Capital losses incurred in respect of loans to small business corporations may also qualify as allowable business investment losses that are not subject to the deduction restrictions generally applicable to ordinary capital losses.

B. SALE OF SHARES OF THE COMPANY [§7.6]

Another method of financing a company is to sell shares of the company. The purchaser provides the company with the capital it requires and acquires in return rights, in the form of shares, with respect to voting, dividends, and return of capital.

1. ADVANTAGES OF SALE OF SHARES [§7.7]

The founders of a company may prefer to finance their company by purchasing its shares rather than lending it money. They may anticipate that there is a greater upside for their investment in the long run as their shares appreciate in value, or they may be unable to reach agreement on the terms and conditions for the company's indebtedness to its shareholders. Each company has unique capitalization requirements, and individual circumstances must be considered carefully. See also "Selecting an Appropriate Capital Structure" in chapter 5.

Where the conditions set out in CRA's guidelines on interest deductibility cannot be met, the company should carefully consider proceeding with a share sale instead of shareholder loans. With respect to the deductibility of interest on money borrowed to purchase common shares, see Income Tax Folio S3-F6-C1.

2. DISADVANTAGES OF SALE OF SHARES [§7.8]

Funds lent by a shareholder to a company are easily repaid to the shareholder, but money paid for shares is not.

One method whereby an investment in shares can be returned to a shareholder is to have the company purchase or redeem those shares, which is permitted if the company's articles permit such redemption or purchase (see "Purchase or Redemption of Shares" in chapter 5, "Redemption and Purchase of Shares" in this chapter, and "Redemption, Purchase, and Other Acquisition of Shares" in chapter 10). However, the company must be solvent for this to be an option (see ss. 78 and 79 of the *BCA*). In addition, this approach may have detrimental tax consequences if the redemption or purchase price

exceeds the capital of the shares for tax purposes. To the extent that the redemption or purchase price paid by the company for the shares exceeds the capital, the shareholder will be deemed to have received a taxable dividend. This consequence does not imply that a redemption or purchase of shares should not be effected, only that care must be taken in drafting the articles to provide for it, and that appropriate tax advice should be sought at the outset.

A second method of returning a shareholder's investment is by payment of dividends on the shares (see "Dividends" in this chapter), but, as with redemption or purchase of shares, the company must be solvent for this to be an option (see s. 70 of the *BCA*).

A third method is to effect a capital reduction under s. 74 of the *BCA* (see "Reduction of Capital" in chapter 10). If a capital reduction is effected by court order, the time and legal costs in effecting the reduction could be significant compared to a simple repayment of a shareholder's loan.

Another disadvantage of financing a company by selling shares is that shareholders rank behind both unsecured and secured creditors.

C. CORPORATE BORROWING [§7.9]

Another method of financing a company is borrowing funds from non-shareholder lenders. These are most commonly banks and other institutional lenders, but can include any party willing to lend money to the company.

Except in the case of unlimited liability companies (discussed at "Unlimited Liability Companies" in chapter 1), a principal reason for incorporating a company is to take advantage of limited shareholder liability. A company is a legal entity separate from its shareholders, and as a general rule the liability of the shareholders is, in the absence of an agreement to the contrary, limited to the amount they have agreed to pay for their shares (s. 87(2) of the *BCA*).

The advantages of limited liability can be maximized if a company can find a third party lender who will lend money directly to the company without taking personal guarantees from the shareholders. In practice, however, lenders will not typically make loans directly to small or newly incorporated companies without personal guarantees of the shareholders, effectively negating the benefit of limited liability for the shareholders, at least with regard to those lenders.

Assuming that a lender is not willing to lend funds to a company without a personal guarantee, the question then arises as to which of the following methods of financing the company is better:

(1) direct loan by a third party to the company, combined with a shareholder guarantee of the loan; or

(2) loan by a third party to the shareholder who, in turn, makes a shareholder's loan to the company or purchases shares.

Often the lender will dictate the terms of borrowing and specify one course of action or the other, but if the shareholder does have a choice, the answer to this question will depend on the following:

(1) whether the individual or the company is better able to use tax deductibility of the interest payable on the loan;

(2) the balance sheet presentation the company may be trying to achieve;

(3) the shareholder's personal preference for borrowing as opposed to guaranteeing; and

(4) the fees involved in structuring the transaction one way versus the other.

If a third party makes a loan directly to the company, only the company can use the interest deduction, and it will benefit the company only if there are corporate profits against which the company can make the deduction. If a third party lends to the shareholder who in turn makes a loan to the company, the shareholder can take the interest deduction against its other income. Regardless of which choice is made, if there are two or more shareholders and only one of them is guaranteeing or borrowing on behalf of the company, it is reasonable for the guarantor/lender to be paid a fee for providing the financing. If there is a shareholders' agreement, that agreement could provide that such a fee will be payable in priority to dividends or return of capital.

1. ADVANTAGES OF BORROWING [§7.10]

Borrowing funds from non-shareholder or "outside" lenders provides the company with another source of financing.

If shareholders are not required to provide personal guarantees of the company's indebtedness, the shareholders will enjoy the maximum benefit of limited liability inherent in the company's existence under the *BCA*.