

Docket: 2011-1874(IT)G

BETWEEN:

MICHAEL MAST,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

Appeals heard on March 14, 2013, at Montreal, Quebec.

Before: The Honourable Justice François Angers

Appearances:

Counsel for the Appellant: Philip Aspler

Counsel for the Respondent: Simon Petit

JUDGMENT

The appeals from the reassessments made under the *Income Tax Act* in respect of the 2006, 2007 and 2008 taxation years are dismissed, with costs, in accordance with the attached Reasons for Judgment.

Signed at Ottawa, Canada, this 28th day of October 2013.

"François Angers"

Angers J.

Citation: 2013 TCC 309
Date: 20131028
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BETWEEN:

MICHAEL MAST,

Appellant,

and

HER MAJESTY THE QUEEN,

Respondent.

REASONS FOR JUDGMENT

Angers J.

[1] By notices dated March 8, 2010, the Minister of National Revenue (the Minister) reassessed the appellant for his 2006, 2007 and 2008 taxation years, including in his income the amounts of \$786,828, \$97,551 and \$53,260 for each of those taxation years respectively pursuant to paragraph 15(2) of the *Income Tax Act* (the *Act*). After the filing of notices of objection with respect to the reassessments, the Minister confirmed the reassessments on March 16, 2011. Hence these appeals.

[2] At the beginning of the hearing, the appellant was granted permission to file a re-amended notice of appeal dated March 5, 2013.

[3] The appellant was at all relevant times an employee as well as the sole officer, director and shareholder of Michael Mast Investments Ltd. (Mastco). It is to be noted that the corporate name of Mastco was changed to 2038617 Canada Inc. by Articles of Amendment dated December 2, 2011. For the purpose of these reasons, I will nonetheless still refer to that entity as Mastco.

[4] Mastco is in the packaging business. It operates out of the appellant's home. It has one other employee in the appellant's wife, who has a background in design and assists the business with regard to design in addition to exercising administrative

functions. Her salary was \$39,000 a year. On occasion, their son would also work for Mastco.

[5] In 2004 or 2005, the appellant decided to build his dream home. He spoke with his accountant regarding how he could finance the construction and was told he could do it by borrowing money from Mastco. A resolution of the board of directors of Mastco passed on April 1, 2004 authorized Mastco to enter into a loan agreement with the appellant and his wife so that they could borrow up to one million dollars to enable them to acquire a dwelling for their own habitation. The loan agreement, signed on the same day, contained the following terms:

Loan Amount: The lender will make available to the borrowers a maximum amount of \$1,000,000. Funds will be advanced as required to fund the acquisition of land and the cost of building a new house located at 93 Rue Oxford, Hudson, Quebec.

Loan Purpose: The purpose of the loan is to allow the lender's president and his spouse to acquire a dwelling for their own habitation.

Loan Repayment: The loan will be repayable over a term of 10 years commencing with the company's fiscal year ending March 31, 2008. Annual principal repayments shall be not less than \$50,000. If the property is sold prior to complete repayment of the loan, the balance outstanding at the date of the sale shall become immediately due and payable.

Loan Interest: This loan shall be non-interest bearing.

[6] No other security document was given to Mastco by the appellant. At the time the loan agreement was signed, the appellant did not foresee any problem in paying back the loan. The appellant, in the four years prior to the loan agreement, had had an average yearly remuneration of \$238,892. After the loan agreement, his salary was reduced to an average of about \$72,000 a year. According to Mastco's accountant, the plan was for the appellant to repay the loan primarily out of bonuses or dividends.

[7] Mastco's financial statements were prepared by Mr. Larry South and approved by the appellant on behalf of the board of directors. The appellant would meet with his accountant on a quarterly basis. Mr. South testified that the appellant would write cheques from Mastco for things that were not related to the business and that they would later apportion the amounts of the cheques between business and personal expenses. This was particularly the case when construction of the house began. Cheques were issued by Mastco directly to contractors and other suppliers.

[8] The financial statements for Mastco for the years 2000 to 2012 in Exhibit A-19 refer to these personal advances as "loan receivable—shareholder" or "advance to shareholder". All loans made to the appellant during a particular year were, according to the accountant, paid back, except those that were made for the construction of the appellant's home. The repayments were made before the end of each year.

