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DOCNUM 2012-0464411I7
REFDATE 121212
SUBJECT Indirect Benefit
SECTION 15(1), 15(2), 56(2), 80.4(2), 105(1), 246(1)

PRINCIPAL ISSUES: Is a benefit conferred on an individual shareholder as a result of an interest-free inter-corporate loan?
POSITION: Not in these circumstances.
REASONS: Benefit not supported by current legislation.

December 12, 2012

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HEADQUARTERS
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2012-046441

Interest Free Loan to a Canadian Corporation

We are writing in reply to your memorandum of October 2, 2012 in which you requested our views concerning the application of certain benefit provisions to the facts set forth below. In this letter, unless otherwise stated all statutory references are to the Income Tax Act (Canada).

FACTS

In simplified terms, the situation presented is one where Mr. A is the trustee and a discretionary beneficiary of Trust. The Trust owns all of the shares of Holdco. In turn, Holdco is a significant partner of Partnership (XXXXXXXXXX%), which carries on an active business operation in Canada in partnership with XXXXXXXXXX related corporations. (footnote 1)

The Partnership borrows $XXXXXXXXXX from a bank and distributes the borrowed funds to the partners. Holdco then uses the borrowed funds it received to make an interest-free loan to a corporation (Investco) all of the shares of which are owned by Mr. A personally. Investco uses the borrowed funds to earn investment income.

Holdco and Investco are both taxable Canadian corporations that are private corporations.

AUDIT PROPOSAL

You have proposed to deny a supposed interest deduction claimed by Partnership (including a $XXXXXXXXXX banker's acceptance fee that was deducted as interest) and, as we understand it, to include an imputed interest benefit in the hands of Mr. A pursuant to a combination of 80.4(2) and 246(1). As well, you appear to be considering whether the amount of the loan can itself be included in the income of Mr. A pursuant to a combination of 15(1) and 246(1) or 105(1).

OUR VIEW

(a) Treatment of Partnership Interest Expense

Based on the facts provided, we agree that the distribution by the Partnership to the partners of loan proceeds in excess of the capital accounts of the partners may prevent the deduction by the Partnership of interest on the loan. See, for example, paragraphs 23 and 24 of IT-533 "Interest Deductibility and Related Issues" (2003/10/31) that describe the deduction permitted for interest on borrowed funds used to "fill the hole" of capital, an exception to the direct use of borrowed funds requirement of paragraph 20(1)(c). (footnote 2)

In the event that the expense claimed is not in respect of interest but, instead and as suggested in paragraph 8 of your October 2, 2012 memorandum, is in respect of a "banker's acceptance fee", its deduction may be governed by paragraph 20(1)(e) in respect of an expense incurred in the course of borrowing money. In that event and if otherwise allowed, the deduction would be one that is amortized over a 5 year period. In Document 2005-0161661e5 (2007/03/14) we stated that where a deduction of interest would be allowed under paragraph 20(1)(c) based on a permitted "indirect use" of borrowed funds (i.e. "fill the hole" of capital), a similar permitted use will be available in respect of a deduction claimed under paragraph 20(1)(e). However, we do not appear to have yet considered whether the fee that is entitled to the amortized deduction under paragraph 20(1)(e) will be limited and proportionate to the portion of the borrowed funds that are considered to "fill the hole" of capital (as described in the preceding paragraph) or if no proration will apply to such a fee. If you would like us to consider this issue further, please contact us at your convenience.

(b) Is Loan Amount a Benefit Included in the Income of Mr. A

As pointed out in your memorandum, since the amount advanced by Holdco to Investco was a "loan", there is no "payment" that would be considered to have been made that would allow the provisions of 56(2) to apply to include the loan amount in the income of Mr. A (i.e. on the basis that a payment was made with the concurrence of Mr. A for the benefit of Mr. A or Investco). For example, in Dunkelman v. Minister of National Revenue, 59 DTC 1242 (Ex. Ct.), with reference to whether a loan constituted a "transfer of property" for the purpose being considered, the court stated:

"... in my opinion, it requires an unusual and unnatural use of the words "has transferred property" to include the making of this loan. For who, having borrowed money and knowing he must repay it, would use such an expression to describe what the lender has done? Or what lender thinks or speaks of having transferred his property, when what he has done is to lend it? Or again, what casual observer would say that the lender, by lending, "has transferred property"? ... I am, accordingly, of the opinion that the making of the loan in question was not a transaction within the meaning of the expression "has transferred property" and that s. 22(1) does not apply."

Also, for the purposes of 15(1) we have generally not considered that a benefit is conferred on a shareholder by reason of the making of a loan to that shareholder. Exceptions may apply where, for example, there is no reasonable expectation of repayment of the loan amount so that the value of the lender corporation itself can be said to have been reduced and that value then appropriated, generally, to the benefit of the loan recipient. XXXXXXXXXX

Somewhat similarly, see Document 2005-0140961C6 where we considered an interest-free loan that was made by a corporation owned by father to a corporation owned by his son. Again, in that case we concluded that none of 246(1), 15(1) or 56(2) would apply.

In this case a more substantial problem with the application of 15(1) is the fact the loan has been made to Investco, which is not, itself, a shareholder of Holdco. Any appropriation benefit alleged to have been obtained by Mr. A would then have to be supported on the basis of an indirect benefit – for example, on the basis that by moving funds to Investco, a corporation owned by Mr. A, and permanently removing such value from Holdco, Mr. A has, himself, appropriated value from Holdco for his personal benefit as a shareholder of Holdco. However, complicating this approach is the fact that it is the Trust, rather than Mr. A personally, that is the shareholder of Holdco and it is the Trust, and not Mr. A himself, that would effectively be conferring the benefit on Mr. A.

