder loan rule does not apply if the shareholder is a Canadian resident corporation.
- The rule does not apply to loans between non-residents.
- The rule does not apply to a debt that arose in the ordinary course of the corporation's business or a loan made in the ordinary course of its 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.
- The rule does not apply if the loan is repaid within one year after the end of the corporation's taxation year in which the loan was made. For example, if the corporation has a December 31 year-end and lends you money in January 2017, you have until December 31, 2018 to repay to avoid inclusion of the loan in your income. However, the repayment must not be part of a series of loans (or other transactions) and repayments.

Lastly, there are exceptions that apply to shareholders that are also employees of the corporation. These are discussed under the next subheading.

Loans to shareholder / employee

If you are both a shareholder and an employee of the corporation, the shareholder loan rule does not apply in any of the following situations:

- You are **not** a "specified employee" of the corporation. Generally, in order to **not** be considered a specified employee, you must deal at arm's length with the corporation and own less than 10% of the shares of any class of the corporation (and for these purposes, you are deemed to own shares owned by non-arm's length persons like your spouse, children, and so on);
- The loan is used to purchase a home in which you will live;
- The loan is used to purchase shares from the corporation or a corporation related to it (the shares must be newly issued by the corporation, and not, for example, purchased from a previous shareholder); or
- The loan is used to purchase a motor vehicle to be used in your employment duties.

However, the above exceptions apply **only if**:

- It is reasonable to conclude that you received the loan because of your employment and not because of your shareholdings; and

- When the loan was made, *bona fide* arrangements were made for repayment of the loan or debt within a reasonable time.

Deduction upon repayment

If the loan was included in your income in one year, you can claim a deduction when you repay the loan. The deduction is allowed in the year of repayment (or years of repayment, if you repay the loan in instalments over several years).

However, a deduction is not allowed if it is established by subsequent events that the repayment was part of a series of loans or other transactions and repayments. For example, if you receive a loan in one year, repay it later, and then receive another loan of the same amount, you may be denied the deduction of the repayment.

Back-to-back loans

The 2016 Federal Budget extended the shareholder loan rules to certain "back-to-back" loans. For example, the rules can apply where a corporation in which you are a shareholder lends money to a third party, which in turn lends money to you. The rules can also apply where the corporation provides security to the third party, and it is reasonable to conclude that the security was provided so that the third party would lend you money.

The rules can extend to multiple “intermediaries”, so that they can apply where the corporation lends money to a third party, which lends money to another party, and so on, where the chain ultimately results in you receiving a loan from a third party.

Where the back-to-back loan rule applies, you are generally treated as if you received the loan from the corporation, so that it will be included in your income unless one of the exceptions applies.

Deemed Interest Benefit Where Shareholder Loan Rule Does Not Apply

If the loan is not included in your income because one of the exceptions applies, you may be assessed an imputed interest benefit if the loan is interest-free or carries a rate of interest that is less than the prescribed rate of interest under the Income Tax Act. The prescribed rate is set quarterly, and is based on 90-day Federal Treasury bill rates, so that it a relatively low rate.

For the current quarter ending on March 31, 2017, the prescribed rate is 1%, and it has been that amount for several years.

The interest benefit is computed by applying the prescribed rate to the principal amount of the loan outstanding during the relevant year. The benefit is reduced by the interest you pay on the loan, as long as it is paid in the year or by January 30 of the following year. If you do not pay the interest or are late paying it, the benefit is not reduced.

> *Example:*
>
> *You are a shareholder of a corporation and it lends you $100,000 interest-free on January 1 of this year. The principal amount of the loan is not included in your income under the shareholder loan rules because you fall within one of the exceptions discussed above.*
>
> *The loan remains outstanding for the year. Assume that the prescribed rate of interest throughout the year remains at 1%.*

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You will include in income 1% of $100,000, or $1,000. The inclusion will be reduced if you actually pay interest in the year or by January 30 of the next.

TAXATION OF TRUSTS AND BENEFICIARIES

There are various tax rules that apply to trusts and their beneficiaries. Below is a summary of some of the main rules.

