COURT UPHOLDS SHAREHOLDER-EMPLOYEE LOAN TO ACQUIRE A RESIDENCE

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Case Comment on *Neko Trade v. RQ*, 2024 QCCQ 1590 ("*Neko Trade*")

The Court of Quebec—which hears tax appeals under Quebec's income tax legislation—has issued a welcome judgement finding that a loan made from a corporation to its owner-manager to refinance his home (the "**Loan**") was not a shareholder benefit, but fell within the scope of Quebec's equivalent to the rarely-litigated paragraph 15(2.4)(b) of the *Income Tax Act* ("**ITA**")[1] (the "**Employee Dwelling Exception**"). The decision also includes some rather pointed remarks about Revenu Québec ("**RQ**")'s aggressive decision to re-open a statute-barred year to reassess the owner-manager in respect of the Loan.

The Employee Dwelling Exception has long been a risky provision for shareholder-employees to rely on due to the ambiguity and subjectivity in the criteria set out in paragraphs 15(2.4)(e) and (f), namely: that the loan be granted to the shareholder-employee *qua* employee and not *qua* shareholder, and that *bona fide* arrangements be made for repayment within a reasonable time. However, *Neko Trade* provides useful guidance for shareholder-employees willing to take the risk.

Background

The Canada Revenue Agency ("**CRA**") and RQ seem always ready to zealously challenge any transfer in value—real or imagined—from a corporation to a shareholder that is not duly reported as a salary, a dividend or other reported transaction with established tax consequences. Various provisions of the ITA prescribe tax consequences for taxpayers who receive such "shareholder benefits", including subsection 15(2), which essentially provides that when a corporation lends money to an individual shareholder (or to an individual connected to a shareholder), the shareholder must include the full amount of the lent funds in his or her income.

Subsection 15(2.4), however, creates a number of exceptions to subsection 15(2) that apply to shareholders who are also employees of a corporation, including the Employee Dwelling Exception at paragraph 15(2.4)(b). This exception applies to loans given to a shareholder-employee (or to their spouse) "to enable or assist the individual to acquire a dwelling [...], where the dwelling is for the individual's habitation". However, for this

exception to apply, paragraphs 15(2.4)(e) and (f) require, respectively, that:

- the loan be received "because of the employee's employment and not because of any person's shareholding"—an abstract standard that has no obvious meaning in the context of business whose only employee is its sole shareholder, and
- "at the time when the loan was made [...] *bona fide* arrangements were made for repayment of the loan or debt within a reasonable time".

Quebec's *Taxation Act*[2] has essentially analogous provisions.

The Facts of *Neko Trade*

Neko Trade concerned a corporation ("**Neko**") created in 2009 by Dimitry Korenblit, its sole employee and sole shareholder (via a holding corporation). Neko sold titanium for use in paints and other products. RQ conducted an audit that focussed on Neko's 2015-2017 taxation years but also led RQ to review a loan that Neko had made to Mr. Korenblit in 2011 (defined above as the "**Loan**").

Essentially, Mr. Kornblit and his spouse purchased their family residence in February 2010, financed by a bank mortgage as well as a line of credit. This was intended to be a temporary arrangement until Neko—which was still in its start-up period—had amassed surplus funds from its business activities to provide further financing. In 2011, Mr. Kornblit consulted an accountant who advised him that a loan from Neko would satisfy the requirements of the Employee Dwelling Exception. Mr. Kornblit retained specialised counsel to draft the Loan agreement and related corporate documents.[3] The Loan was finalised and disbursed in three tranches in August and September 2011. Two months later, Mr. Kornblit transferred title to the residence to his wife to avoid financial risks related to his business activities, after which he and his wife took out a further bank loan secured by the value of the residence.[4]

