



Normal Borrowing by CCPC Owners Can Create an Income Inclusion

On December 15, Budget 2016's extension of the back-to-back loan rules received royal assent. These rules are applicable to all loans outstanding on March 21, 2016 and all future loans, and they may have an unintended consequence for individual shareholders of a CCPC who borrow money from a third party. Pursuant to subsection 15(2.17), if the corporation guarantees a loan obtained by one of its shareholders (or a connected individual) from a third party and pledges property as security, the loan can be deemed to be a loan made directly from the corporation to the individual shareholder, causing a subsection 15(2) income inclusion for the individual shareholder in the amount of the loan. A revision of the standard wording used by financial institutions in guarantees and related security agreements would solve this problem.

Subsection 15(2) may apply when an individual shareholder of a corporation (or an individual who is connected with a shareholder) owes a debt to the corporation. The consequence is that the indebtedness is included in the income of the debtor if it is not repaid by the end of the next fiscal year of the corporation following the fiscal year in which the indebtedness arose. The government's concern was that the pre-budget rules allowed an individual shareholder to avoid the income inclusion by interposing between the shareholder and the corporation a third-party lender that was not connected to the shareholder. However, the new tax rules do more than close down this planning strategy: they catch normal commercial loans from financial institutions to individuals when certain types of loan security have been provided.

In general terms, the back-to-back loan rules in subsections 15(2.16) to (2.192) apply (causing the subsection 15(2) income inclusion) when a funder is owed an amount under a funding arrangement by an individual shareholder of a Canadian-resident corporation and the existence of a specified right is required under the terms of the funding arrangement. "Funder" is defined in subsection 15(2.192) to include a particular person or partnership that is not connected with the shareholder, such as a financial institution. "Specified right" is defined in subsection 18(5) as a right to (1) mortgage, hypothecate, assign, pledge, or in any way encumber the property to secure payment of an obligation other than the shareholder debt, or (2) use, invest, sell, or otherwise dispose of, or in any way alienate, the property unless all of the net proceeds from doing so are used to repay the shareholder debt. The key consideration is that the secured property in question can be used only to repay the shareholder debt (which is defined in paragraph 15(2.16)(a)).

Does a specified right include a corporation's pledge of security for its guarantee of a debt of its shareholder? The Department of Finance's explanatory notes to subsections 18(6) and 15(2.16) suggest that it does not, but the standard wording of most guarantees and related security agreements used by financial institutions might fall under point (1) and/or point (2) above. The reason for this is that the typical wording in these documents is not limited to the specific shareholder debt.

A specified right could arise in the following situations:

- As indicated above, most guarantees and related security agreements contain broad language that covers not just the present debt but also any future indebtedness of the individual shareholder. Because of this breadth of coverage, a specified right arises, and with it the tax problem.
- In certain circumstances, a single security document (given by the corporation to the third party) can cover both (1) the individual shareholder's loan from the third party and (2) an existing operating loan given by the third party to the corporation. Because the single security document covers more than just the individual shareholder's loan, a specified right arises.

It is possible to put in place a guarantee and related security agreements that fall outside the definition of "specified right." Such documentation must be limited to having the corporation guarantee only the particular indebtedness of the individual shareholder to the funder. Similarly, the security granted by the corporation should be limited to the corporation's guarantee obligation respecting the particular debt. Of course, the party providing the funds must be willing to agree to the change in wording.

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