In this case there has been no suggestion that the loan advance to Investco is in jeopardy of repayment such that value has been permanently shifted from Holdco to Investco. Accordingly, it is our view that there is no benefit of the loan amount that has been received by Mr. A that would be included in his income.

We have considered the decision in Massicotte v. The Queen, 2008 DTC 6610 (FCA) aff'g 2008 DTC 3132 (TCC), which may be authority for an assessment being made under 246(1) of a benefit conferred on a person who is a shareholder of a first tier corporation and who obtains the benefit from a subsidiary of that first tier corporation (such that the recipient of the benefit is not a direct shareholder of the corporation that confers the benefit). However, the case we are considering does not involve a holder of shares of a parent corporation obtaining a benefit from a subsidiary corporation. Also, as mentioned, there is no suggestion in this case that the making of the loan would result in an absolute reduction in the value of Holdco so as to support the finding that the loan amount was, itself, a benefit.

(c) Interest Element Benefit to Mr. A

80.4(2) provides for an interest benefit to be included in the income of a shareholder of a corporation who, by virtue of the shareholding, receives a loan from the corporation. The benefit also extends to persons who receive such a loan that are connected to shareholders of the lender corporation. However, the provision specifically excludes any such benefit from being imposed where the person who receives the loan, being either the shareholder or a person connected to the shareholder, is a corporation resident in Canada.

Based on the foregoing, no interest benefit under 80.4(2) would arise in respect of a loan from Holdco to Investco.

Since the inter-corporate loan does not give rise to an interest benefit pursuant to 80.4(2), it is our view that there is no "benefit" amount that would otherwise be considered to be paid to Mr. A and included in his income for the purposes of 246(1). Also, as discussed in the preceding paragraph (b) above, it is our view that subsection 246(1) does not permit characterizing a loan to a corporation as, instead, one made to the individual who controls that corporation in order to then calculate a benefit under paragraph 80.4(2).

(d) 105(1) Benefit to Mr. A

You have submitted that Mr. A, as trustee of the shareholder of Holdco, has participated in the conferral by Holdco of an advantage that will benefit him personally, at the expense of the Trust; that is, monies are not being invested by Holdco in an arrangement that will earn a return for Holdco. Accordingly, it is submitted by Audit that such benefit may be included in the income of Mr. A pursuant to 105(1). That provision includes in a taxpayer’s income the value of any benefit to the taxpayer from or under a trust.

This provision has not been considered often but, in somewhat similar circumstances quite long ago, was decided in favor of the taxpayer. In Cooper v. The Queen, 88 DTC 6525 (FCTD) the plaintiff, who was a co-executor of his father’s estate with his mother, received an interest-free loan from the estate. The Minister assessed a benefit under 105(1). The headnote of the decision reads:

"The taxpayer entered into an arrangement that might be considered as a "benefit" to the man in the street; however, it did not necessarily follow that he had received a taxable benefit within the meaning of the Income Tax Act. Prior to the enactment of section 80.4, which only applies to corporation officers and shareholders, there was no specific provision of the Act relating to benefits from interest-free loans or loans at less than market interest rates. Interest-free loans were not taxable benefits before the enactment of section 80.4. Section 105, and other relevant provisions, have been in existence without affecting interest-free loans for too long to assume that they were originally intended to include the value of interest-free loans into taxable income."

It does not appear that circumstances have changed and no similar case has come before the courts for their consideration since that time. Accordingly, it is our view that 105(1) would not be considered favorably as a ground for including a foregone interest benefit in the income of Mr. A.

CONCLUSION

It is our view that the making of the interest-free loan by Holdco to Investco does not give rise to a taxable benefit to Mr. A.

We trust that our comments will be of assistance.

Yours truly,

for Director
Reorganizations Division
Income Tax Rulings Directorate
Legislative Policy and Regulatory Affairs Branch

FOOTNOTES

Note to reader: Because of our system requirements, the footnotes contained in the original document are shown below instead:

1 The related corporations are owned by or for the benefit of persons related to Mr. A.

2 That paragraph reads:

Exceptions to the direct use test – borrowed money used by a corporation to redeem shares, return capital or pay dividends

23. Interest expense on borrowed money used to redeem shares or return capital can be an exception to the direct use test. In connection with this use, the purpose test will be met if the borrowed money replaces capital (contributed capital or accumulated profits) that was being used for purposes that would have qualified for interest deductibility had the capital been borrowed money (eligible purposes). Consistent with the concept of filling the hole, contributed capital generally means the funds provided by the shareholders to commence, or otherwise further, the carrying on of the business. ...

The key concept in this context remains that of "filling the hole" of capital withdrawn from the business.

Exceptions to the direct use test – borrowed money used by a partnership to return capital to a partner

24. The concepts described in paragraph 23 are equally applicable where a

partnership borrows money to return capital to a partner. In such a case, the "hole that can be filled" generally consists of the capital contributed by the partner to commence or further the carrying on of the business, plus any partnership income less any partnership losses allocated to the partner, and less any previous distributions to the partner. Generally, the balance in the partner's capital account would represent this amount.