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## • ISSUING SHARES FOR A PROMISSORY NOTE •

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During the course of tax-driven reorganizations, it may be convenient or advantageous to issue corporate shares in exchange for a promissory note. It is particularly useful where a taxpayer desires to create paid-up capital ("PUC") or cost basis ("ACB") in shares without having to transfer cash. Although this practice is generally limited by corporate statutes, there are ways of making it work. This article examines the pitfalls and solutions to issuing shares for a promissory note.

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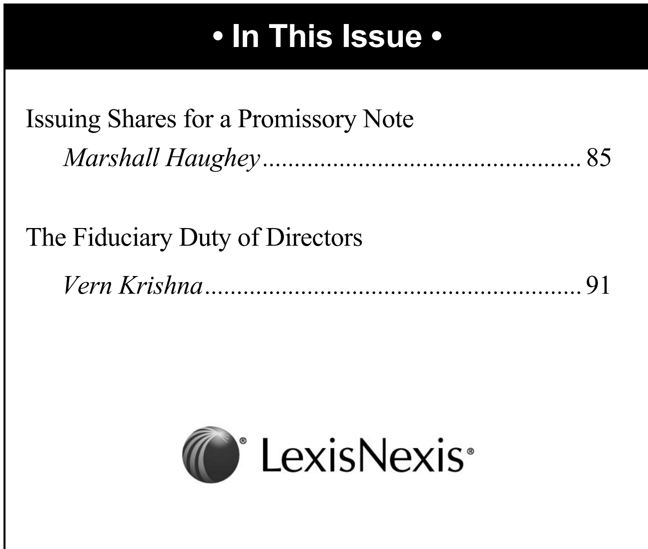

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Corporate statutes generally provide that a share cannot be issued until it is fully paid in money, property, or past services that are not less in value than the monetary equivalent.[1] At common law, a promissory note is a chose in action and would thus constitute a form of property. However, corporate legislation generally excludes promissory notes from the definition of "property" for the purpose of issuing shares.[2] This restriction varies from province to province and comes in one of four forms:

1. Total Restriction – This restriction applies in Saskatchewan, Manitoba, New Brunswick, and Newfoundland. In these provinces, a promissory note cannot be given as consideration for the issuance of shares under any circumstances. There is a total prohibition, even if the subscriber was in receipt of the promissory note as a result of *bona fide* business transactions with an unrelated third party.

2. Subscriber and Non-Arm's Length Restriction – In Alberta, Ontario, and under the *CBCA*, the restriction only applies to promissory notes issued by the subscriber or a person who does not deal at arm's length with

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the subscriber within the meaning of that expression in the *Income Tax Act*.[3] For this purpose, subs. 251(1) of the *ITA* defines the arm's length concept. However, this is not always a straightforward determination because para. 251(1)(c) provides that if neither of paras. (a) or (b) apply, it is a question of fact whether unrelated persons are dealing at arm's length. It will then be necessary to review the Canada Revenue Agency's ("CRA") published positions along with the relevant case law.[4] Unlike under the Total Restriction jurisdictions, a subscriber could pay for shares with a promissory note issued by an arm's length party.

3. Subscriber Restriction – In British Columbia, the restriction only applies to "a record evidencing indebtedness of the person to whom shares are to be issued"[5] (*i.e.*, a promissory note issued by the subscriber). Therefore, in B.C., the subscriber could pay for shares with a promissory note issued to the subscriber by a non-arm's length party.
4. No Restriction – Nova Scotia and Prince Edward Island's corporate legislation contains no restriction on issuing shares for a promissory note.[6]

It is worth noting that in the jurisdictions where paying for shares with notes is restricted, directors of a corporation who vote for or consent to a resolution authorizing the issue of a share for consideration other than money are jointly and severally liable to the corporation to make good any deficiency.[7]

The next consideration is to confirm that the subscription for shares with a promissory note will create PUC and ACB in those shares. The starting point for ACB is the "cost" of the property.[8] The term "cost" is not defined in the *Income Tax Act*. However, case law suggests that cost means "the price that the taxpayer gave up in order to get the asset".[9] The CRA has accepted that a taxpayer's cost of shares purchased with a promissory note is equal to the value of the promissory note since that is what a taxpayer gave up in order to acquire the shares.[10] Therefore, a promissory note given in consideration for the issuance of shares should create an ACB in those shares equal to the value of the note.

