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# Canadian Thin Capitalization Developments for Foreign Currency Debt

by Steve Suarez

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# PRACTITIONERS' CORNER

## Canadian Thin Capitalization Developments for Foreign Currency Debt

by Steve Suarez

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The Canada Revenue Agency recently confirmed that under Canada's thin capitalization rules, which limit interest deductions on debt owed by Canadian subsidiaries to foreign parent or sister companies, the outstanding principal amount of non-Canadian-dollar debt will no longer be affected by foreign exchange fluctuations.

The Canada Revenue Agency recently made an announcement that will help many Canadian subsidiaries of multinational groups that borrow from non-Canadian group members in foreign currencies.[1] The announcement indicates that the CRA applies Canada's thin capitalization rules (which limit the deductibility of interest) so as to ignore foreign exchange (FX) fluctuations on the debt principal after the debt is incurred. This confirmation will considerably assist many Canadian debtors, given that the recent depreciation of the Canadian dollar (particularly against the U.S. dollar) may otherwise have caused them to exceed the permitted thin capitalization limits.

### Canada's Thin Capitalization Rules

Canadian corporate income tax rates (combined federal and provincial) currently range from around 25 to 30 percent, depending on the province. Thus, $1 of interest incurred by a Canadian corporation on debt owed 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 typical cost of 10 cents (or zero, for U.S. creditors entitled to benefits under the Canada-U.S. tax treaty) in Canadian interest withholding tax. This can create an incentive for multinational groups to thinly capitalize their Canadian operations, with high levels of interest-generating debt and low equity.

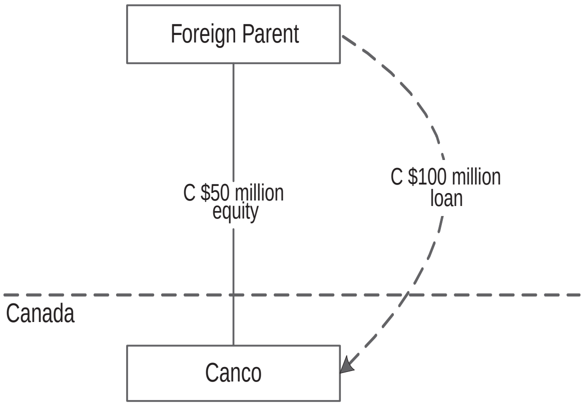
Canada's thin capitalization rules restrict the amount of interest-deductible debt owed to related nonresidents that a Canadian corporation (Canco)[2] can incur, so as to limit the potential for cross-border, intragroup interest stripping. Essentially, these rules prevent Canco from deducting interest on outstanding debt to specified nonresidents[3] to the extent that the debt exceeds 150 percent of Canco's equity.

[1]The announcement was made at the CRA Round Table at the Canadian Tax Foundation annual conference in Montreal on November 24.

[2]The thin capitalization rules apply not only to Cancos, but also to Canadian resident trusts and to nonresident trusts and corporations that either carry on business in Canada or elect to be taxed as Canadian residents. Partnerships in which those kinds of entities are members are also generally included.

[3]A specified nonresident for this purpose is defined as a nonresident person who either: (1) owns at least 25 percent of Canco's shares (by votes or value, including any shares held by non-arm's-length persons); or (2) does not deal at arm's length with shareholders holding at least 25 percent of Canco's shares.

Basic Thin Capitalization Example




For example, a Canco that owes C $100 million to its foreign parent and has only C $50 million of equity for thin capitalization purposes will only be able to deduct interest relating to C $75 million of that debt (see figure). Interest on the remaining C $25 million of debt will be nondeductible for Canadian tax purposes and will be recharacterized as a dividend liable to the Canadian nonresident dividend withholding tax of 25 percent (subject to reduction under an applicable tax treaty).

## The Debt/Equity Test

Canco's outstanding debt to specified nonresidents for a given tax year is determined by adding the maximum amounts of such debt owed at any time during each calendar month ending in that year, and dividing the total by the number of calendar months in the year to produce an average. Canco's equity is calculated as the sum of the following three amounts:

- Canco's unconsolidated retained earnings at the beginning of the year;
- Canco's total of the start-of-month contributed surplus contributed by its specified nonresident shareholders[4] for each calendar month ending in the year, divided by the number of calendar months; and
- the total of the start-of-month paid-up capital of Canco shares owned by specified nonresident shareholders for each calendar month ending in the year, divided by the number of those calendar months.

The CRA's historical position was that if Canco borrowed in a currency other than the Canadian dollar (the loan currency), fluctuations in the exchange rate between the Canadian dollar and the loan currency would affect the thin capitalization computations.[5] Specifically, the CRA's position was that each time Canco's outstanding debt was calculated under the thin capitalization rules, non-Canadian-dollar debt was to be recomputed in Canadian dollar terms by converting the outstanding principal to Canadian dollars at the current exchange rate. Given the significant (25 percent) decline in the Canadian dollar versus the U.S. dollar during 2014-2015, having to express a constant amount of U.S. dollar-denominated outstanding debt owing to specified nonresidents at current Canadian dollar exchange rates would cause many Canadian subsidiaries of multinationals with U.S. dollar intragroup borrowings to exceed the 1.5-1 debt-to-equity ratio allowed under the thin capitalization rules, simply because of FX movements.

## CRA Announcement

On November 24 the CRA confirmed that the 2007 enactment of section 261 of the Income Tax Act (Canada) means that its historical administrative position is no longer applicable. At the 2015 Canadian Tax Foundation annual conference, the CRA stated that its position on this matter predated the enactment of section 261 ITA, and that the appropriate interpretation of section 261(2) ITA requires that the principal amount of the debt be converted into Canadian dollars based on the FX rate on the date the loan was made. The resulting Canadian dollar figure would represent the relevant amount for thin capitalization purposes. Accordingly, it is not necessary to periodically recompute non-Canadian-dollar debt principal amounts for thin capitalization purposes simply because of subsequent fluctuations in FX rates. This is a fair tax policy result and, from a practical perspective, this interpretation confirms that many Canadian members of multinational groups will not be penalized under the thin capitalization rules solely because of FX fluctuations over which they have no control. ◆

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[4]That is, a shareholder holding at least 25 percent of Canco's shares who is a nonresident.

[5]CRA Document RCT 8031-5, dated September 28, 1988. For Canadian tax purposes, all taxpayers must compute relevant amounts in Canadian dollars, unless they have validly elected under section 261 of the Income Tax Act (Canada) to use a different permitted functional currency.