RQ took the position that the Loan was a "smoke screen" designed to conceal a shareholder benefit,[5] and that a "simple employee" would never have obtained such a loan.[6] Facts relied on by RQ included, *inter alia*, that: the value of the Loan significantly exceeded Neko's retained earnings; there were supposed deficiencies in the loan documentation; Neko never registered a hypothec[7] on the residence; Neko subsequently hired another employee to whom it did not offer a home-acquisition loan; Mr. Korenblit ceded the residence to this wife without her concluding any contract with Neko; and Mr. Korenblit and his wife refinanced the residence with the bank soon after receiving the Loan.[8]

In response, Mr. Korenblit argued, *inter alia*, that: Neko had ample funds to fund the Loan; the Loan bore a market rate of interest (1%); he paid interest on the Loan in the first year and included in his income as a shareholder benefit the value of the interest in subsequent years; and he paid off the principal each year until

the Loan was completely retired in 2020. He also argued that his salary and dividend income from Neko did not decline in conjunction with the Loan, demonstrating that he was not seeking to disguise his income.[9]

RQ ultimately reassessed Mr. Korenblit's 2011 taxation year on the basis that the Loan was not eligible for the Employee Dwelling Exception, and that by preparing his 2011 tax return otherwise, Mr. Korenblit had made a misrepresentation that was wilful or attributable to carelessness that allowed RQ to re-assess the year even though it was statute-barred.

The Decision

With respect to the requirement that a loan be conferred to the shareholder-employee *qua* employee and not *qua* shareholder, the Court held that because the Employee Dwelling Exception is not limited to businesses of a certain size, it must somehow be available to businesses where a shareholder is the sole employee.[10] However, the Court acknowledged that the issue is "delicate and difficult to decide" and "susceptible to having more than one right answer".[11]

Ultimately, the Court concluded that the Loan qualified for the Employee Dwelling Exception, listing eight factors that "played a fundamental role" in its decision:[12]

- The Loan replaced a temporary financing to acquire a residential dwelling for Mr. Korenblit.
- Arrangements were concluded at the time of the Loan.
- The repayment period was consistent with the market for home loans.
- The interest rate was the market rate at the time.
- Mr. Korenblit duly repaid the Loan.
- Neko's general ledger and financial statements refer to the loan being granted to Mr. Korenblit as an employee, and they faithfully recorded his repayments.
- Neko had sufficient liquidity to fund the loan.
- Mr. Korenblit held a key post that required virtually all of his time.

The Court placed particular emphasis on the fact that all the Loan payments were faithfully recorded over the years and that Mr. Korenblit was completely transparent in his tax returns with respect to the Loan.[13] This course of conduct enabled the Court to conclude that the Loan was not—as RQ claimed—a "smoke screen" that aimed to conceal the conferral of a shareholder benefit.

RQ also made the legal argument that the Employee Dwelling Exception can never apply to loans granted to refinance an already-acquired residence. The Court rejected this argument, however, noting that RQ's own published position with respect to the Employee Dwelling Exception provided that can apply to a refinancing if the lender had previously agreed to provide the refinancing at the time when the residence was originally

acquired,[14] which the Court found had occurred in the case of Neko and Mr. Korenblit.[15]

With respect to transfer of title from Mr. Korenblit to his wife two months after the conclusion of the Loan, the Court noted that "a short possession can certainly raise questions but should not lead to a robotic decision".[16] The Court held that the Employee Dwelling Exception "does not prescribe any minimum period of ownership" and hence that an "an employee can thus sell, whenever he wants, his home financed in whole or in part by his employer".[17] The Court also noted that Mr. Korenblit continued to have a degree of control over the residence even after the transfer of title because it was a "family residence".[18]

With respect to the additional loans taken out with the bank after the conclusion of the Loan, the Court held that the simple fact that the Loan enabled Mr. Korenblit to obtain further low-cost financing does not prevent application of the Employee Dwelling Exception. To the contrary, the Court observed that the Employee Dwelling Exception "does not prohibit an employee from being a knowledgeable businessman"[19] and it "does not prohibit it being used by a person who seeks to increase his wealth".[20]