The starting point for PUC is the capital account (usually referred to as stated capital) under corporate legislation.[11] Corporate legislation generally allows the directors to add the full amount of any consideration received by the corporation to the stated capital account of the shares issued. In this regard, the CRA has stated that it generally accepts as a statement of fact by taxpayers in the context of para. 55(3)(*b*) butterfly rulings that a non-interest bearing note that is payable on demand and issued as consideration for certain property acquired by the taxpayer may have a fair market value equal to its stated principal amount.[12] It is therefore relatively safe to presume that the value of a non-interest bearing demand promissory note will equal its principal amount, at least where the debtor corporation is solvent. This amount can therefore be added to the stated capital account and will be the PUC of the class of shares issued for tax purposes.

Next, I will discuss the consequences if shares are issued for a promissory note in contravention of corporate legislation.

The case law is divided on what results when shares are issued for less than adequate or no consideration. The two streams of cases can be described as the "Nullification Stream" and the "Contextual Stream".[13] The genesis of the "Nullification Stream" can be traced to Professor Bruce Welling's commentary from his textbook *Corporate Law in Canada*,[14] which

was adopted by the Québec Superior Court in *Javelin International Ltd. v. Hillier*.[15] In Welling's view, the use of the phrase "*shall* not be issued" in s. 25(3) of the *CBCA* (and its provincial equivalents) means that inadequate consideration results in a nullity as between the issuer corporation and the registered holder. This was also the view of the Tax Court in *Ball v. MNR*[16] where the facts involved a taxpayer employee who received an option to purchase 25,000 shares of stock in his employer. The taxpayer purported to exercise the option but only paid the exercise price for 9,700 shares and gave a promissory note for the balance. Justice Mogan ruled that only 9,700 shares were issued.[17]

Nullification was used in the recent Federal Court of Appeal case *St Arnaud v. The Queen* [*St Arnaud*].[18] *St Arnaud* involved taxpayers whose RRSPs and RRIF were defrauded of retirement funds by fraudsters who sold them shares in worthless companies. The Minister assessed the taxpayers to include amounts in their income under subs. 146(9) or 146.3(4) on the basis that the trusts governed by their RRSPs or RRIF had acquired shares in these private companies the fair market value of which was nil. The court stated that it was clear that these provisions only applied if an RRSP or RRIF disposes of or acquires an interest in property. The majority decision, written by Justice Webb, disposed of the case on the basis that the RRSPs and RRIF did not acquire the shares. Justice Webb reviewed the share purchase agreement, noted its deficiencies, and concluded that the shares could not have been acquired under the agreement. He then considered whether the shares were validly issued apart from the purchase agreement, based on one corporation's records. After reviewing subs. 27(3) and (5) of the *ABCA*, the court found that the money paid for shares was either not received by the corporation or received simply as a conduit for the fraudster. The result was that the shares were not validly issued.

The Contextual Stream of cases posits that corporate legislation does not explicitly state what remedy is available when shares are issued without being fully paid for; thus, it is up to the courts to decide on the appropriate remedy. The result can then be nullification, director liability, or permitting the purported shareholder to pay the subscription price to validate the share issue. There are lines of cases out of British Columbia[19] and Ontario,[20] supporting this view. A more recent Alberta Court of Appeal case also adopts the contextual approach. In *Pearson Finance Group Ltd. v. Takla Star Resources Ltd.* [*Takla*],[21] the issue was whether a corporate director owned certain shares he had obtained under a stock option plan but never paid for. Justice Côté acknowledged the Nullification Stream but explicitly rejected automatic nullification. Rather, he compared nullification to a "hand grenade in a confined space"[22] and emphasized that context should dictate the outcome to provide judges with flexibility on the appropriate remedy.

In the end, the more recent cases out of provincial courts support the view that judges can decide on an appropriate remedy, based on what they consider fair in the circumstances. However, the Nullification Stream has been used by the Tax Court and very recently by the Federal Court of Appeal. Also, the Contextual Stream still leaves open the possibility for nullification if the context supports it.[23] Where nullification has been found to be inappropriate, the courts typically allow the purported shareholder

to remedy the situation by paying the subscription amount for the shares. This is particularly the case where the subscription price was a nominal amount.

