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by Steve Suarez

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PRACTITIONERS' CORNER

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by Steve Suarez

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A notice of ways and means motion (NWMM) containing legislative changes to the Income Tax Act (Canada) was tabled in Canada's House of Commons on October 20, 2014.[1] Several international tax measures were included in the NWMM, including those that had been released by the Department of Finance on August 29 in draft legislation. One such measure was a significant expansion of antiavoidance elements of Canada's thin capitalization and interest withholding tax rules dealing with back-to-back loans.

The NWMM includes a revised (and apparently final) version of the back-to-back loan rules (the B2B rules). This version provides significant improvements over both the initial version included in the federal budget of February 11, 2014,[2] and the revised version included in the August 29 release.[3] The B2B rules apply starting in taxation years beginning after (or to interest paid or credited after) 2014, with no grandfathering relief provided for existing debt.

Background

Canadian domestic law imposes withholding tax (at a 25 percent rate) on interest paid by a Canadian to a nonresident only when:

- the nonresident does not deal at arm's length with the payer; or
- the interest is participating interest.

When the recipient is fiscally resident in a country with which Canada has a tax treaty, the withholding tax rate is generally reduced to 10 percent. The rate on nonparticipating interest under the Canada U.S. tax treaty is zero for a U.S. resident recipient that meets the treaty's limitation on benefits requirements.

Canada has thin capitalization rules in place that limit the extent to which a domestic taxpayer can deduct interest expense on debt owing to non-arm's-length nonresidents. Such rules restrict potential base erosion that might otherwise occur if interest expense that reduces the payer's domestic income tax (by roughly 25 cents per dollar of interest, in the case of Canadian corporations) is used to strip out Canadian-source profits, often with little or no Canadian interest withholding tax.

Canada's thin capitalization rules limit the extent to which a Canadian resident corporation[4] (Canco) can incur interest expense payable to a nonresident who is either a 25-plus percent shareholder of Canco (by votes

[1]Explanatory notes articulating the Department of Finance's thinking behind these legislative amendments (which usually accompany any legislation released) were not included with the October 20 NWMM, and are expected to be released at a later date.

[2]For prior coverage, see Steve Suarez, "Canada's Problematic Proposed New Loan Rules," *Tax Notes Int'l*, May 5, 2014, p. 441.

[3]For prior coverage, see Steve Suarez, "An Analysis of Canada's Latest International Tax Proposals," *Tax Notes Int'l*, Sept. 29, 2014, p. 1131.

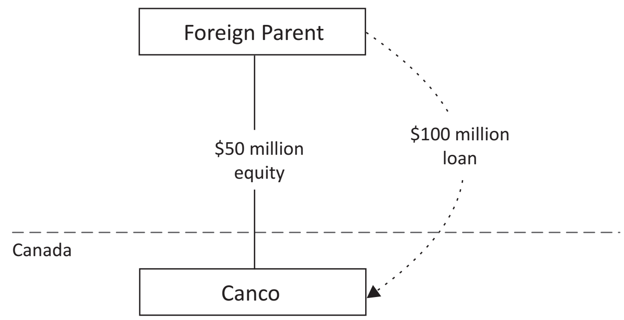
[4]The discussion that follows is framed with reference to a debtor that is a Canadian corporation, notwithstanding the fact that Canada's thin capitalization rules now also apply to debt incurred by Canadian resident trusts and by nonresident trusts and corporations carrying on business in Canada.

or value)[5] or someone not dealing at arm's length with a 25-plus percent shareholder (in either case, a specified nonresident). If the amount of debt owing by Canco to specified nonresidents in a given year exceeds 150 percent of Canco's equity,[6] the thin capitalization rules apply to the interest on the excess debt. The result is that such interest is:

- not deductible in computing Canco's income; and
- treated as a dividend (not interest) for nonresident withholding tax purposes.

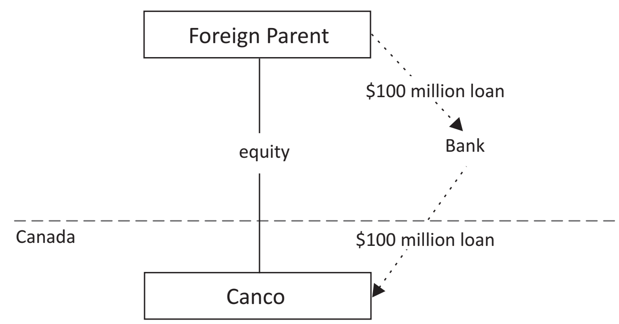
For example, a Canadian company that owes $100 million to its foreign parent and has only $50 million of equity for thin capitalization purposes will be able to deduct interest expense relating to only $75 million of that debt. (See Figure 1.) Interest on the remaining $25 million of debt will be nondeductible 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).

