***Lehigh Cement Limited* v. The Queen**

2009 DTC 776

Keywords: GAAR ■ interest ■ withholding taxes ■ exemptions ■ assignment ■ bifurcation

The recent decision of the Tax Court of Canada in ***Lehigh Cement Limited*** *v. The Queen* deals with the application of GAAR (section t) to a related-party cross-border loan arrangement that was restructured in an attempt to avoid Canadian withholding tax.

Facts

By way of background to the transactions under scrutiny, the Canadian corporate taxpayer, **Lehigh Cement Limited** ("LCL"), was at all relevant times a member of a group of entities engaged in various aspects of the construction industry. This group was ultimately owned by Heidelburger Zemeni ("HZ"), a German publicly traded company. In addition to LCL, the corporate group ("the HZ Group") included a Canadian-resident corporation, CBR Materials Corporation of Canada **Limited** ("Materials"), and two Belgian-resident corporations, Cimentrics CBR SA ("CBR SA") and CBR International Services SA ("CBR IS").

The court commenced its examination of the relevant facts with the initial loan to LCL by a syndicate of Canadian banks ("the loan") in October 1986 to finance an asset acquisition from an unrelated party. In December of that year, the loan was assigned to Materials for $140 million, which Materials financed through the issuance of preferred shares to CBR SA. Approximately eight years later, Materials assigned the loan to CBR IS through a series of transactions that included the redemption of the preferred shares. Because the loan was now held by a non-resident, interest payments on the loan became subject to a 15 percent withholding tax (by operation of paragraph and the relevant tax treaty).[37]

In early 1997, LCL and its advisers began to review the terms of the loan to determine whether it could be restructured in such a way as to avoid withholding tax on the interest amounts being repatriated to Belgium, without jeopardizing LCL's ability to deduct such amounts in its Canadian corporate income tax filings. This review ultimately led to a "restatement" of the loan in the form of a subordinated note ("the note"), which, the minister conceded, satisfied all of the criteria set forth in subparagraph (as it then existed),[38] including the requirement that LCL not be obligated (other than upon the occurrence of a specified event of default) to repay more than 25 percent of the principal amount of the note within five years from its issue date. The terms of the note also expressly entitled the holder (CBR IS) to sell rights to receive future interest payments under the note to a third party ("interest rights").

On August 28, 1997, CBR IS sold interest rights, which then had a face value of approximately $49.5 million, to a Belgian-resident financial institution ("BBL") for approximately $42.7 million, while retaining its entitlement to the $140 million principal amount of the note. BBL received a put right from CBR SA (an indirect parent of LCL in connection with this transaction), which, in the event of a default under the note, obligated CBR SA to purchase the

37

38

interest rights at a fixed price.[39] In addition, CBR IS provided an indemnity in favour of BBL to protect it against any hedging-related losses it suffered in the event of an early payout of interest under the note, and LCL agreed to pay any withholding tax in respect of the interest rights.[40] On the basis of these transactions, LCL took the position that interest paid to BBL in respect of the note was paid to an arm's-length party and was therefore exempt from part XIII tax by virtue of subparagraph As a consequence, LCL did not withhold part XIII tax on any of the amounts that it paid to BBL.

The minister took issue with the foregoing transactions and reassessed LCL (for its 1998 through 2002 taxation years) on two separate bases, with reliance on two distinct (and contradictory) arguments. First, the minister asserted that a significant portion of the payments made by LCL to BBL had constituted payments of capital (not interest), and that such payments could accordingly not be deducted by LCL as interest expenses under paragraph Second, the minister reassessed LCL for failing to withhold part XIII tax in respect of the payments to BBL, relying on GAAR to deny BBL the benefit of subparagraph

ReasoningThe minister's interest deduction denial reassessment, based on the position that the amounts paid by LCL to BBL constituted mixed payments of capital and interest, was thoroughly rejected by the court. The minister's stated theory was that, since BBL had paid CBR IS approximately $42.7 million for interest rights that were expected to generate payment amounts of close to $49.5 million over the relevant term, it was "reasonable," with reference to subsection , to regard a significant portion of the payment amounts (that is, approximately $42.7 million) as payments of "capital." The fundamental problem with the minister's position, as the court rightly noted, was that it attempted to recharacterize amounts paid by LCL under the note from the perspective of another taxpayer (BBL) and on the basis of a transaction to which LCL was not a party (the sale of the interest rights from CBR IS to BBL). However, the court, in viewing the payments to BBL from the perspective of LCL and with reference to the terms of the note, found it untenable to characterize any portion of such amounts as payments of capital, since those amounts were, in both legal form and economic substance, payments of interest in respect of the principal amount owing under the note. In that light, after noting the minister's concession with respect to the reasonableness of the applicable interest rate under the note, the court easily determined[42] that LCL was entitled to the interest expenses that it had claimed in respect of the note for the taxation years at issue.