Interestingly, neither the Nullification Stream nor the Contextual Stream referred to subs. 16(3) of the *CBCA* or its provincial equivalents.[24] That provision states that "[n]o act of a corporation, including any transfer of property to or by a corporation, is invalid by reason only that the act or transfer is contrary to its articles or this Act". This wording is seemingly dispositive of the issue; yet, this is not entirely clear as ambiguity exists in the wording "by reason only". The wording leaves it open to a court to find a reason outside of the corporate statute to invalidate the share issuance.

The improper issuance of corporate shares has the potential for adverse tax implications in addition to director liability under corporate law. For example, nullification may give rise to a shareholder benefit under subs. 15(1), where the taxpayer incorporates a company and attempts to subscribe for a nominal amount of shares. If the taxpayer has not paid for the shares and the issuance is subsequently annulled, the taxpayer will not be able to purchase shares for a nominal amount (assuming the business has increased in value) without running into subs. 15(1). This flows from a 2003 Technical Interpretation[25] where the CRA stated that in a situation where a company was incorporated and carried on business for 16 years without having issued shares, the proposed transaction involving the taxpayer subsequently subscribing for a share of the corporation at a nominal amount would be considered a benefit under subs. 15(1) or 246(1) because the fair market value of the corporation's property was now $150,000. The CRA did note that this result might be avoided if an appropriate rectification order were obtained.

Another issue that could arise is the characterization of payments from the corporation to the purported shareholder. If the share issuance were nullified, these payments could no longer be classified as dividends eligible for dividend tax credits or a deduction under subs. 112(1) where the recipient is a corporation. The purported shareholder would be subject to reassessment on this basis. If the purported shareholder were also an employee of the corporation, the payments might be characterized as wages, and the corporation could be subject to reassessment for failure to withhold and remit under subs. 153(1) of the *ITA*.

This area of the law has enough uncertainties and potential for unfavourable consequences, tax and otherwise, that advisers should be aware of the issues and how to plan around them. For example, it is possible to issue shares for promissory notes, no matter which legislation it is desired the corporation be governed under, by incorporating in a jurisdiction with less (or no) restriction on the ability to issue shares for a promissory note, then continuing the corporation under the desired legislation immediately thereafter.[26] For example, if an *ABCA* corporation ("Parentco") wants to incorporate a subsidiary *ABCA* corporation ("Subco") and to fund it with a promissory note received from a non-arm's length party, Parentco can simply incorporate Subco in British Columbia, where this type of transaction is permitted, then continue Subco under the *ABCA* the next day. If, instead of paying with a note from a non-arm's length party, Parentco wants to issue its own note in exchange for Subco shares, then, instead of British Columbia, Subco could be incorporated in

Nova Scotia, where there are no restrictions on issuing shares for promissory notes, and subsequently continued under the *ABCA*. The share issuance will continue to be valid under the *ABCA*, since subs. 188(8) of the *ABCA* states:

> A share of an extra‐ provincial corporation issued before the extra‐ provincial corporation was continued under this Act is deemed to have been issued in compliance with this Act and with the provisions of the articles of continuance irrespective of whether the share is fully paid and irrespective of any designation, rights, privileges, restrictions or conditions set out on or referred to in the certificate representing the share, and continuance under this section does not deprive a holder of any right or privilege that the holder claims under, or relieve the holder of any liability in respect of, an issued share [emphasis added].

The *CBCA* and the other provincial corporate legislation have similar provisions.[27]

One issue that arises upon continuance is whether the stated capital (and therefore PUC) created on the issuance of the shares can be carried over on the continuance. Initially, it appears that it can. Legislation that follows the *CBCA* model generally provides that "[w]hen a body corporate is continued under this Act, it may add to a stated capital account any consideration received by it for a share it issued".[28] However, within the same section, it states that "[w]hen a body corporate is continued under this Act, any amount unpaid in respect of a share issued by the body corporate before it was so continued and paid after it was so continued shall be added to the stated capital account".[29] This latter provision may suggest by implication that amounts owing under a promissory note cannot be added to stated capital upon continuance. However, this result seems unlikely since there would be no amount unpaid for the shares—they were fully paid for with the promissory note. Any unpaid amount would be on the note itself, not the shares. It is possible that this latter provision is in reference to corporations incorporated by guarantee (*e.g.*, a company limited by guarantee under the *NSCA*)[30] where no property was given in exchange for the shares issued. As such, the former provision should operate to ensure that the stated capital will be maintained in the continuance jurisdiction.