Figure 1. Basic Thin Capitalization Example



Absent antiavoidance measures, better interest withholding tax or thin capitalization results could be obtained through various means, the most direct of which is a simple back-to-back loan, whereby a ''good'' (for example, arm's-length) creditor is inserted between Foreign Parent and Canco. For example, if Foreign Parent makes a loan to an arm's-length bank that in turn makes a corresponding loan to Canco, the thin capitalization rules do not apply to Canco's debt because Canco's creditor (the bank) is an arm's-length party. (See Figure 2.) Moreover, the withholding tax rate on interest paid by Canco to an arm's-length creditor such as a bank is zero, which is better than the rate that would apply on an interest payment to Foreign Parent if Foreign Parent is any nonresident other than a U.S. resident entitled to the zero interest withholding rate under the Canada-U.S. tax treaty.

Figure 2. Back-to-Back Loan



Absent antiavoidance rules, back-to-back loans could get around thin capitalization and interest withholding limitations.

The result then is that the potential for avoidance exists in the case of an indirect arrangement involving:

- an intermediary (that is, Canco's creditor); and
- some other transaction between the intermediary and a nonresident related to Canco who would otherwise be Canco's creditor (Foreign Parent in the above example) under the following circumstances:
  — *Thin Capitalization*: the related nonresident is a specified nonresident (that is, a ''bad'' creditor from a thin capitalization perspective) and Canco's direct creditor (the intermediary) is not; or
  — *Interest Withholding Tax*: the related nonresident would be subject to a higher Canadian interest withholding tax rate than Canco's direct creditor — for example, if Canco's creditor is:
    - a Canadian resident;
    - an arm's-length nonresident; or
    - another related nonresident entitled to a better Canadian interest withholding tax rate under an applicable tax treaty.[7]

It is neither surprising nor unreasonable that Finance would see such indirect arrangements as contrary to the tax policy behind these rules and hence

[5]For this purpose, a person is deemed to own any shares owned by non-arm's-length persons, and certain rights to acquire more shares or to cause the corporation to redeem shares are deemed to have been exercised.

[6]''Equity'' for this purpose consists of Canco's unconsolidated retained earnings, the paid-up capital of Canco shares held by nonresident 25-plus percent shareholders, and contributed surplus attributable to such shareholders.

[7]That is, a potential ''treaty shopping'' situation. As noted, Canada's tax treaty with the U.S. is the only one that provides for a zero withholding tax rate on interest.

unacceptable. The difficult question becomes where to draw the line between what is offensive and what is not.

Prior Versions

The original version of the B2B rules was clearly overbroad in some respects. In particular, any secured guarantee of Canco's debt by a nonresident (as commonly occurs within multinational groups for purely commercial reasons) was treated as the equivalent of a back-to-back loan (unsecured guarantees were not included). Notional cash-pooling arrangements were also identified as potentially being caught. Treating such arrangements as the equivalent of back-to-back loans is unnecessary to achieve the desired tax policy result, and would simply increase the cost of borrowing for the corporate group (including its Canadian members).

The August 29 version of the B2B rules helpfully sought to address the secured guarantee point (which was probably the biggest complaint).[8] Also, a new de minimis exception to the application of the rule was created to prevent the rule from applying when the Canco debt is a relatively small part of a larger multinational group borrowing. However, the revised version effectively treated Canco's debt and another obligation as back-to-back loans if it were merely reasonable to conclude that if the other obligation did not exist, some or all of Canco's debt would not be outstanding or its terms and conditions would be different in any way (no materiality threshold was included).

Since any number of normal commercial situations can be envisioned when the existence of one obligation might affect the terms and conditions of Canco's debt in some way or another, and from a practical perspective it is difficult to imagine how one would ever be able to prove the absence of such an effect, this development caused much concern.

