

## Canada's Problematic Proposed New Loan Rules

by Steve Suarez

Reprinted from *Tax Notes Int'l*, May 5, 2014, p. 441

# FEATURED PERSPECTIVES

---

## Canada's Problematic Proposed New Loan Rules

by Steve Suarez

Steve Suarez is a partner with Borden Ladner Gervais LLP in Toronto.

**C**anada's 2014 federal budget included some alarming international tax initiatives. While the most disturbing is a radical proposal to override all of Canada's tax treaties under an extremely broad domestic anti-treaty-shopping rule,<sup>1</sup> another proposed change is creating problems in the financing sector.

Proposed new "back-to-back loan" rules that treat the provision of security for another person's debt as the equivalent of a loan to that person are already producing unfortunate (and unintended) consequences under Canada's interest withholding tax and thin capitalization rules. The result is that beginning in 2015, many Canadian borrowers will find that interest on debt they have incurred (even to a Canadian creditor) bears nonresident interest withholding tax and is subject to restrictions on interest deductibility, if a nonresident has provided security for the debt (directly or indirectly). These proposed rules go far beyond actual back-to-back loans, and Canada's Department of Finance is aware that they need to be scaled back significantly.

The proposed back-to-back loan rules are in fact two separate amendments to the existing interest withholding tax and thin capitalization rules. It is necessary to summarize the existing rules in order to explain how the proposals operate to extend their reach. The wording of both elements of the proposals is largely identical, however, and they can be discussed together.

<sup>1</sup>Steve Suarez, "Canada to Unilaterally Override Tax Treaties With Proposed New Anti-Treaty-Shopping Rule," *Tax Notes Int'l*, Mar. 3, 2014, p. 797.

### Canadian Interest Withholding Tax

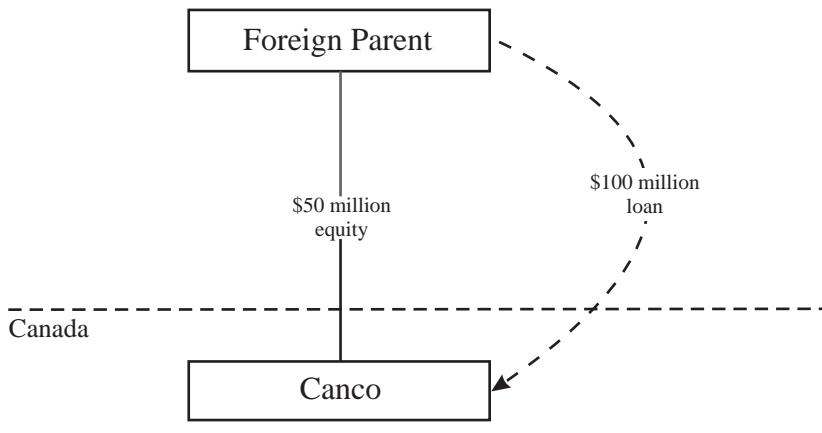
Canadian domestic law imposes interest withholding tax only on (1) interest paid to a nonresident person not dealing at arm's length with the payer, or (2) participating interest. Thus, Canadian interest withholding tax is generally relevant only in a non-arm's-length context.

Most Canadian tax treaties reduce the rate of Canadian interest withholding tax to 10 percent. Canada's tax treaty with the United States is the only Canadian tax treaty that reduces the interest withholding tax rate to zero for interest paid to a U.S. resident entitled to claim the benefit of such reduction under the Canada-U.S. treaty's limitation on benefits article.<sup>2</sup>

### Canada's Thin Capitalization Rules

Canadian corporate income tax rates (combined federal and provincial) currently range from about 25 to 30 percent, depending on the relevant province to which the income is attributable. Thus, \$1 of interest expense incurred by a Canadian corporation on debt owing to a non-arm's-length nonresident creditor (for example, a foreign parent or sister corporation) yields roughly 25 to 30 cents in Canadian income tax saved, at a cost of 10 cents (or zero, for U.S. creditors) interest withholding tax. Depending on the amount of tax paid in the creditor's home country, this can create an incentive for multinational groups to thinly capitalize their Canadian operations, with high (interest-expense-generating) debt and little equity.