The minister had significantly more success with respect to his reassessment of LCL under part XIII. As noted above, the parties had agreed that, but for GAAR, subparagraph applied to exempt the subject interest payments from withholding tax under part XIII. In light of LCL's concession that a tax benefit had been received and that the relevant transactions constituted avoidance transactions within the meaning of subsection , the only remaining GAAR issue was

39 *Lehigh Cement Limited v. The Queen, 2009 DTC 776, at paragraph 4 (TCC) (paragraph 36 of the "Statement of Agreed Facts").39: Lehigh Cement Limited v. The Queen, 2009 DTC 776, at paragraph 4 (TCC) (paragraph 36 of the "Statement of Agreed Facts").*

40

41

42 *Lehigh , supra note 39, at paragraph 16.*

whether the transactions in question resulted in a misuse or abuse of subparagraph 212(1)(b)(vii) within the meaning set forth in subsection

Relying for guidance on the decision of the Supreme Court of Canada in *Canada Trustco Mortgage Co. v. Canada*, [44] Mogan J sought to examine whether, "having regard to the text, context and purpose" of subparagraph , the impugned transactions could be said to frustrate or defeat the "object, spirit or purpose" of that provision.[45] After examining the text of the provision and citing several scholarly articles relied on by the minister, he concluded:

> Left to myself, I might well have concluded that this exemption was intended to help Canadian corporations borrow from foreign arm's length lenders who would receive interest free from withholding tax. Having reviewed the articles quoted in paragraphs 37 and 38 above, I find that the purpose of subparagraph (vii) is to help Canadian corporations needing to borrow money by increasing their access to international capital markets. The cost of the withholding tax on interest paid to foreign lenders is often shifted to the Canadian borrower, thereby increasing the cost of capital. The exemption from withholding tax on arm's length borrowing[s] from foreign lenders makes such borrowing more competitive with domestic borrowing in Canada. [46]

It is difficult to find fault with the court's analysis and conclusion respecting the purpose of subparagraph

Again with direction from *Canada Trustco*, Mogan J then considered whether the series of transactions at issue had "frustrated or defeated the object, spirit or purpose of subparagraph (vii)." [47] Central to the court's analysis in this regard was the fact that LCL had never, at any time, borrowed money from BBL. As Morgan J stated,

> The only money advanced by BBL was the purchase price ($42 million) paid by BBL to CBR IS for the right to receive quarterly interest payments from December 1997 to September 2002. *At all relevant times from and after September 1994, CBR IS was [Lehigh's] creditor with respect to the $140 million principal amount*. [48]

Following the suggestion in *Canada Trustco* that statutory provisions may dictate that they only apply to transactions with a certain commercial purpose, Mogan J held that the exemption in subparagraph applies only "to the arm's length borrowing of capital from a non-resident lender."[49]

He further stated:

43

44

45 ***Lehigh*, *supra* note 39, at paragraph 33.**

46

47

48

49

> In this appeal, the Appellant did not borrow any money from BBL or any other non-resident lender. The absence of a non-resident [and, presumably, arm's-length] lender causes me to infer that the sale transaction between CBR IS and BBL abused subparagraph (vii). . . .

I find that the relationship between CBR IS and BBL with respect to the sale of 20 quarterly interest amounts for $42 million; and the relationship between the Appellant and BBL with respect to the payment of those 20 quarterly interest amounts are wholly dissimilar to the arm's length borrower/lender relationship contemplated by subparagraph (vii). The sale transaction between CBR IS and BBL frustrated the object, spirit and purpose of subparagraph (vii). [50]

On the basis of the foregoing reasons, Mogan J determined that GAAR applied to deny the application of subparagraph to the 20 quarterly interest amounts paid by LCL to BBL, with the result that part XIII tax was payable with respect to those amounts.

Comments

This decision is important, perhaps less for the guidance that it provides on the application of GAAR to transactions that rely on former subparagraph than for its potential implications in relation to cross-border loan and debt restructuring transactions that rely on the recently expanded interest withholding tax exemption in part XIII. This new withholding tax exemption (under revised paragraph is applicable to most arm's-length interest payments, and was motivated, it is understood, by policy considerations similar to those underlying former subparagraph 212(1)(b)(vii) - namely, to reduce the cost of capital to Canadian borrowers. [51]

Although it is legitimate to question whether the transactions in this case resulted in an abuse of subparagraph (or would result in an abuse of new paragraph , the broad analysis adopted by the Tax Court could result in many innocent transactions being considered abusive. In particular, Mogan J's misuse and abuse analysis with respect to the interest rights transaction appears to place an unduly high level of emphasis on the finding that LCL did not, at any point during the relevant timeline, borrow money from BBL (or from any other arm's-length non-resident lender). Such emphasis could be construed (inappropriately in our view) as restricting the benefits of paragraph 212(1)(b) (by operation of GAAR) only to those loans *originated* by arm's-length non-resident lenders.