October 20 Version

The NWMM version of the B2B rules commendably scales back the scope of arrangements considered to constitute back-to-back loans, and in general constitutes a logical and workable rule that appropriately balances competing concerns. As in previous versions, one branch of the rule is directed at attempts to circumvent the thin capitalization rules, while another with largely identical wording is directed at structures that reduce Canadian interest withholding tax. While there are some differences between the thin capitalization and interest withholding tax elements of the rule, the two branches share the same basic architecture as applied to a particular debt:

- a debtor to whom the relevant branch of the rule (thin capitalization or interest withholding) applies (a Relevant Debtor) owes an amount to a creditor (Creditor). As noted above, for discussion purposes a Canadian resident corporation (Canco) is used as the Relevant Debtor;
- Creditor is either:
  - — a Canadian resident dealing at arm's length with the Relevant Debtor; or
  - — a nonresident of Canada (or in the case of the thin capitalization branch of the test, a nonresident who is not a ''specified nonresident''[9] in respect of the Relevant Debtor); and
- a secondary obligation (discussed below) exists between:
  - — Creditor or a person not dealing at arm's length with Creditor (in either case, a Creditor Party); and
  - — a person (Nonresident) who is a ''worse'' creditor than Creditor under the relevant branch of the test.[10]

If all of these conditions are met, unless the facts are such as to come within the de minimis exception, the B2B rule applies to effectively deem the Relevant Debtor to owe to Nonresident some or all of the debt in fact owed to Creditor. The result is that more of the Relevant Debtor's debt will be subject to thin capitalization limitations, and/or the Canadian interest withholding tax on interest payments on the Relevant Debtor's debt will be increased. Figure 3 provides an overview of how the two branches of the NWMM version of the B2B rules operate.

Secondary Obligation

The key element of the B2B rules is the concept of a secondary obligation. Earlier versions of the rules had defined this term too broadly; the latest version

[8]This was done somewhat obliquely by including a statement in the accompanying explanatory notes to the draft legislation that a person ''will not be considered to have a specified right in respect of a property solely by virtue of having been granted a security interest in the property.''

[9]As noted earlier, a ''specified nonresident'' in respect of a corporation is a nonresident who is either:
- a 25-plus percent shareholder of the corporation (by votes or value); or
- someone not dealing at arm's length with such a 25-plus percent shareholder of the corporation.

A comparable definition exists for Relevant Debtors that are trusts.

[10]That is:
- under the interest withholding tax branch of the rule, a nonresident subject to a higher Canadian withholding tax rate than Creditor on a payment of interest from the Relevant Debtor; or
- under the thin capitalization branch of the rule, a ''specified nonresident'' in respect of the Relevant Debtor.

Figure 3. Back-to-Back Loan Rule Overview

Thin Capitalization		Interest Withholding Tax
Relevant Debtor: Corporations or trusts resident in Canada; nonresident corporations or trusts carrying on business in Canada	Is the debtor a Relevant Debtor?	**Relevant Debtor:** Canadian residents; certain nonresidents deemed to be Canadian residents for this purpose
	Yes	
"Good" creditor: Canadian resident dealing at arm's length with Relevant Debtor; nonresident person that is not a "specified nonresident"[1] in respect of Relevant Debtor	Is the creditor under the debt (Creditor) a "good" creditor?	**"Good" creditor:** Canadian resident dealing at arm's length with Relevant Debtor; nonresident person
	Yes	
"Secondary obligation": Relevant Debtor's debt owing to Creditor "because" (1) Creditor Party[2] owes an amount to Nonresident, or (2) Nonresident granted a "specified right"[3] to Creditor Party[2]	Does a secondary obligation exist between a Creditor Party[2] and a nonresident person (Nonresident)?	**"Secondary obligation":** Relevant Debtor's debt owing to Creditor "because" (1) Creditor Party[2] owes an amount to Nonresident, or (2) Nonresident granted a "specified right"[3] to Creditor Party[2]
	Yes	
"Bad" creditor: A "specified nonresident"[1] in respect of Relevant Debtor	Is Nonresident a "bad" creditor?	**"Bad" creditor:** A nonresident person subject to a higher Canadian interest withholding tax rate than Creditor on an interest payment from Relevant Debtor
	Yes	
De minimis exception: Secondary obligations relating to the debt are <25 percent of the amount of Relevant Debtor's debt plus certain connected debts	Does de minimis exception apply to the debt?	**De minimis exception:** Secondary obligations relating to the debt are <25 percent of the amount of Relevant Debtor's debt plus certain connected debts
	No	
Effect of rule: Debt of Relevant Debtor deemed to be owed to Nonresident instead of Creditor for thin capitalization purposes	Back-to-back loan rule applies	**Effect of rule:** Relevant Debtor deemed to pay some or all of interest on the debt to Nonresident instead of Creditor for withholding tax purposes