<sup>2</sup>A U.S. resident may claim such benefit as a "qualifying person" or under one of the other exceptions in the Canada-U.S. treaty's LOB rules; see Suarez, "Thoughts on the New LOB Clause in the Canada-U.S. Treaty," *Tax Notes Int'l*, Oct. 5, 2009, p. 39. For purposes of this article, U.S. residents are assumed to be entitled to the 0 percent withholding tax rate on Canadian-source payments of interest.

**Figure 1. Basic Thin Capitalization Example**

To limit the potential for cross-border intragroup interest stripping, the thin capitalization rules<sup>3</sup> limit the amount of debt owing to certain nonresidents on which a Canadian resident corporation (Canco)<sup>4</sup> can deduct interest expense. The debt caught by these rules is debt owing by Canco to “specified nonresidents.”

The first step in the analysis is to determine whether any “specified shareholder” of Canco exists. A specified shareholder of Canco is a person who (alone or together with non-arm’s-length persons) owns Canco shares representing 25 percent or more of the votes or value attributable to all Canco shares.<sup>5</sup>

A specified nonresident as regards Canco is defined as a nonresident person who either:

- is a specified shareholder of Canco; or
- does not deal at arm’s length with a specified shareholder of Canco.

<sup>3</sup>Subsections 18(4)-(8) of the Income Tax Act (Canada). All statutory references are to the ITA except where otherwise noted.

<sup>4</sup>While the discussion that follows is framed with reference to a debtor that is a Canadian resident corporation, as a result of changes included in the 2013 federal budget, the thin capitalization rules now apply not only to Canadian resident corporations, but also to Canadian resident trusts and to corporations and trusts not resident in Canada that either carry on business in Canada or elect to be taxed as Canadian residents. Partnerships in which such entities are members are also generally included. See Suarez and Stephanie Wong, “Canadian Tax Planning Deadlines for 2013,” *Tax Notes Int’l*, Nov. 11, 2013, p. 551.

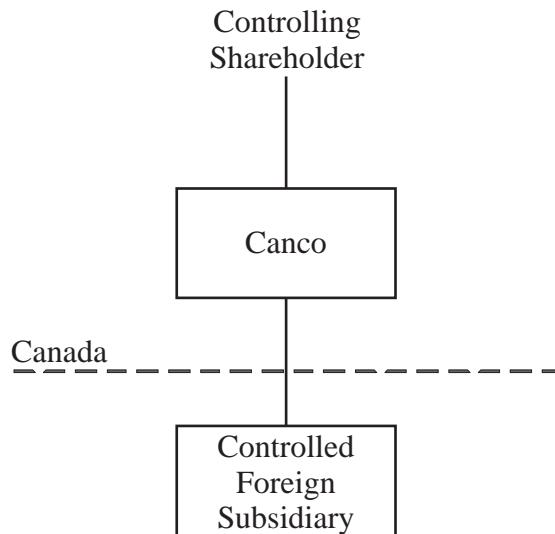
<sup>5</sup>For this purpose, rights to acquire shares or control the voting rights of shares or to cause shares to be redeemed by the issuer may be deemed to have been exercised so as to cause a person who might not otherwise be a specified shareholder to nonetheless be one.

The thin capitalization rules function on the basis of a permitted debt-to-equity ratio. They apply if, in a given Canco tax year, the amount of debt owing by Canco to specified nonresidents (hereinafter “restricted debt”) exceeds 150 percent of Canco’s equity, which for this purpose is limited to the sum of the following:

- Canco’s unconsolidated retained earnings at the start of the tax year;
- the paid-up capital (PUC) of Canco shares held by nonresident specified shareholders of Canco; and
- Canco’s contributed surplus to the extent contributed by nonresident specified shareholders of Canco.