Given the Court's conclusion that the Loan fell within the scope of the Employee Dwelling Exception, the issue of whether Mr. Korenblit had made a misrepresentation either wilfully or due to carelessness became moot. Nevertheless, the Court offered some rather pointed criticism of RQ's decision to re-open the 2011 taxation year, noting that Mr. Korenblit "undertook best efforts to obtain the advice of an accountant and a lawyer"[21] and that a *bona fide* divergence of opinion with RQ does not constitute carelessness or a voluntary omission.[22]

Observations

While the decision turns to some extent on its particular facts, *Neko Trade* offers encouragement to taxpayers in disputes over shareholder benefits, which can feature particular aggressiveness and inflexibility from revenue officials.

Neko Trade stands in contrast with the Tax Court of Canada's 2013 decision in *Mast*,[23] which held that a loan to a shareholder-employee to build a home had been made to the shareholder-employee *qua* shareholder, and thus did not qualify for the Employee Dwelling Exception, for largely similar reasons as those raised by RQ against Mr. Korenblit, including that the size of the loan was large in comparison to the corporation's retained earnings, no mortgage was registered by the corporation on the residence, and repayment terms were very flexible.[24] On the other hand, in *Mast*, the loan at issue did not bear interest and was reported in the corporation's books and records as an "advance to shareholder"[25]—both key points of difference with *Neko Trade* that arguably pushed the needle in the taxpayer's favour.

Accordingly, owner-managers seeking to avail themselves of the Employee Dwelling Exception will want to ensure, in particular: (i) strict compliance after the fact with the terms and conditions of the loan, (ii) that the

loan arrangements specify a market term and rate of interest, and (iii) that the corporation's books and records properly document the loan as being made to the shareholder-employee *qua* employee.

One might also hope—perhaps naively—that RQ will take to heart the Court's reminder that a misstatement in a tax return resulting from *bona fide* difference of opinion between a taxpayer and RQ over the characterisation of a transaction does not constitute "carelessness" justifying the reopening of a statute-barred year.

[1] RSC 1985, c 1 (5th Supp).
[2] CQLR c I-3, s 113-114.
[3] As noted in the decision, McMillan was the counsel retained to draft the contract and associated corporate documents (*Neko Trade* ¶75).
[4] *Neko Trade* ¶170-79.
[5] *Neko Trade* ¶180.
[6] *Neko Trade* ¶181.
[7] A "hypothec" is the counterpart to a "mortgage" in Quebec civil law.
[8] *Neko Trade* ¶182.
[9] *Neko Trade* ¶183.
[10] *Neko Trade* ¶186.
[11] *Neko Trade* ¶185, 87 (our translation).
[12] *Neko Trade* ¶189.
[13] *Neko Trade* ¶190-94.
[14] *Neko Trade* ¶97, citing Bulletin d'interprétation IMP.113-1/R4, « Dette ou prêt contracté par un actionnaire ou par une personne rattachée à un actionnaire » (31 mars 2008). Note that CRA's published guidance is to the same effect. See IT-119R4 Debts of Shareholders and Certain Persons Connected With Shareholders (August 7, 1998) (archived) ¶18.
[15] *Neko Trade* ¶96-101.
[16] *Neko Trade* ¶105 (our translation).
[17] *Neko Trade* ¶103-104 (our translation).
[18] *Neko Trade* ¶109. The Court was apparently referring to Article 404 of the Civil Code of Quebec, which provides that "Neither spouse, if the owner of an immovable with fewer than five dwellings that is used in whole or in part as the family residence, may, without the written consent of the other, alienate the immovable, charge it with a real right or lease that part of it reserved for the use of the family."
[19] *Neko Trade* ¶113 (our translation).
[20] *Neko Trade* ¶114 (our translation).

[21] *Neko Trade* ¶124 (our translation).
[22] *Neko Trade* ¶127.
[23] *Mast*, 2013 TCC 309.
[24] *Mast* ¶27-30.
[25] *Mast* ¶29-30.

by Michael Lubetsky

A Cautionary Note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.