PRACTITIONERS' CORNER

Budget Proposal to Affect Gross-Up Clauses in Canadian Loan Agreements

by Daniel Lang

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The 2012 Canadian budget has proposed measures to treat interest that is not deductible by a Canadian borrower because of the thin capitalization restriction as being in the nature of a dividend that is deemed to be paid to the relevant nonresident lenders. As a result, a portion of the interest paid to a non-Canadian borrower may instead become subject to the imposition of Canadian withholding tax on the amount of this deemed dividend. The budget legislation was introduced in the Canadian Parliament on October 18, 2012, as Bill C-45 and, in particular, is reflected in proposed subsection 214(16) of the Canadian Income Tax Act.

The proposals are changing the scope of the tax ''gross-up'' clause typically included in loan documentation. Accordingly, non-Canadian lenders should carefully consider its impact before committing to new loan arrangements with Canadian resident borrowers.

Background

It has become standard practice under Canadian loan agreements for a Canadian resident borrower to compensate the lender through a gross-up, or additional interest payment, for the withholding taxes that are imposed on interest payments made by that borrower.

In understanding the significance of the gross-up provision, note that the ITA has various statutory exemptions that limit the imposition of withholding tax on interest payments. Therefore, the interest payable under the Canadian commercial loan agreements might already be payable free of withholding tax and, before the application of the budget proposal, render moot the application of any gross-up clause. First, the ITA does not impose withholding tax on interest paid by a Canadian borrower to a Canadian resident lender. The tax gross-up provision in a lending agreement should be irrelevant to loans made by a Canadian resident lender to a Canadian borrower. Second, there is currently no withholding tax imposed on interest payments made by a Canadian borrower to an arm's-length nonresident lender, except for interest that would be characterized as ''participating interest.'' Participating interest is generally calculated by using the borrower's revenue, profit, cash flow, or a commodity price. Conventional lending agreements that use either a fixed rate or a floating rate tied to an industry benchmark, such as LIBOR, should not be characterized as being participating interest. As a result, interest paid to nonresidents of Canada under the loan agreement should not be subject to Canadian withholding tax, unless that recipient dealt at non-arm's-length to the borrower.

Even if the ITA imposes withholding tax on interest payments between a Canadian borrower and a non-arm's-length U.S. resident lender, there might still be relief available from Canadian withholding tax if the lender qualified under Article XI(1) of the Canada-U.S. tax treaty.

Assuming that the lender is a nonresident of Canada and also does not qualify for relief under the Canada-U.S. tax treaty, the Canadian statutory exemption from withholding tax would require an assessment whether the nonresident lender deals at arm's length to the Canadian borrower.

It can be a somewhat complicated exercise to apply the ITA definition of arm's length. One branch of the definition focuses on whether the particular shareholder (and other related entities) holds a sufficient number of voting shares to elect a majority of the board of directors of the affected company. This is known as the de jure control test. If the particular shareholder (and other related entities) owned more than 50 percent of the voting shares of the company, then that shareholder would have de jure control over the company and the parties would not deal at arm's length. Since the 50 percent voting control threshold is a mechanical test, it is usually straightforward to apply. However, a second branch of the test is based on facts and circumstances. Even if that shareholder did not have sufficient votes to exercise de jure control of the borrower, it could still be considered to deal at non-arm's-length if circumstances caused that lender to exercise de facto control over the borrower.

Existing Canadian Gross-Up Provisions

The gross-up clause in Canadian loan agreements is not unlimited. Under current Canadian commercial practices, the gross-up clause would require that the lender and the nonresident borrowers be dealing at arm's length.

Even with the difficulty that may arise in formulating a definition for arm's length, the arm's-length requirement should not present concerns regarding the typical Canadian loan agreement. The commercial loan agreements are premised on the notion that the lender would want sufficient security from the borrower to ensure repayment of the loan but that the lender would not otherwise wish to exercise any control over the management of the borrower. Nonresident lenders should recognize the consequences of acquiring control — either voting control or control in fact — over a Canadian corporate borrower. If such arm's-length threshold were to be violated by the nonresident lender, neither the Canadian statutory exemption from withholding tax (but subject to the possible subsequent relief under the Canada-U.S. tax treaty) nor the gross-up protection against withholding tax that is provided under the typical Canadian loan agreement should be available to that particular lender.

From a risk perspective, the intent of the gross-up clause is to provide protection to the arm's-length non-Canadian lenders should there ever be an unforeseen change in Canadian tax law that results in the imposition of a withholding tax. Moreover, from a regular operational perspective of the borrower, the gross-up clause should not present a financial cost to the borrower as it is unlikely to require a compensation payment be made under that gross-up clause.