For example, a Canadian company that owes \$100 million to its foreign parent and has only \$50 million of equity for thin capitalization purposes will be able to deduct interest expense relating to only \$75 million of that debt. (See Figure 1.) Interest on the remaining \$25 million of debt will be nondeductible for Canadian tax purposes and will be recharacterized as a dividend to which Canadian nonresident dividend withholding tax will apply at a 25 percent rate (subject to reduction under an applicable tax treaty), instead of as interest (which as noted above would generally be received by most U.S. recipients free of Canadian withholding tax).<sup>6</sup>

<sup>6</sup>In the 2012 federal budget, the debt-to-equity ratio was tightened from 2 to 1 to 1.5 to 1, interest deemed nondeductible under these rules was recharacterized as a dividend for withholding tax purposes, and the rules were extended to debt incurred by partnerships that have one or more Canadian resident corporations as members. See Suarez, “Canadian 2012 Federal Budget: Tightening the Screws,” *Tax Notes Int’l*, Apr. 16, 2012, p. 247.

**Figure 2. Thin Capitalization Anomalies**

- Controlled Foreign Subsidiary deals non-arm's-length with Controlling Shareholder. Therefore, Controlled Foreign Subsidiary is a specified nonresident.
- If Controlling Shareholder is a Canadian resident, PUC/contributed surplus attributable to its Canco investment is not included in computation of Canco "equity."

The thin capitalization rules contain several technical anomalies and potential traps for the unwary.<sup>7</sup> In particular, the following should be noted (illustrated in Figure 2):

- when Canco has a controlling shareholder (either resident in Canada or nonresident), any foreign subsidiaries controlled by Canco will be specified nonresidents by virtue of not dealing at arm's length with that controlling shareholder; and
- when a specified shareholder is a Canadian resident, the PUC of its Canco shares (and any contributed surplus received by Canco from such Canadian resident) is *not* included in Canco's equity, even though Canco debt owing to nonresidents not dealing at arm's length with that controlling shareholder is deemed to be restricted debt.

### **Proposed Back-to-Back Loan Rules**

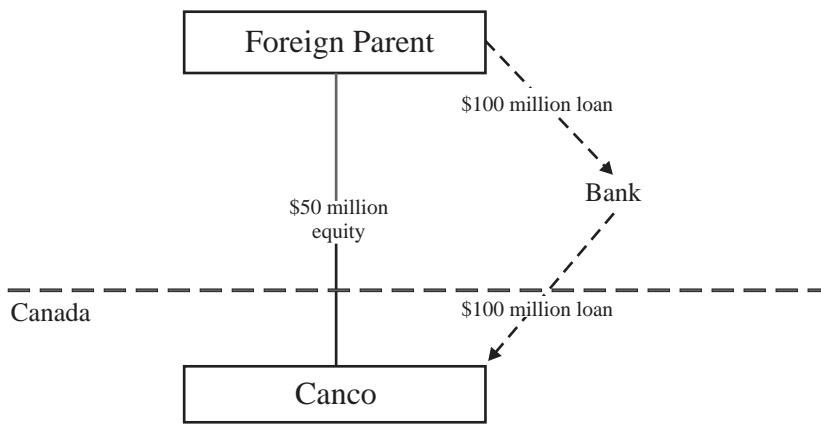
Absent antiavoidance measures, a back-to-back loan could be used fairly easily to get around the limitations

of the interest withholding tax and thin capitalization rules. As illustrated in Figure 3, Foreign Parent could make a loan to a bank or other arm's-length intermediary (whether resident in Canada or not), which could in turn make a corresponding loan to Canco. Because a loan by an arm's-length lender to Canco does not give rise to Canadian interest withholding tax and is not included in Canco's restricted debt, interposing such an intermediary could achieve indirectly what could not be achieved by a direct loan from Foreign Parent to Canco.

While some existing provisions in the Income Tax Act (Canada) address the simplest forms of back-to-back loans (and historically, some forms of back-to-back loans have been permitted administratively),<sup>8</sup> the Department of Finance is clearly concerned with variations on this theme that are not quite so direct. This

<sup>7</sup>There are various computational anomalies in the determination of restricted debt and equity. For example, restricted debt for a tax year is determined based on the *greatest* amount of restricted debt owing at any time during each calendar month ending in that tax year. The PUC and contributed surplus elements of equity are based on the amount of such attributes at the *beginning* of each calendar month that ends in the tax year.