It is also worth noting that under the *ABCA*, which contains the same two provisions quoted above, it states that "[w]hen a body corporate is continued under this Act, the stated capital of each class and series of shares of the corporation immediately following its continuance is deemed to equal the paid up capital of each class and series of shares of the body corporate immediately prior to its continuance".[31] The term "paid up capital" is not defined, or used anywhere else, in the *ABCA*. It is, therefore, not entirely clear whether this term refers to PUC for tax purposes or generally to a capital account under other corporate legislation (either in another jurisdiction or the pre-*ABCA* corporate legislation in Alberta). Although it appears that the stated capital account will be maintained in the continuance jurisdiction, one can avoid any potential uncertainty surrounding PUC on continuance by effecting any reorganization transactions requiring PUC prior to the continuance.

As the foregoing demonstrates, purchasing shares from a corporation's treasury with a promissory note could have dire consequences if it is done in contravention of corporate law. Incorporating in a less restrictive jurisdiction and then continuing in the desired province (or federally) is a simple way to safely perform this type of transaction. Using this technique will insulate corporate directors from liability and protect against unfavourable tax consequences.

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1 *Canada Business Corporations Act*, R.S.C. 1985, c. C-44, s. 25(3) [*CBCA*]; *Business Corporations Act*, S.B.C. 2002, c. 57, s. 64(3) [*BCBCA*]; *Business Corporations Act*, RSA 2000, c. B-9, s. 27(3) [*ABCA*]; *The Business Corporations Act*, R.S.S. 1978, c. B-10, s. 25(3) [*SBCA*]; *The Corporations Act*, C.C.S.M. c. C225, s. 25(3) [*MCA*]; *Business Corporations Act*, R.S.O. 1990, c. B.16, s. 23(3) [*OBCA*]; *Business Corporations Act*, S.N.B. 1981, c. B-9.1, s. 23(5) [*NBBCA*]; *Corporations Act*, R.S.N.L. 1990, c. C-36, s. 50(1) [*NLCA*].

2 *Ibid*., *CBCA*, s. 25(5); *BCBCA*, s. 64(1)(b); *ABCA*, s. 27(5); *SBCA*, s. 25(5); *MCA*, s. 25(5); *OBCA*, s. 23(6); *NBBCA*, s. 24; *NLCA*, s. 50(3).

3 R.S.C. 1985, c. 1 (5th Supp.) [*ITA*]. The wording of s. 23(6) of the *OBCA* differs slightly from s. 25(5) of the *CBCA* and s. 27(5) of the *ABCA* in that the former makes reference to "a document evidencing indebtedness of a person" instead of a "promissory note" or a "promise to pay". However, it appears the difference in wording is not one that will make a difference in practice: see Kevin P McGuinness, *Canadian Business Corporations Law*, 2nd ed. (Markham: LexisNexis, 2007), §7.174.

4 See, for example, *Interpretation Bulletin* IT-419R2 (June 8, 2004); *Canada v. McLarty*, [2008] S.C.J. No. 26, 2008 SCC 26. The tests used to determine non-arm's length are (1) whether a common mind directing the bargaining for both parties to a transaction existed; (2) whether the parties to a transaction were acting in concert without separate interests, and (3) whether there was "de facto" control.

5 *Supra* note 1, *BCBCA*, s. 64(1)(b).

6 See *Companies Act*, R.S.N.S. 1989, c. 81 [*NSCA*] and *Companies Act*, R.S.P.E.I. 1988, c. C-14 [*PEICA*].

7 *Supra* note 1, *CBCA*, s. 118(1); *BCBCA*, s. 154(2); *ABCA*, s. 118(1); *SBCA*, s. 113(1); *MCA*, s. 113(1); *OBCA*, s. 130(1); *NBBCA*, s. 76(1); *NLCA*, s. 192. See also *Re Baldwin*, [1999] 18 B.C.S.C.W.S. 12, a decision of the British Columbia Securities Commission where a director breached his director's duties when he participated in the issue of 1.2 million shares of the corporation in exchange for promissory notes in contravention of the corporate legislation and the listing agreement.

8 *ITA*, *supra* note 3, s. 54, para. (*b*), the "adjusted cost base" definition.

9 *R. v. Stirling*, [1985] F.C.J. No. 69, [1985] 1 F.C. 342, [1985] 1 CTC 275, para. 3 (F.C.A.).

10 *CRA Views*, 2001-0097357 (January 8, 2002).