[9] According to the accountant, the "advance to shareholder" item is from a template and should have read "advance to employees" or even "advance to shareholder and employees", but this does not change the nature of the loan, which is explained in a note to the financial statement. That note first appeared in the March 31, 2010 financial statement and stated that the company had advanced funds to the shareholder for the purpose of acquiring a principal residence. This loan was non-interest bearing and was repayable in minimum annual repayments. The appellant did add to his income, as a benefit, deemed interest at a prescribed rate.

[10] The total cost for building the appellant's home was 2.6 million dollars. Of that amount, Mastco made advances totalling \$999,572, of which amounts of \$766,828, \$97,551 and \$53,260 were advanced in the 2006, 2007 and 2008 taxation years respectively towards the building costs. Those payments were made directly to the seller of land, the contractor, a paving company and other suppliers. The remaining costs were paid by the appellant and his wife from personal funds and their line of credit.

[11] The appellant paid back the loan to Mastco by making yearly payments starting in 2007. The balance remaining as of February 28, 2013 was \$566,000. All the yearly payments were slightly above \$50,000, except for one of \$100,760 in 2008.

[12] During the audit, the accountant for Mastco provided the Canada Revenue Agency (CRA) with a breakdown of Mastco's bank transactions for the 2007 and 2008 fiscal years. All the payments made by Mastco for the construction of the house are shown under the heading "shareholder loan". No "housing loan" heading was created nor was the auditor provided with any breakdown between shareholder loan and housing loan amounts. The accountant testified that the amount appearing as a shareholder loan at the end of a fiscal year was only the housing loan, as all other loan amounts were repaid. That information was not communicated to the auditor. In fact, the auditor was never advised that the "shareholder loan" column should have been separated into two columns or that it included a housing loan. The auditor had no way of knowing the difference.

[13] The issue before the Court is whether the loan made to the appellant by Mastco falls within the provisions of section 15(2.4) of the *Act*. In other words, was the loan made by Mastco to the appellant and his wife as employees of Mastco or to the appellant in his capacity as shareholder and to his wife as a person connected with a shareholder?

[14] The relevant provisions are subsections 15(2) and 15(2.4) of the *Act*, which read as follows:

15.(2) **Shareholder debt** — Where a person (other than a corporation resident in Canada) or a partnership (other than a partnership each member of which is a corporation resident in Canada) is

- (a) a shareholder of a particular corporation,
- (b) connected with a shareholder of a particular corporation, or
- (c) a member of a partnership, or a beneficiary of a trust, that is a shareholder of a particular corporation

and the person or partnership has in a taxation year received a loan from or become indebted to (otherwise than by way of a pertinent loan or indebtedness) the particular corporation, any other corporation related to the particular corporation or a partnership of which the particular corporation or a corporation related to the particular corporation is a member, the amount of the loan or indebtedness is included in computing the income for the year of the person or partnership.

(2.4) **When s. 15(2) not to apply — certain employees** — Subsection (2) does not apply to a loan made or a debt that arose

- (a) in respect of an individual who is an employee of the lender or creditor but not a specified employee of the lender or creditor,
- (b) in respect of an individual who is an employee of the lender or creditor or who is the spouse or common-law partner of an employee of the lender or creditor to enable or assist the individual to acquire a dwelling or a share of the capital stock of a cooperative housing corporation acquired for the sole purpose of acquiring the right to inhabit a dwelling owned by the corporation, where the dwelling is for the individual's habitation,
- (c) where the lender or creditor is a particular corporation, in respect of an employee of the particular corporation or of another corporation that is related to the particular corporation, to enable or assist the employee to acquire from the particular corporation, or from another corporation related to the particular corporation, previously unissued fully paid shares of the capital stock of the particular corporation or the related corporation, as the case may be, to be held by the employee for the employee's own benefit, or

- (d) in respect of an employee of the lender or creditor to enable or assist the employee to acquire a motor vehicle to be used by the employee in the performance of the duties of the employee's office or employment,

where

- (e) it is reasonable to conclude that the employee or the employee's spouse or common-law partner received the loan, or became indebted, because of the employee's employment and not because of any person's share-holdings, and
- (f) at the time the loan was made or the debt was incurred, *bona fide* arrangements were made for repayment of the loan or debt within a reasonable time.