[1]A "specified nonresident" is a nonresident who either is, or deals non-arm's-length with a person who is, a 25-plus percent shareholder (by votes or value) of Relevant Debtor (a comparable rule applies to debtors that are trusts).
[2]A Creditor Party is Creditor or any person not dealing at arm's length with Creditor.
[3]The provision of a typical commercial security interest in property will generally not constitute a "specified right."

scales back the scope of secondary obligations to something that should generally produce appropriate results. In particular, the NWMM version of the secondary obligation concept:

- generally excludes the provision of security by and guarantees from related nonresidents, which were caught under the original version; and
- creates the need for some causal connection between the secondary obligation and the Canco debt, which did not exist under the August 29 version.

These are commendable improvements for which Finance deserves credit.

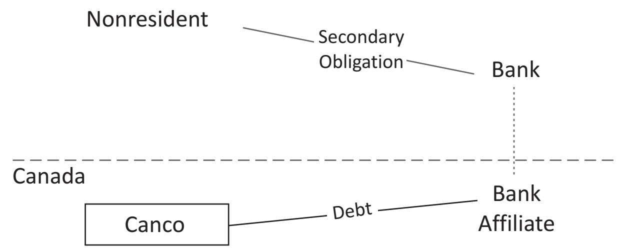
Under the NWMM version, a secondary obligation between a Creditor Party and Nonresident may cause the B2B rule to apply to Canco's debt to Creditor (the Canco debt) in two circumstances:

- *Creditor Party debt*: A Creditor Party has an obligation to pay an amount to Nonresident that meets either or both of two conditions (the Creditor Party debt):
  - — Nonresident's recourse under the Creditor Party debt is in any way limited to the Canco debt; or
  - — it can reasonably be concluded that all or a portion of the Canco debt became (or remained) owing ''because'' the Creditor Party debt was entered into or remained outstanding.
- *Creditor Party right*: Nonresident has directly or indirectly granted a Creditor Party a ''specified right'' in a property that meets either or both of two conditions (a Creditor Party right):
  - — that specified right is required under the terms of the Canco debt; or
  - — it can reasonably be concluded that all or a portion of the Canco debt became (or remained) owing ''because'' that specified right was granted.

Figure 4 illustrates a simple example of where the rule may apply (Nonresident and Canco will generally be related parties).[11]

Two aspects of the revised secondary obligation definition merit further comment. First, both the Creditor Party debt and Creditor Party right elements of the revised definition now use the term ''because'' to delineate what causes a secondary obligation to exist. This represents a significantly higher standard than was the case under the August 29 version of the term, and the

Figure 4. Back-to-Back Loan Conditions



1. Canco owes the Debt to Creditor.
2. Secondary obligation exists between Creditor Party and Nonresident.

concept appears to have been imported from another ''indirect loan'' rule in the ITA.

When a nonresident person owes an amount to a Canco, a specific rule applies to ensure that Canco reports at least a minimum amount of interest on that debt for tax purposes.[12] This rule governing direct debts is supported by an ''indirect loan'' provision, which applies when a:

- a nonresident person owes an amount to a person (other than a Canco); and
- it is reasonable to conclude that this debt was incurred ''because [a Canco] made a loan or transfer of property.''[13]

This indirect loan rule was characterized as follows by the Department of Finance in explanatory notes accompanying a pending technical amendment:

> Subsection 17(2) of the Act is an anti-avoidance rule intended to prevent the use of indirect arrangements to circumvent the application of subsection 17(1). Subsection 17(2) generally provides that — where a corporation resident in Canada (Canco) makes a loan or transfers property and, because of that loan or transfer, a loan or transfer of property is made to a non-resident person (the final debtor) — the final debtor is treated for the purposes of section 17 as if it owes to Canco an amount equal to the amount owing by the final debtor.