<sup>8</sup>The Canada Revenue Agency has said that it will apply the existing back-to-back loan rule within the thin capitalization provisions (section 18(6)) only when those provisions are being frustrated; see paragraph 3 of Interpretation Bulletin IT-59R3, "Interest on Debts Owing to Specified Non-Residents (Thin Capitalization)," Sept. 26, 1986. For example, the CRA has specifically accepted a loan from a foreign parent to a high-equity Canadian subsidiary, which then on-loans the funds to a low-equity Canadian subsidiary; see *Income Tax Technical News*, No. 15, Dec. 18, 1998. It is unclear whether this favorable administrative position would survive the proposals.

**Figure 3. Back-to-Back Loan**

concern is completely understandable in principle. The question from a tax policy perspective is under what circumstances should multiple transactions that include third parties be ignored and treated as the equivalent of a direct loan to Canco that ignores the third parties.

### When the Proposed Rules Apply

Following are the threshold conditions for the application of the proposals that are common to both the thin capitalization and interest withholding tax elements<sup>9</sup>:

- Canco owes a debt to a person or partnership (Creditor). Note that Creditor's fiscal residence and relationship to Canco are irrelevant.
- One of the following three circumstances (hereinafter, the "secondary obligation") exists between Creditor (or someone not dealing at arm's length with Creditor) and a nonresident of Canada (Nonresident), as part of the same series of transactions that includes Canco incurring the debt to Creditor (or becoming liable to pay interest on that debt):
  - Nonresident gives Creditor or a Creditor affiliate (directly or indirectly) an interest in any property that secures Canco's debt to Creditor (for example, a secured guarantee);
  - Creditor owes an amount to Nonresident, and Nonresident's recourse under that secondary debt is limited (immediately or in the future, absolutely or contingently) to Canco's debt to Creditor; or
  - Creditor or a Creditor affiliate owes an amount to Nonresident, and that secondary

debt was entered into on condition that Canco's debt to Creditor will also be entered into (for example, a traditional back-to-back loan).

While Canco's incurrence of the debt to Creditor (or obligation to pay interest on that debt) must be part of the same "series of transactions" that includes the creation of the secondary obligation in order for the proposals to apply, the nexus required between two events to make them part of the same series of transactions for Canadian tax purposes is low.<sup>10</sup> Figure 4 provides a basic illustration of the threshold conditions for the proposals.

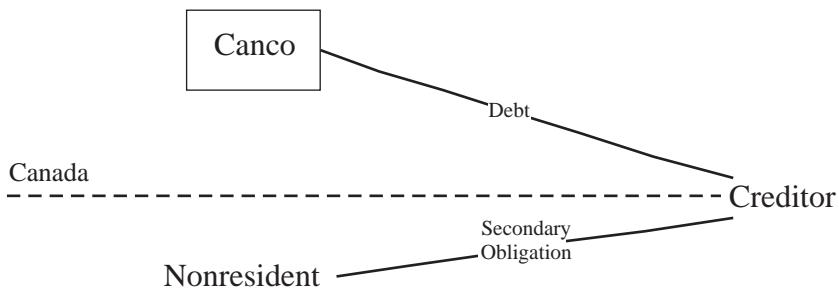
Note that the proposals are not triggered by Canco pledging *its own assets* (including shares of foreign subsidiaries) as security for its own debt. Also, *unsecured guarantees* from nonresidents (including foreign subsidiaries) do not engage the proposals.

The proposals may apply when the secondary obligation involves a person not dealing at arm's length with Creditor rather than Creditor itself. For example, if a bank has separate subsidiaries in different countries or across different lines of business, a loan to Canco by one member of the bank group may be affected by a secondary obligation to another bank group member (as depicted in Figure 5).