Changes to Canadian Thin Cap Restrictions

Until the budget measures were released, the Canadian thin capitalization provisions generally denied an interest expense deduction to the Canadian borrower if two conditions were satisfied. These conditions were that first, interest must be paid to a ''specified shareholder,'' and second, the debt owing to all specified shareholders could not exceed a determined ratio. If the non-Canadian lender were to qualify as a specified shareholder of the Canadian borrower and the thin capitalization ratios were then exceeded, a portion of the interest as calculated under a mathematical formula would not have been eligible for a Canadian tax deduction by the Canadian resident borrower.

The debt-to-share capital ratio was formerly 2 to 1, and it was calculated monthly. The budget measure will reduce this threshold to 1.5 to 1, by virtue of proposed subsection 18(4) of the ITA.

The thin capitalization restriction also required that some portion of the interest expense be payable to a lender who was not a resident of Canada and who met the conditions to be a specified shareholder of the Canadian borrower. A specified shareholder includes a nonresident person who holds shares in the Canadian corporate borrower, when those shares represent at least a 25 percent voting interest in that Canadian corporation or at least 25 percent of the fair market value of all issued shares of that Canadian corporation. Although a 25 percent shareholding may not represent a controlling share interest in the Canadian borrower, it would arguably represent a significant shareholding with a possible ability to influence the operations of the company. It is also important to recognize that even though the lender may be classified as a specified shareholder of the borrower, the lender and the borrower could still be dealing with each other at arm's length.

The budget measure, as provided under proposed subsection 214(16), will cause denied interest expense to be recognized by the nonresident lender as a dividend. This deemed dividend would then cause that lender to be subject to the imposition of Canadian withholding tax at the rate applicable to dividends. The statutory rate of withholding tax under the ITA for the payment of a dividend to a nonresident of Canada is 25 percent, but it could be reduced to a lower rate under a relevant tax treaty. However, none of Canada's tax treaties provide for a withholding tax rate of less than 5 percent.

Implication to Loan Agreements

The budget and proposed subsection 241(16) of the ITA will alter the withholding tax dynamics that have existed between the Canadian corporate borrowers and its nonresident lenders.

Subsequent to the budget measure, the evolving practice in the loan documentation applicable to a Canadian resident borrower is to exclude a lender who is a specified shareholder of the Canadian resident borrower from claiming the benefit of a gross-up clause. As a consequence, a tax gross-up clause inserted into

Canadian loan agreements would now reflect the additional provisions of clause (2) as follows:

> *the foregoing obligations to pay additional interest amounts do not apply* (1) to any Taxes imposed on a payment to a holder or beneficial owner of the loan with which the applicable Payor does not deal at arm's length (within the meaning of the Income Tax Act (Canada)) at the time of the payment; and *(2) by virtue of all or any portion of such payment being deemed to be a dividend paid to such holder or beneficial owner pursuant to proposed subsection 214(16) of the Income Tax Act (Canada)*. [Emphasis added.]

From a non-Canadian lender's perspective, the concern is that a portion of the disallowed thin capitalization interest expense paid to that lender would now be recharacterized as a dividend receipt and, thereby, would subject the nonresident lender to Canadian withholding tax on a portion of the interest payment. Any such interest amount that would be reclassified as a deemed dividend would not be eligible for the interest withholding exemption provided under the ITA, since by definition it is to be treated for Canadian withholding tax purposes as a dividend.

The carveout from the gross-up clause for specified shareholders is a significant departure of the previous Canadian position that all nonresident lenders who dealt at arm's length with the Canadian borrower were protected from Canadian withholding tax that could be imposed on the interest payments. The implication is clear: A non-Canadian lender runs the risk of incurring uncompensated withholding tax once it crosses the threshold of being a specified shareholder of the Canadian borrower.

The potential exposure for Canadian withholding tax will not be problematic for those non-Canadian lenders who wish to maintain only a commercial lending relationship with the Canadian resident borrower.

Nonetheless, it is possible to conceive of unintended and adverse tax results, particularly in situations involving private equity and hedge funds. For example, assume that particular fund accumulates debt issued by a distressed Canadian company and then wishes to accumulate equity of that borrower in order to influence the restructuring process. If the fund acquires sufficient equity to then become a specified shareholder to the Canadian borrower, some portion of the interest received by a non-Canadian lender may now become subject to Canadian withholding tax. Under the evolving Canadian lending standards, such withholding tax would no longer be eligible for the benefit of the gross-up clause. Admittedly, based on the relevant mathematical formula under the ITA, the affected interest amount may only be a small portion of the total interest payable to the nonresident lender. Nonetheless, the key principle is that there is no longer any certainty that a non-Canadian lender dealing at arm's length with a Canadian borrower will always be compensated for any Canadian withholding tax that may be levied.

The exclusion from the tax gross-up clause would suggest that a non-Canadian lender, even if that lender deals at arm's length with the Canadian borrower, should carefully review whether it also wishes to become a shareholder in that borrower. ◆