Appellant's Submissions

[15] Counsel for the appellant submits that the loan was used only to acquire a dwelling house for the appellant and his wife and that it was obtained by them in their capacity as employees of Mastco. The agreement of April 1, 2004 between Mastco, the appellant and his wife constitutes a bona fide arrangement.

[16] Counsel further submits that the loan was made at a time when Mastco's retained earnings were strong, that it was part of an "ever-growing remuneration package", and that it made "good business sense". The appellant had relied on professional advice with regard to the loan arrangement.

[17] In addition, counsel submits that no amounts under shareholder loan were carried over from year to year except for the housing loan and that, instead of being included as a shareholder loan, that loan amount should have been entered as a "loan receivable – employees and shareholder". The appellant paid tax on the "free interest" benefit conferred on him, in accordance with section 80.4 of the *Act*. According to counsel, the loan at issue is no different than such loans found in larger corporations with established policies regarding employee loans. Counsel submits that, in light of the evidence, it is reasonable to conclude that the loan was received by the appellant and his wife because of their status as Mastco's only full-time employees and not because of the appellant's status as a shareholder.

Respondent's Submissions

[18] Counsel for the respondent submits that the actions taken by the appellant were consistent with those of a shareholder and not a mere employee. He describes the loan as a "non-interest bearing and unsecured advance". Since the loan

represented a significant portion of Mastco's retained earnings, the appellant's actions were consistent with those of a shareholder.

[19] Counsel further submits that the following facts support his position:

- the appellant simply took money out of Mastco and used it to make progressive payments to build a home;
- the appellant never paid any interest but just reported a deemed interest benefit;
- the appellant's spouse never repaid any of the amounts advanced nor did she report a deemed interest benefit;
- Mastco's balance sheet consistently included the advances at issue as a current asset described as either a "Loan receivable - shareholder" or an "Advance to shareholder";
- the registers of bank transactions provided to the auditor included a single column titled "Shareholder Loan" and the auditor was never advised that this column should have been segregated into two items, i.e., "Shareholder Loan" and "Housing Loan";
- the amounts advanced by Mastco represented a substantial part of its assets and retained earnings for the period in question.

[20] The respondent's counsel submits that, given the factual circumstances of this case, it is not reasonable to conclude that the appellant received the loan because of his employment and not because of his shareholdings. He further submits that, from a subjective standpoint, it would never occur to an employee that it would be possible to take money out of a company and to use that money to make progressive payments to build a home.

Analysis

[21] The determination whether or not it is reasonable to conclude that the employee or the employee's spouse received the loan because of the employee's employment and not because of any person's shareholdings is a factual one.

[22] Although the relevant CRA Interpretation Bulletin, namely, IT-119R4 of August 7, 1998, is not binding on this Court, it nevertheless provides assistance in making the determination. At paragraph 11, one reads:

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.

[23] In Views Doc. No. 2011-0406271E5, the CRA states:

Whether the conditions set forth in paragraphs 15(2.4)(e) and (f) of the Act have been satisfied are [*sic*] always questions of fact to be determined on a case by case basis. Where a shareholder is the only employee of a corporation, the Canada Revenue Agency will generally consider a loan to be received by virtue of employment where a shareholder-employee can demonstrate that employees with similar duties and responsibilities with another employer of similar size, but who are not shareholders of that other employer-corporation, receive loans of similar amounts under similar conditions as that granted to the shareholder-employee.

[24] The appellant did establish through the evidence of an expert witness what employee-salesmen earn in a business similar to Mastco's. A salesman's yearly base salary is \$100,000 and the employer will cover the salesman's expenses, such as laptop computer and automobile expenses. Salesmen also receive commissions, which may result in an average yearly income of between \$150,000 and \$250,000. According to the expert, the appellant would have been at the low end of the average.

[25] Questioned on whether his corporation provides advances of funds to its employees, the expert answered that if an employee's credit rating is poor, his corporation may lend money for an automobile. He testified that money had been lent to employees for boats, campers or a down payment for a house. Such loans are made to employees in general and not just salesmen. The advance for a down payment on a house was made in the 1990's and the amount was \$10,000.