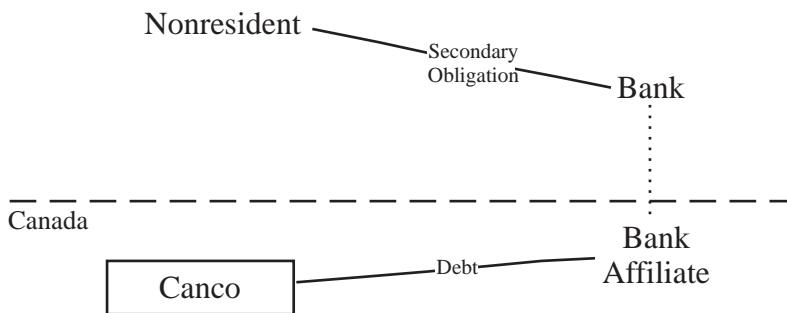
Clearly the most common and problematic of the three secondary obligations is when Nonresident has provided Creditor or a Creditor affiliate (directly or indirectly) with an interest in property that secures payment of the Canco debt to Creditor because Canco debt is frequently secured by property owned by a foreign parent, subsidiary, or sister entity. This type of security arrangement occurs almost invariably for

<sup>9</sup>The text of the proposals is available at <http://www.budget.gc.ca/2014/docs/plan/toc-tdm-eng.html> (p. 393).

<sup>10</sup>See on this point Suarez, "Canada's 88(1)(d) Tax Cost Bump: A Guide for Foreign Purchasers," *Tax Notes Int'l*, Dec. 9, 2013, p. 935, at 939.

**Figure 4. B2B Proposal Preconditions**

1. Canco owes the Debt to Creditor.
2. Secondary obligation exists between Creditor and Nonresident:
  - (a) Nonresident (directly or indirectly) gives Creditor an interest in property that secures the Debt; or
  - (b) Creditor owes an amount to Nonresident and either (i) Nonresident's recourse for that secondary debt is limited (absolutely or contingently) to the Debt, or (ii) that secondary debt was entered into on condition that the Debt be entered into.

**Figure 5. Creditor and Creditor Affiliate Example**

purely commercial reasons: Lenders want as much security as possible, and borrowers want to reduce the interest rates at which they borrow wherever possible. It is therefore perplexing why as a tax policy matter the Department of Finance chose to treat all secured guarantees from nonresidents as equivalent to a direct loan from the nonresident to Canco. The discussion that follows is framed using the provision of security for Canco's debt as the relevant secondary obligation.

If the threshold conditions of the proposals apply, it is then necessary to determine whether either or both of the separate thin capitalization and interest withholding tax elements of the proposals exist. Essentially, these elements can be summarized as follows:

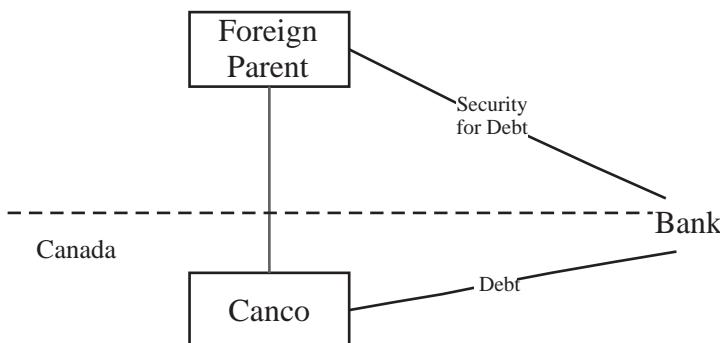
- *Thin Capitalization:* If Creditor is *not* a specified nonresident, and Nonresident is a specified non-

resident, Canco's debt to Creditor<sup>11</sup> is instead deemed to be owed to Nonresident for thin capitalization purposes. The result is that what would otherwise be "good" debt for thin capitalization purposes becomes restricted debt. This proposal applies to tax years beginning after 2014.

- *Interest Withholding Tax:* If the rate of Canadian interest withholding tax applicable to Nonresident would be higher than the rate applicable to Creditor, Canco effectively computes its withholding tax as if the interest payment had been made to

---

<sup>11</sup>Or the value of the property Nonresident has provided as security for Canco's debt, if less than the amount of that debt.

**Figure 6. Thin Capitalization Example 1**

Canco treated as owing debt directly to Foreign Parent for thin capitalization purposes.

Nonresident rather than to Creditor — that is, the higher withholding tax rate applies.<sup>12</sup> This proposal applies to interest paid or credited after 2014.

#### **Consequences of Application: Thin Capitalization**

Because thin capitalization restrictions are premised on the existence of a specified shareholder of Canco, this element of the proposals would generally be relevant only when such a person exists. Closely held Canadian companies are therefore most at risk under the thin capitalization element of the proposals.