The use of the ''because'' standard in section 17 ITA seems to have worked reasonably well since its

[11]In order to be a ''bad'' creditor, Nonresident must (1) be (or not deal at arm's length with a person who is) a 25-plus percent Canco shareholder, under the thin capitalization branch of the rule, or (2) not deal at arm's length with Canco, under the interest withholding tax branch of the rule.

[12]Section 17(1) ITA. Specifically, to the extent that the debt has remained outstanding for more than one year and Canco includes in its income for a tax year an amount that is less than a ''reasonable'' rate of interest on the debt, Canco must include in income for the year an amount equal to interest on the outstanding debt computed at a prescribed rate (less any interest on the debt otherwise included in Canco's income for that year).

[13]In such circumstances, the nonresident is deemed to owe to the Canco an amount equal to the amount the nonresident in fact owes to the intermediary, with the result that the primary rule in section 17(1) ITA applies to the deemed debt.

introduction in 1999, and adopting it in the NWMM version of the B2B rules seems like a logical and workable approach. The term ''because'' would clearly seem to include the ''on condition that'' test used in earlier versions of the B2B rules that deemed a secondary obligation to exist where the secondary obligation was entered into ''on condition that'' the Canco debt also be entered into. In fact, it would likely be interpreted more broadly to encompass other forms of causal connection beyond a strict legal requirement that the secondary obligation be effective only if the Canco debt also be created.[14]

At the same time, the ''because'' standard certainly requires a much higher nexus than the proposed test in the August 29 version of the B2B rules that created a secondary obligation if it could reasonably be considered that the secondary obligation had any effect (however immaterial) on the terms and conditions of the Canco debt. The term ''because'' seems to involve a reasonably strong causal connection. For example, in *AG of Canada v. Hoefele et al.; Krull v. AG of Canada,*[15] the Federal Court of Appeal interpreted the ''because'' standard as implying a ''strong causal connection'':

> On the other hand, the phrases used in the amended subsection 80.4(1), ''because of,'' or ''as a consequence of,'' as well as in the original version, ''by virtue of,'' require a strong causal connection. I find little or no difference between the meanings of the phrases ''because of,'' ''as a consequence of'' and ''by virtue of.'' Each phrase implies a need for a strong causal relation between subject matters, not merely a slight linkage between them.

It therefore appears that the B2B rules will apply only in cases in which the secondary obligation has a very significant causal connection with the creation of the Canco debt.[16] This standard (supported by the general antiavoidance rule where necessary) seems appropriate, and Finance should be commended for adopting into the B2B rules a concept that is evidently working satisfactorily in another comparable rule.

Second, the definition of a ''specified right'' has also been helpfully amended. A specified right in respect of a property at any time means a right to (at that time):[17]

- mortgage, assign, pledge, or encumber the property to secure payment of a debt;[18] or
- use, invest, sell, or otherwise dispose of the property, unless all of the net proceeds from doing so must be used to repay the Canco debt or another debt owing to Creditor by Canco or someone not dealing at arm's length with Canco under a connected agreement.

The revised ''specified right'' definition appears to have been improved in two ways, both of which in general seem to accommodate normal course secured guarantees and similar security arrangements typically found in commercial lending agreements. First, the party holding the security can pledge the secured property to secure the repayment of other debts, as is sometimes provided for in secured property legislation and some derivatives agreements. These situations do not amount to avoidance of the relevant thin capitalization and withholding tax limitations, and so do not present a realistic antiavoidance concern.

Second, earlier versions of the ''specified right'' definition seemed to cause an event of default under the Canco debt (which typically gives a Creditor Party the immediate right to sell the secured property) to itself result in a specified right, thereby potentially causing financial distress to trigger the B2B rules. Again, it is difficult to see why this result would be warranted, and the revised definition seems to prevent this if it can be shown that the Creditor Party must use any sale proceeds from the secured property to repay the Canco debt (or certain related debts). This seems eminently logical, and due credit should be given for these changes.

De Minimis Test

When the preconditions to the B2B rules are met, a de minimis exception (unchanged from the August 29 version) may exclude the application of the rules in certain circumstances.

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[14]This observation is also made in the context of the indirect loan rule in section 17(2) ITA by Gwendolyn Watson and Steven Baum, ''Section 17: Interpretive Considerations'' in ''International Tax Planning,'' *Canadian Tax Journal* (2010), Vol. 58, No. 3, 653-673 at 669.