Tax rates for trusts

Most trusts are subject to a flat tax equal to the highest marginal tax rate – currently 33% federally plus the applicable provincial rate. As a result, there is typically no tax savings if income is earned and retained in a trust.

There are two exceptions to the high flat tax. The first applies to a "graduated rate estate", which is a deceased individual's estate for up to 36 months after death (certain other conditions apply). The second applies to a "qualified disability trust", which is a testamentary trust that has a beneficiary who qualifies for the disability tax credit (again, certain other conditions apply). Generally, a testamentary trust is one that is created upon your death, such as a trust created by your will. Graduated rate estates and qualified disability trusts are subject to the same graduated tax rates that apply to individual (e.g. 15% on the first $45,916 in 2017).

When an amount of income of a trust is paid or payable to a beneficiary in a year, it can normally deduct the amount. The beneficiary in turn includes the amount in income. As a result, there is generally no double taxation of the same income.

Taxation year

All personal trusts other than graduated rate estates have a calendar year taxation year.

A graduated rate estate can have an off-calendar year taxation year for the first 36 months, after which, if it is still in existence, it will have a calendar year end. For example, if an individual died on June 30, 2016, the estate could have its first three taxation years ending on June 30 of 2017, 2018 and 2019, respectively, with the next taxation year ending on December 31, 2019. Alternatively, the estate could have calendar year ends right from the start, so that its first taxation year would be short and would end on December 31, 2016, and all subsequent taxation years would be calendar years. The decision as to the taxation year would normally be made by the executor or administrator of the estate.

Note that before 2016, all testamentary trusts could have off-calendar year taxation years.

Deemed disposition rules

Most personal trusts are subject to a deemed disposition of their property at fair market value every 21 years. The deemed disposition ensures that accrued capital gains cannot be deferred indefinitely. At the time of the deemed disposition, the cost of the properties is also adjusted to fair market value.

There are some exceptions where the deemed disposition occurs at a different time. For example, under certain spousal (or common-law partner) trusts, the first deemed disposition occurs at the death of the spouse beneficiary. Similarly, for an *alter ego* trust (basically a trust in which you are the settlor and sole beneficiary during your lifetime), the

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first deemed disposition occurs at the time of your death.

Tax-free rollover for property distributed out of trust

A personal trust can normally distribute its properties to its beneficiaries on a tax-free "rollover" basis, at the original cost. Thus, for example, a trust can avoid the deemed disposition referred to above by transferring out its property tax-free to a beneficiary before the deemed disposition date.

The transfer of the property out of the trust takes place at the cost of the property, which also becomes the cost to the beneficiary. Therefore, accrued gains can be eventually taxed if and when the beneficiary disposes of the property.

Again, there are some exceptions to the tax-free rollover. For example, the rollover does not apply to distributions to non-resident beneficiaries. It does not apply to a spousal trust if property is distributed to someone other than the spouse beneficiary during his or her lifetime. In these cases, the distribution takes place at fair market value, and therefore will trigger accrued gains (or in some cases losses).

Taxation of beneficiary

As mentioned, when income of a trust is paid or payable to a beneficiary in a taxation year, it is included in the beneficiary's income for the year. Most forms of income can retain their character. For example, a trust can designate that taxable capital gains and dividends of the trust paid to a beneficiary retain the same character in the hands of the beneficiary, so as to benefit from the reduced taxation that applies to these kinds of income.

Trust losses cannot be flowed out to beneficiaries and therefore always remain losses of the trust.

However, a trust with income in the current year can carry forward losses from previous years to offset the income inclusion in the current year. The trust can then pay out the income to a beneficiary in the current year, and make a special designation that has the effect of not taxing the beneficiary on that income (since it was already included in the trust's income, although offset by the losses). The designation is valid only if the trust's "taxable income" is nil for the year – which basically means that the income is fully offset by the loss carryforward.

Example:

A trust has two beneficiaries. In the current year, it earns $20,000 of interest income. The trust has $20,000 of losses from previous years which it carries forward to the current year, resulting in nil taxable income for the trust.

The trust distributes $10,000 to each beneficiary and makes the designation. Each beneficiary receives the amount free of tax. And, of course, the trust will pay no tax because of the loss carryforward.