The most obvious example will be when Canco is a Canadian subsidiary of a foreign parent corporation and that foreign parent or another member of the same multinational group provides security for Canco's debt. (See Figure 6.) In this instance, the foreign parent will be a specified shareholder, and it (and any nonresident not dealing at arm's length with it) will be a specified nonresident. The result is that what would otherwise be ordinary bank debt is transformed into restricted debt, which either triggers the immediate application of the thin capitalization rules (that is, non-deductible interest expense to which dividend withholding tax applies) or uses up thin capitalization capacity available under the 1.5-to-1 debt-to-equity limit for future cross-border intragroup debt financing of Canco.

The thin capitalization aspect of the proposals can also apply, however, when Nonresident is a foreign

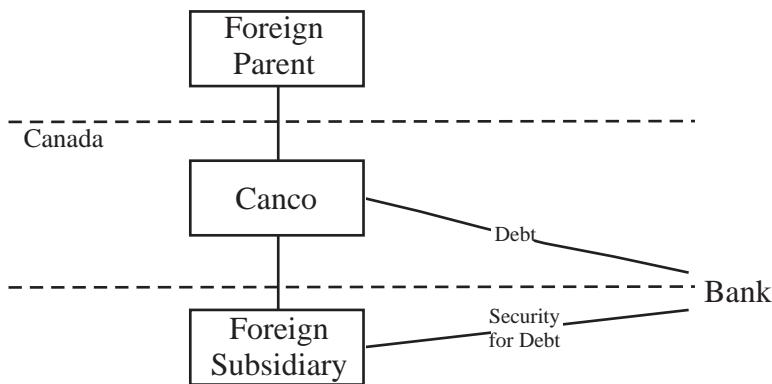
subsidiary of Canco, as illustrated in Figure 7. If there is a specified shareholder of Canco that has de jure control of Canco, then Canco's foreign subsidiary will be a specified nonresident by virtue of not dealing at arm's length with the specified shareholder. If the foreign subsidiary provides security for Canco's debt, the proposals would deem Canco to owe the debt to the foreign subsidiary for thin capitalization purposes, creating restricted debt.<sup>13</sup> Worse still, if that controlling shareholder of Canco is a Canadian resident, then, as noted above with reference to Figure 2, the PUC of any Canco shares owned by such Canadian resident is not included in the computation of Canco's equity, even though the presence of that same Canadian resident causes Canco's bank debt secured by the foreign subsidiary's property to be restricted debt. The tax policy justification for this result is very difficult to see.

#### **Consequences of Application: Withholding Tax**

From a withholding tax perspective, under the proposals the presence or absence of a specified shareholder or controlling shareholder of Canco generally does not matter. Instead, the relevant question is simply whether the nonresident providing security for Canco's debt would be subject to a higher Canadian interest withholding tax than Creditor on interest payments from Canco. In this regard, because U.S. residents can generally receive interest payments from Canco free of

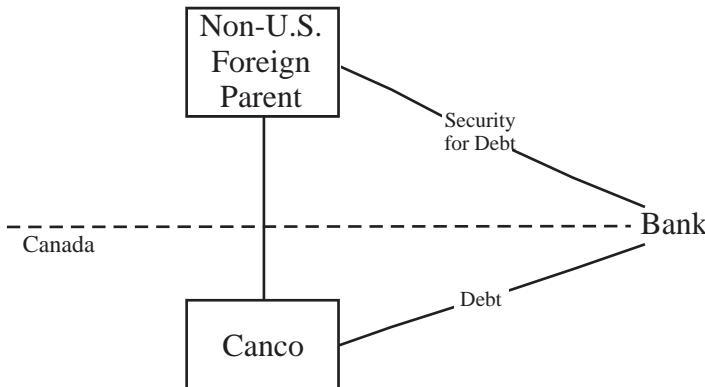
<sup>12</sup>The actual mechanism is somewhat more complicated, but this is the practical effect. Where more than one nonresident provides security for Canco's debt, anti-double-counting rules prevent the increased Canadian withholding tax arising from the proposals from applying to more than the actual amount of interest paid. If the value of the property provided as security is less than the amount of the debt, the effect of the proposals is reduced proportionately.

