Dividend vs. bonus: How your remuneration strategy may affect interest deductibility

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The Federal Court of Appeal ("FCA") in *Swirsky v. R.*, 2014 FCA 36 recently upheld the Tax Court of Canada ("TCC")'s decision (2013 TCC 73) to disallow the deduction of interest pursuant to paragraph 20(1)(c) of the *Income Tax Act* (the "Act") on money that was borrowed to buy shares of the family's corporation. Two key factors led to the decision to disallow the interest expense. The first was the trial judge's finding of fact that the borrower's subjective intention when obtaining the loans was creditor-proofing. The second was the objective fact that the shares of the family's corporation had no history at paying dividends; instead the corporation had in the past remunerated its owner-manager by paying a bonus to him and providing advances via his shareholder loan account.

Facts

Swirsky involved a husband and wife who owned shares of a family corporation engaged in the real estate development business. For years, the husband and wife's family was supported by the income earned from the corporation. When the real estate market crashed, the husband suddenly found himself at risk of bankruptcy as a result of personal guarantees he had provided on bank financing used to develop a large project that had fallen significantly underwater. To protect the "golden goose", the family's accountant devised a plan whereby the husband sold his shares of the corporation to his wife, placing the shares outside the reach of the husband's creditors. The husband then paid the proceeds received from the share sales to the corporation as repayment of his outstanding shareholder loan account leaving the share sale proceeds outside the grasp of his creditors and avoiding the application of subsection 15(2) of the Act on any outstanding shareholder loan.

Both the husband and wife testified at trial that the main purpose of the plan was to creditor-proof the shares of the family's corporation from the husband's creditors. There was also evidence that the wife never personally paid the interest expense, but that the corporation had paid the interest on her behalf and charged such amounts to the husband's shareholder loan account. Subsequent to the transaction, the corporation continued to pay income to the family in the form of shareholder advances and bonuses; however, several years later the corporation paid dividends to the wife (both taxable and tax-free capital dividends).

In total, approximately $1.6 million of interest and carrying costs were paid on the loans during the years under assessment. In accordance with the attribution rule in section 74.1 of the Act, the husband, and not the wife who actually incurred such costs, claimed deductions for these expenses in his income tax return. The Canada Revenue Agency ("CRA") reassessed the husband to deny the deductions on the basis that the loan was not used for the purpose of earning income from property pursuant to paragraphs 20(1)(c) and (e.1) of the Act.

TCC Decision

At trial, the husband argued that the wife had a reasonable expectation of income from the shares at the time of borrowing which was evidenced by the subsequent payment of dividends. The husband also argued that the corporation constituted the primary source of income for the entire family and that the creditor-proofing purpose of the transaction was, in itself, evidence of the family's belief in the future income earning potential of the shares.

The trial judge disagreed with the husband's submissions, finding that:

- At the time of borrowing, the shares had no dividend paying history. The trial judge noted that the past bonuses received were income from employment and **not** income from property, as required by paragraphs 20(1)(c) and (e.1).
- There was no evidence that the income producing potential of the shares was ever considered by the wife at the time of borrowing. This was evidenced by the wife confirming that the purpose of entering into the transactions was to assist her husband, and that she was unaware of how money was distributed from the corporation to the family.
- Further, the transactions were structured such that the wife would not have to pay the interest on the loans personally supporting the view that she was likely not concerned with the income earning potential of the shares.

While of little comfort to the husband, the trial judge disagreed with the CRA's alternative arguments raising the anti-avoidance rule contained in subsection 74.5(11) which applies to deny "reverse attribution" where the application of the attribution rules in sections 74.1 to 74.4 is relied upon to reduce tax, and the general anti-avoidance rule (GAAR) in subsection 245(2), since the sole purpose of the transactions was creditor-proofing and not tax avoidance.