Such a formalistic and restrictive approach as to what constitutes an "abuse or misuse" of paragraph could result, we would submit, in the application of GAAR to transactions that should not be considered offensive. For example, suppose that instead of selling the interest rights, CBR IS had simply assigned the note to BBL in its entirety. In that instance, LCL would not have, in the words of the court, "borrowed funds from BBL or any other non-resident borrower," thus calling into question LCL's ability to rely on paragraph 212(1)(b), despite the fact that such a transaction could in essence be economically indistinguishable from an alternative series of transactions under which BBL loaned funds to LCL for purposes of repaying the note.

Similarly, according to the reasoning in ***Lehigh***, it appears that if the syndicate of Canadian banks that made the initial loan to LCL in 1986 had directly assigned the loan to BBL (and

50

51

assuming sufficient changes to the loan to otherwise satisfy the criteria set out in subparagraph , the prospect of a successful GAAR challenge would not be negated in connection with any subsequent interest payments, even though this would in essence require a court to ignore both the legal form and the economic substance of the transaction.

In our view, Mogan J's apparent emphasis on debt origination is really a red herring. It is quite common for a Canadian loan to be restructured to qualify for a withholding tax exemption and then be assigned to a non-resident. It would be absurd to suggest that such a commonplace commercial transaction was a misuse or abuse of the provisions of the Act. A Canadian corporate borrower's cost of funds is certainly reduced to the extent that (even if the funds are borrowed domestically) its obligation may be sold to international capital-market participants without negative withholding tax ramifications (which, as the court noted, were historically passed on to the Canadian corporate borrower by way of a gross-up mechanism). Indeed, many Canadian lenders will make and price their loans on the basis that the loan will shortly thereafter be assigned to a non-resident. To suggest that such assigned loans do not qualify for the withholding tax exemption would defeat the purpose of the exemption by diminishing the pool of capital available to Canadian borrowers. Moreover, a sole focus on the origination of the relevant borrowing (as opposed to the owner of the accessed capital - that is, the holder of the relevant principal amount at the time a particular interest payment is made) could have the effect of opening up other avenues of perceived abuse. (For example, consider a scenario where a non-resident party originates a loan to an arm's-length Canadian corporate borrower and then assigns the principal amount of the loan to the Canadian borrower's non-resident parent, while retaining the interest coupons.)

The key issue, we suggest, is whether it was offensive that BBL acquired only the interest component of the debt obligation. What was arguably different about the series of transactions in ***Lehigh*** as compared with a simple loan assignment was not the fact that LCL did not *borrow* from BBL, but rather that to achieve a tax objective, CBR IS assigned only the interest component of the debt. It was likely this partial assignment that led Mogan J to find the relationship between BBL as creditor and LCL as debtor to be "wholly dissimilar" to the arm's-length borrower-lender relationship contemplated by the drafters of subparagraph . However, the court did not specifically outline what made the relationship between LCL and BBL "wholly dissimilar." The LCL debt was not the first debt to have its interest coupon stripped from the principal amount and assigned to a different creditor than the principal holder. Commercially, BBL was in a position similar to that which it would have been in if it had advanced funds to LCL with the support of a related-party guarantee. It expected to receive a return on its investment, and in the event that its debtor and the guarantor were unable to pay the amount advanced, it would have suffered a loss. It is important to remember that the withholding tax levied by part XIII is a tax on the creditor and the payment of the tax by the debtor is simply a collection mechanism. Given that BBL dealt at arm's length with LCL, was legally and beneficially entitled to receive the interest payments, was making a profit from the interest, and was subject to the credit risk of the debtor and the related parties providing credit support, it could easily be argued from a policy perspective that BBL should be entitled to the exemption from withholding tax.

It is interesting to note that the Canada Revenue Agency (CRA) did not challenge the legal effectiveness of the assignment of the interest rights to BBL. We are aware of similar interest-stripping structures that typically have involved a loan between a foreign parent ("Parentco") and its Canadian subsidiary ("Cansub"), where Parentco assigns its right to receive future interest payments in respect of that loan to a Canadian-resident financial institution ("Finco").[52] We understand that the CRA has recently attempted to characterize the payments by Cansub to Finco in these circumstances as being interest credited to Parentco (subject to part XIII tax), which Parentco then directs to be paid to Finco.[53] In essence, the CRA has attempted to recharacterize the assignment of future interest rights to Finco as a mere direction by Parentco to pay interest (when due) to Finco, notwithstanding that the transactions were documented in a substantially similar manner to those in ***Lehigh*** (that is, as an assignment of rights as opposed to a direction of payments). Given this similarity, one might have thought that, to the extent that the CRA's position is tenable (we would argue that it is not), it could have been made equally with respect to the payments by LCL to BBL. It will be interesting to see whether the lack of challenge to the commercial efficacy of the transactions in ***Lehigh*** might embolden taxpayers wishing to engage in other forms of stripping transactions (for example, separating a royalty stream from the underlying intellectual property).

Todd A. Miller and Carl Irvine

52 ***This scenario does not afford the CRA with the advantage that it had in Lehigh, which involved a statutory provision (subparagraph 212(1)(b)(vii)) with a relatively clear purpose. Moreover, Finco would presumably be liable for tax under part I of the Act in respect of its profit.***

53