<sup>13</sup>In fact, if Canco owes an *actual* debt to a controlled foreign affiliate, a specific exception (section 18(8)) prevents the denial of interest expense deductions under the thin capitalization rules if the creditor's interest income is imputed back to Canco on a current basis as passive income under Canada's CFC rules. However, the proposals do not incorporate this exception, since they deem amounts to be owed by Canco to foreign subsidiaries only for thin capitalization purposes, not for CFC rule purposes — that is, the notional loan cannot meet the terms of section 18(8).

**Figure 7. Thin Capitalization Example 2**

Canco treated as owing debt directly to Foreign Subsidiary for thin capitalization purposes.

Same result if Foreign Parent is resident in Canada (in which case PUC of its Canco shares excluded from “equity”).

**Figure 8. Withholding Tax Example 1**

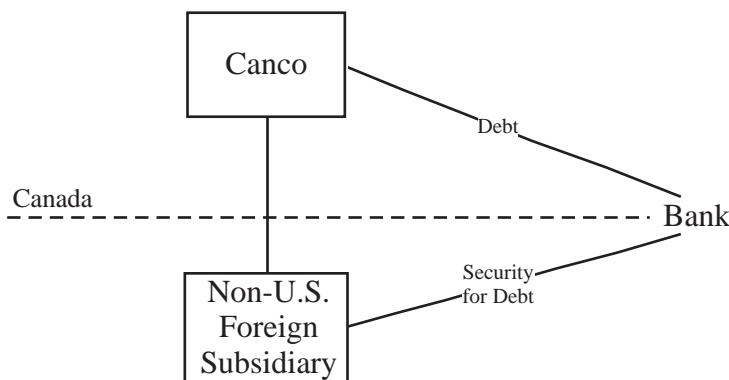
Canco treated as owing debt directly to Non-U.S. Foreign Parent for interest withholding tax purposes.

Canadian interest withholding tax, an important distinction exists between U.S. residents and all other non-residents of Canada.

As Figure 8 illustrates, in the simplest case, a foreign parent of Canco that is not a U.S. resident and that secures Canco's debt will be subject to a higher Canadian interest withholding tax rate than an arm's-length creditor, such as a bank. As such, non-U.S. foreign parent or sister corporations that guarantee debt owing by Canco to an arm's-length creditor (or a U.S. resident creditor, for that matter) will attract the application of the interest withholding tax element of the proposals,

and Canadian interest withholding tax will apply on arm's-length bank debt by virtue of a security interest having been provided by a non-U.S. nonresident.

As with the thin capitalization element of the proposals, the interest withholding tax rule may apply to a Canco that has no foreign shareholders. For example, a Canco that has a foreign subsidiary may find itself paying Canadian interest withholding tax on its bank debt where that debt is supported by a secured guarantee provided by a foreign subsidiary, except where that foreign subsidiary is a U.S. resident. Because any non-U.S. foreign subsidiary would be subject to a higher

**Figure 9. Withholding Tax Example 2**

Canco treated as owing debt directly to Non-U.S. Foreign Subsidiary for interest withholding tax purposes.

Canadian interest withholding tax rate than an arm's-length creditor on interest from Canco, a secured guarantee from such a foreign subsidiary will create Canadian interest withholding tax under the proposals. (See Figure 9.)

Given how frequently members of multinational groups provide security for the external debts of other group members, many Canadian corporations (whether parent corporations or subsidiaries) are likely to be affected by the proposals. For example, many multinational groups have cross-guaranteed external financing, or have cash pooling arrangements whereby surplus cash in one group entity is swept into a financial institution and credited in one form or another against debts owing by other group members to the same financial institution (including its local affiliates). These arrangements often involve the assets of all group members securing the overall net balance owing by the group to the financial institution. Ostensibly, in these circumstances a balance owing by a Canadian group member will be caught by the proposals simply by virtue of being secured by the assets of a foreign group member (or possibly by virtue of the foreign group member's surplus cash having been directed to the financial institution "on condition that" the Canadian group member be allowed to run a deficit).