[26] The business described by the expert witness is quite different in size from Mastco. Between 2000 and 2008, that business had between 50 and 80 employees and its gross sales were seven times greater than those of Mastco. It is therefore impossible to conclude on that basis that an employee with another employer, similar in size to Mastco, who has similar duties and responsibilities to those of the shareholder-employee herein and who is not a shareholder of that employer would

have received a similar loan to that granted to the shareholder-employee herein and under similar conditions. No evidence was adduced to show that this type of loan and in similar amounts exists or is even possible for employees of corporations in similar size to Mastco who are not shareholders.

[27] The threshold requirement of the subsection 15(2.4) test is reasonableness. The test requires that the person in question, whether an employee or the employee's spouse or common law partner, have received a loan or have become indebted and that this have occurred because of the employee's employment and not because of any person's shareholdings. As indicated earlier, for the purposes of the reasonableness test, whether such a loan is made to the person qua employee or qua shareholder can be determined by comparison with loans made to employees in other businesses of the same kind as the business being considered (here Mastco).

[28] The question of whether the loan is made to an employee and not a shareholder must be decided in relation to the time at which the loan is made. There is no doubt that at the time the loan was made to the appellant, Mastco's retained earnings were strong. Yet the amount of the loan represented a very substantial part of those retained earnings, which in turn makes it difficult to conclude that a loan of such an amount could reasonably have been made to an employee. In my opinion, the amount of the loan in these circumstances is far more consistent with the loan being one made to a shareholder.

[29] The terms and conditions of the loan can also be an indication of whether or not such a loan is one that is available to employees of a corporation who are not shareholders. In our fact situation, we have a loan agreement that provides for a term of 10 years with payments of not less than \$50,000 a year with no interest. Although the appellant did declare interest as a taxable benefit, the repayment conditions are nonetheless very flexible. It is reasonable as well to conclude that no employee would receive such a sizeable loan without having to give his or her lender a lien or similar security on the house to be built.

[30] There are other factors in the evidence submitted that are indicative of the underlying intent of Mastco and the appellant that the loan at issue was to be a shareholder's loan. The appellant was in the habit of using Mastco to pay his personal expenses, including many related to the construction of his house; an employee would not have had such a benefit. Moreover, the financial statements of Mastco showed the advances under "loan receivable – shareholder" or "advance to shareholder"; the note that first appeared in the March 31, 2010 financial statement referred to "advance to shareholder"; the bank transactions provided to the CRA

auditor indicate that all the payments made by Mastco for the construction of the house were entered under "shareholder loan"; no separate housing loan heading was created nor was the auditor provided with any breakdown between shareholder loan and housing loan amounts and no such information was ever communicated to the auditor at any time. These factors reflect a loan made to the appellant but are nevertheless an indication that, at the time it was made, the loan was intended to be made to the appellant in his capacity as a shareholder.

[31] Having concluded that the loan is consistent with its being one made to a shareholder, I do not have to consider, under paragraph 15(2)(f), whether, at the time the loan was made or the debt incurred, bona fide arrangements were made for repayment of the loan within a reasonable time. Suffice it to say that the loan agreement between Mastco and the appellant does not establish repayment obligations sufficient to create a bona fide repayment arrangement. A minimum payment of \$50,000 a year over a 10-year term with no specific rate of interest on a one-million dollar loan does not constitute a bona fide repayment arrangement.

[32] The appeals are dismissed with costs.

Signed at Ottawa, Canada, this 28th day of October 2013.

"François Angers"

Angers J.

CITATION: 2013 TCC 309
COURT FILE NO.: 2011-1874(IT)G
STYLE OF CAUSE: Michael Mast v. Her Majesty the Queen
PLACE OF HEARING: Montreal, Quebec
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APPEARANCES:

Counsel for the Appellant: Philip Aspler
Counsel for the Respondent: Simon Petit

COUNSEL OF RECORD:

For the Appellant:

Name: Philip Aspler
Firm: Aspler & Associates
Westmount, Quebec

For the Respondent:

William F. Pentney
Deputy Attorney General of Canada
Ottawa, Canada