FCA decision

On appeal, the husband argued that the trial judge had, among other things, erred in the application of the law. Specifically, with respect to the objective standard required to be met to establish a reasonable expectation of income pursuant to paragraphs 20(1)(c) and (e.1). The husband argued that the trial judge had relied too heavily upon the wife's subjective intention which was inconsistent with the Supreme Court of Canada ("SCC")'s statement in *Ludco Enterprises Ltd. v. Canada*,[1] that where a purpose or intention behind an action is to be ascertained, a court should objectively determine the purpose, guided by both objective and subjective manifestations. The FCA dismissed the husband's arguments, noting that the trial judge had cited *Ludco* and had considered and given weight to a number of objective manifestations of the purpose for which the shares were purchased, including the fact that there was no evidence of the corporation paying any dividends prior to the wife's borrowing, no evidence of any dividend policy being in place after the wife acquired the shares and no objective evidence that the wife had a reasonable expectation of receiving either a capital dividend or a taxable dividend.

Implications

Swirsky highlights that an owner-manager's remuneration strategy may be a determining factor of whether shares are purchased for the purpose of earning income from a business or property. As this case indicates, remuneration paid to a shareholder as a bonus is not income from a business or property. Accordingly, an expectation to earn a bonus will not, by itself, satisfy the requirements in paragraph 20(1)(c). This may be an important consideration for owner-managers when deciding how to distribute corporate profits.

While the particular facts in *Swirsky* may be distinguished from most owner-managers' circumstances, this decision is still troubling to us for the following reasons:

1. *Swirsky* suggests that in order for the provisions of paragraph 20(1)(c) to be satisfied, a taxpayer must specifically contemplate an expectation to earn dividend income from the acquired shares. This may prejudice less sophisticated taxpayers who have a *bona fide* general income earning purpose, but who simply did not put their mind towards the likelihood that they may receive income in the form of dividends. Moreover, in our view, a narrow interpretation of the taxpayer's subjective purpose is inconsistent with the SCC's statements at paragraphs 50 and 51 of *Ludco* that earning dividends need not be the primary purpose of the investment, an ancillary purpose is sufficient for paragraph 20(1)(c).[2] As such, it would appear that an ancillary purpose of earning dividend income may be gleaned from a taxpayer's general income earning purpose.
2. *Swirsky* found that the absence of a corporation's dividend paying history was an objective factor that negatively impacted interest deductibility. Consequently, owner-managers with a history of distributing corporate profits in the form of a bonus rather than a dividend will be disadvantaged with respect to this objective factor. In our view, the history of how profits are distributed to an owner-manager should not carry more weight as an objective factor than the history of a corporation actually being profitable and growing its retained earnings. In such case, the expectation of a shareholder to earn dividends may be implied as the payment of dividends is generally the only mechanism by which the corporation's after-tax surplus can be distributed. Thus, it will be only a matter of time before the corporation pays its retained earnings to its shareholders in the form of dividends. Unfortunately, *Swirsky* did not consider this as an objective factor.
3. *Swirsky* also found that the absence of a dividend paying policy was an objective factor that negatively impacts interest deductibility. This finding is especially troubling considering that virtually all closely held private corporations have no future dividend paying policy for their common shares, as the articles of incorporation typically provide that the payment of dividends is at the discretion of the directors. As such, many owner-managers may pay themselves a dividend at any time they choose, eliminating the need for any dividend paying policy. In our view, the absence of a dividend paying policy is not a meaningful factor to consider where an owner-manager can pay a dividend at their own (or at their spouse's) discretion.

We should also note that, although transactions similar to *Swirsky* were undertaken by spouses in *Overs v. The Queen*, and *Lipson v. Canada*, the CRA did not challenge the taxpayer's income earning purpose in those cases.

Notwithstanding our comments above, as a result of *Swirsky,* advisers may wish to clearly document their clients' expectation to earn dividend income from shares acquired with borrowed funds to evidence that the purpose test in paragraph 20(1)(c) has been satisfied.

1. 2001 SCC 62 at paragraphs 54 and 55.

2. This is also echoed in the CRA's commentary at paragraph 9 in *Interpretation Bulletin* IT-533 "Interest Deductibility and Related Issues" (October 31, 2003).