Another example of the odd results produced by the proposals is set out in Figure 10, which describes a fact pattern actually encountered in practice. In this case Canco's shares are publicly traded, but Canco has a Canadian resident shareholder that (together with non-arm's-length persons) owns sufficient shares to have de jure control of Canco. As a result, Canco's foreign subsidiaries are both specified nonresidents from a thin capitalization perspective, and (other than the U.S. subsidiaries) "worse" persons (relative to a bank) from a Canadian interest withholding tax perspective. Unless

the proposals are amended or Canco's bankers are willing to release all secured property interests that Canco's foreign subsidiaries have granted to them, starting in 2014:

- the amount of Canco's bank debt on which interest is deductible will be limited to 150 percent of its unconsolidated retained earnings;<sup>14</sup> and
- for interest withholding tax purposes, Canco will be deemed to pay the interest on its bank debt to its non-U.S. foreign subsidiaries, making interest withholding tax exigible.

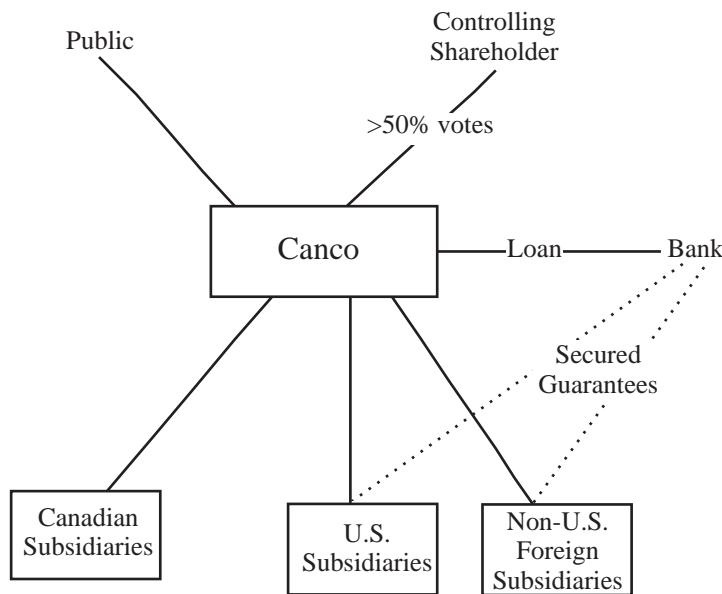
Needless to say, this is a counterintuitive result.

## Conclusion

It is understood that the Department of Finance is aware of the overbreadth of treating the grant of a security interest in property as the equivalent of a loan by the grantor under the proposals. As such, there is some hope that a revised version of these proposals will dramatically scale back their reach to something that reasonably reflects the substantive equivalent of a back-to-back loan.

Until this occurs however, Canadian borrowers and their creditors are left in a difficult position, particularly since credit facilities tend to be several years in duration and take considerable time to establish (especially when more than one country is involved). It is anticipated that Canadian borrowers will be willing to

<sup>14</sup>Because the specified shareholder of Canco is a Canadian resident, the PUC of its Canco shares and any contributed surplus received from it is not included in Canco's equity for thin capitalization purposes.

**Figure 10. Composite Example*****Thin Capitalization***

- U.S. and Non-U.S. Foreign Subsidiaries deal non-arm's-length with Controlling Shareholder.
  - They are “specified nonresidents” for thin capitalization purposes.
  - For thin capitalization purposes, Canco is treated as owing Bank debt to them.

***Withholding Tax***

- If Canco owed debt directly to Non-U.S. Foreign Subsidiaries, interest withholding tax rate would be  $> 0$ .
  - Canco is deemed to owe Bank debt directly to Non-U.S. Foreign Subsidiaries.

pledge as security the interests they own in their foreign subsidiaries, but that they will resist having their debt secured by a pledge of assets owned by foreign subsidiaries, parent corporations, or sister entities. Unsecured guarantees from these foreign entities should be acceptable. If legislative relief does not come by the

end of the summer (or if any new amendments do not adequately address the overreach of the proposals), affected taxpayers will have to consider restructuring their debt to ensure that their borrowing arrangements do not produce nondeductible interest expense and increased withholding tax beginning in 2015. ◆