11 *ITA*, *supra* note 3, subs. 89(1). The beginning of subpara. *(b)(iii)* in the definition of "paid-up capital" states that PUC in respect of a class of shares of the capital stock of a corporation means "an amount equal to the paid-up capital in respect of that class of shares at the particular time, computed without reference to the provisions of this Act". This has been determined to mean the stated capital account for corporate law purposes: see *Copthorne Holdings Ltd. v. R.*, [2011] S.C.J. No. 63, 2011 SCC 63, para. 75.

12 *CRA Views*, *supra* note 10. However, the CRA did go on to state that this determination remains a question of fact that can only be determined on a case-by-case basis.

13 For a more comprehensive discussion of the cases see Greg Johnson, "Recent Developments of Interest to Tax Practitioners", *2005 Prairie Provinces Tax Conference* (Toronto: Canadian Tax Foundation, 2005), 18:1-27 at 18:4-8.

14 Bruce Welling, Lionel D. Smith, and Leonard I. Rotman, *Corporate Law in Canada* (Toronto: Butterworths, 1984).

15 [1988] Q.J. No. 928 (Qc. Sup. Ct.) [*Javelin*].

16 [1992] T.C.J. No. 539, 92 D.T.C. 2123 (T.C.C.) [*Ball*].

17 This position also appears to have been adopted in *Monquart Hardwoods Ltd. v. R.*, [1999] T.C.J. No. 177, 99 D.T.C. 818 (T.C.C.), where the court noted that only fully paid shares can be issued by a corporation pursuant to the *NBBCA* and stated at para. 12:

> MHL was the only shareholder of Riverbrand. Because the essential condition for the subscription for issuance of the first group of shares to WOHL, namely the payment of the lump sum of $300,000 was never met, those shares were never issued and the second group of shares was never paid for or issued.

18 [2013] F.C.J. No. 338, 2013 FCA 88.

19 *Davidson v. Davidson Manufacturing Co. (1977)*, [1978] B.C.J. No. 60 (B.C.S.C.); *Oakley v. McDougall*, [1987] B.C.J. No. 272, 17 B.C.L.R. (2d) 134 (B.C.C.A.); *Re Lajoie Lake Holdings Ltd*, [1991] B.C.J. No. 137 (B.C.S.C.).

20 See *Dunham and Pollo Tours Ltd. (No. 1)*, [1978] O.J. No. 3380, 20 O.R. (2d) 3, (Ont. H.C.J.);

*Gillespie v. Retail Merchants' Assn. of Canada (Ontario) Inc.*, [1997] O.J. No. 956 (Ont. C.J.).

[21] *Pearson Finance Group Ltd. v. Takla Star Resources Ltd.*, [2002] A.J. No. 422, 2002 ABCA 84, aff'g [2001] A.J. No. 917, 2001 ABQB 588 [*Takla*].

[22] *Ibid*., Alta. C.A., para. 21.

[23] At para. 21 of *Takla*, Côté J.A. states that the doctrine of automatic nullity gives the courts no power to distinguish between "the innocent (including the company) and the guilty". This suggests that nullification may be appropriate in a situation where the purported shareholder is "guilty"—*i.e.*, where he or she deals in bad faith or has some other objectionable motive.

[24] *Supra* note 1, *ABCA*, s. 17(3); *SBCA*, s. 16(3); *MCA*, s. 16(3); *OBCA*, s. 17(3); *NBBCA*, s. 14(3); *NLCA*, s. 29. Subsection 33(2) of the *BCBCA* is slightly narrower in that it only validates acts that are done contrary to the company's constating documents.

[25] CRA Views, 2002-0143965 (January 3, 2003).

[26] In order to continue a corporation out of British Columbia, Nova Scotia, or Prince Edward Island, the relevant provisions of the provincial corporate legislation must be complied with. See *supra* note 1, *BCBCA*, ss. 308–310; *supra* note 6, *NSCA*, subs. 133(5) and (6); and *supra* note 6 *PEICA*, s. 86, respectively.

[27] *Supra* note 1, *CBCA*, s. 187(8); *BCBCA*, s. 306(2); *SBCA*, s. 181(8); *MCA*, s. 181(10); *OBCA*, s. 180(8); *NBBCA*, s. 126(8); *NLCA*, s. 298(1).

[28] *CBCA*, *supra* note 1, s. 26(6).

[29] *Ibid*., s. 26(8).

[30] *NSCA*, *supra* note 6.

[31] *ABCA*, *supra* note 1, s. 28(10).

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