[15]95 DTC 5602 (FCA); leave to appeal to the Supreme Court of Canada denied (Aug. 22, 1996).

[16]It has also been suggested in the context of the section 17(2) ITA indirect loan rule that the Department of Finance has interpreted ''because'' in a similar fashion:

> In the view of the Department of Finance, however, the word ''because'' in these circumstances (when taken together with the introductory phrase ''it is reasonable to conclude that'') means something more than ''making it possible for something to happen.'' Rather, the department believes that there is implied in the word ''because'' a purpose or intent requirement such that for subsection 17(2) to apply to a Canco, the Canco must make a loan or transfer of property for the specific purpose of having the proceeds of that loan or transfer be used (directly or indirectly) to make a loan to a specific person.

(Footnote continued in next column.)

Evelyn P. Moskowitz, ''Financing of Non-Residents and the Recent Amendments to Section 17,'' 17 *Report of Proceedings of Fifty-First Tax Conference*, 1999 Conference Report (Toronto: Canadian Tax Foundation, 2000), 43:1-61 at 43.

[17]The reference to ''at that time'' would seem to prevent latent rights that depend on a contingency (for example, a default) from creating a ''specified right'' unless and until they become operative.

[18]Other than the Canco Debt or another debt owing to Creditor by either Canco or someone not dealing at arm's length with Canco under a connected agreement.

Expressed generally, the de minimis exception provides that the B2B rules will not apply if the amount of all secondary obligations relating to the Canco debt is less than 25 percent of the sum of the Canco debt plus certain other debts. More specifically, under the de minimis exception the B2B rules will not apply to a particular Canco debt if A < B x 25 percent, where:

- A equals the sum of:
  - all Creditor Party debts; and
  - the fair market value of all property in respect of which a Creditor Party right has been granted in respect of that Canco debt; and
- B equals the amount of the Canco debt, plus the amount of any other debt owing by Canco or a person or partnership not dealing at arm's length with Canco (in either case, a Canco Party):
  - to Creditor;
  - under the same agreement creating the Canco debt or an agreement connected to that Canco debt agreement; and
  - under which Creditor is granted a security interest in respect of a property that is either a Creditor Party debt held by Nonresident or a property in respect of which a Creditor Party right has been granted in respect of that Canco debt, if each such security interest also secures every other Canco Party debt included within item B.

There are two basic scenarios in which the de minimis exception is intended to provide relief. The first is when the amount of any secondary obligations in respect of the Canco debt is relatively small so as to be less than 25 percent of the Canco debt. This ensures that the B2B rules will not apply when the extent of any back-to-back financing of the Canco debt is relatively small.

The second situation is when the Canco debt is one of a number of debts owing by a group of related debtors to the same creditor, and the same secondary obligations that secure the Canco debt also secure the other debts owing by those group members. The explanatory notes that accompanied the August 29 version of the rules described this element of the de minimis exception as being ''intended to provide possible relief where [Creditor] enters into multiple cross-collateralized debts owing to [Creditor] by multiple group entities, including [Canco].''

Those explanatory notes included examples of the application of the de minimis test to cross-collateralized debts and to a notional cash pooling arrangement whereby a foreign parent puts money on deposit with a bank to support borrowings from that bank by a Canadian subsidiary and a foreign subsidiary.

While the de minimis exception may be helpful in some multinational group borrowing arrangements, it is certainly possible to envision other group borrowing arrangements that do not present an antiavoidance concern and yet will not meet the terms of the de minimis exception for various possible reasons. For example, for other group debts to be included within item B, above:

- the creditor must be Creditor itself, rather than any Creditor Party;
- the security interests relating to the various debts and the Canco debt must correspond quite closely; and
- the other group debts must arise under the agreement creating the Canco debt or an agreement that is ''connected'' to that agreement.

It is not obvious why such a high degree of interconnectivity between the Canco debt and other Canco Party debts is necessary to include the latter in the denominator for purposes of the de minimis exception. Hopefully, the Department of Finance will consider a less restrictive definition that allows more Canco Party debts to be included in the denominator of the 25 percent computation, so as to make the de minimis exception of greater use to multinational groups with Canadian subsidiaries.

In fairness, however, it should be noted that given the other improvements to the B2B rules discussed earlier, there should be significantly less need for taxpayers to rely on the de minimis exception to prevent the B2B rules from applying in ordinary commercial financing situations in the first place. ◆