In some cases, income *retained* in the trust can be subject to tax in the beneficiary's hands. This can be beneficial if the beneficiary is subject to lower tax rates than the trust. This rule can apply to trusts that make a "preferred beneficiary election", which can be made in certain circumstances where the beneficiary is entitled to the disability tax credit. A similar rule can apply in respect of trust income retained in the trust, where the right to the amount of income vests in a beneficiary under the age of 21 (in general terms, this means

that the beneficiary is unconditionally entitled to receive the amount at some point in time in the future, even though it is not paid or payable now).

2017 AUTOMOBILE RATES FOR TAX PURPOSES

Each December, the Department of Finance publishes certain amounts and rates that apply for the purposes of computing automobile benefits for employees and the amounts that may be deducted for the use of a car in business or employment activities. The Department recently released the rates for 2017.

If your employer pays you an amount for the personal use of a car, you are normally assessed a taxable benefit based on the number of personal kilometres driven in the year. For 2017, the benefit is reduced from the 2016 rate by 1 cent to 25 cents per kilometre. For employees who are employed principally in selling or leasing automobiles, the rate is reduced from 23 cents per kilometre amount for 2016 to 22 cents for 2017.

Employers can normally deduct car allowances paid to employees for work-related travel. However, there is a monetary limit to the deduction. The limit for 2017 is the same as for 2016: 54 cents per kilometre for the first 5,000 kilometres driven in the year, and 48 cents per kilometre for each additional kilometre. In the Northwest Territories, Nunavut and Yukon, the tax-exempt allowance is 4 cents higher, and remains 58 cents per kilometre for the first 5,000 kilometres driven, and 52 cents per kilometre for each additional kilometre.

Monetary limits for deductible car expenses remain the same for 2017, and the same limits have been in place since 2001. Tax depreciation or capital cost allowance (CCA) is limited to the first $30,000 cost of the car (plus GST/HST and any provincial sales tax) for purchases in 2017. The deduction of lease payments is limited to $800 per 30-day period and is reduced further if the cost of the car exceeds the CCA ceiling. The deduction of interest on car loans remains limited to $300 per 30-day period. In all cases, the deduction must be pro-rated, based on your work or business use relative to total use of the car.

AROUND THE COURTS

Small business deduction denied

A Canadian-controlled private corporation (CCPC) can claim the small business deduction to reduce its federal tax rate from the general 15% rate to 10.5%. The corresponding provincial rate is also reduced. However, the federal small business deduction applies only to the first $500,000 of *active business income* per year (with adjustments in certain cases).

For these purposes, active business income of a corporation does not include income from a “specified investment business”, which generally means a business carried on by the corporation, the principal purpose of which is to derive income from property such as interest, dividends, rents and royalties. There are a couple of exceptions – for example, if the corporation employs more than five full-time employees throughout the relevant year, the business will not be a specified investment business, meaning that the business income can qualify for the small business deduction.

In the recent *Skartaris Holdings* case, the corporation was a CCPC that purchased eleven houses over a 10-year period. The

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main shareholder of the corporation stated that the business of the corporation involved the purchase of properties with a view of renovating them and selling them at a profit. As such, he took the position that it carried on an active business and could claim the small business deduction.

However, until the properties were sold, they were rented out, so the corporation earned rental income. In fact, in the two taxation years that were at issue, all of the corporation's revenues were earned from renting out the properties and none from the sale of properties. The CRA assessed the corporation to deny the small business deduction on the grounds that it carried on a specified investment business in those two years.

On the taxpayer's appeal to the Tax Court of Canada, the Court upheld the CRA decision. Basically, the Court held that the documentary evidence at hand did not support the taxpayer's position that it was in the business of buying and selling properties, and the shareholder's stated purpose was not backed up by the facts. Accordingly, its main business was earning rental income, and it did not have more than five-full time employees. Therefore, it was carrying on a "specified investment business" and the small business deduction was denied.

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This letter summarizes recent tax developments and tax planning opportunities; however, we recommend that you consult with an expert before embarking on any of the suggestions contained in this letter, which are appropriate to your own specific requirements.