Thin Cap And Withholding Tax Rules Get Tougher

In order to prevent non-residents of Canada from stripping profits from Canadian corporations in the form of deductible interest, the *Income Tax Act* (Canada) has a set of rules (the "**thin cap rules**") designed to limit the amount of deductible interest that can be paid by a Canadian[1] corporation to specified non-resident shareholders. Generally the thin cap rules provide that if the amount of the debt owing by the Canadian corporation to specified non-resident shareholders is greater than 150% of the equity invested in the Canadian Corporation by the specified non-resident shareholders, the Canadian corporation may not deduct interest on the excess debt and will have the excess interest deemed to be a dividend for the purposes of calculating any applicable non-resident withholding taxes. Generally speaking, a specified non-resident shareholder is a non-resident (or a non-arm's length group of non-residents) that owns 25% or more of the shares of the Canadian corporation.

The Department of Finance has historically been concerned that non-residents were avoiding the impact of the thin cap rules by using back-to-back loans. That is, the non-resident would loan funds to an arm's length person, usually a financial institution, on the condition that the financial institution would lend the same amount to the Canadian corporation. Years ago, the Department of Finance obtained an undertaking from the major Canadian banks that they would not engage in these types of transactions, but in today's global financial markets, there are many other

[1] The thin cap rules also apply to Canadian trusts with specified non-resident beneficiaries. The proposed amendments will also apply to trusts in a similar manner.

financial institutions available to assist taxpayers in structuring tax motivated transactions. Parliament had also enacted provisions to discourage taxpayers from making back-to-back loans to circumvent the thin cap rules, however, the Department of Finance believed that the existing anti-avoidance provisions were not robust enough to address all forms of back-to-back loans.

Under the proposed amendment to the thin cap rules, the amount of any back-to-back loan arrangement will be included in the amount of debt due to specified non-resident shareholders for the purpose of the thin cap rules. A back-to-back loan arrangement will exist if the Canadian corporation owes a debt to a person (the "intermediary") and as part of a transaction or series of transactions that includes the issue of such debt,

(i) the intermediary is pledged property by the specified non-resident shareholder as security for the payment of the debt (note, the draft amendments specifically state that a simple unsecured guarantee is not considered property),

(ii) credit was granted to the intermediary on the condition that the debt be advanced to the Canadian corporation, or

(iii) credit was granted to the intermediary and the recourse for such credit was limited to the debt that was advanced to the Canadian corporation.

The amount of the back-to-back loan arrangement that is treated as debt from a specified non-resident shareholder for the purposes of the thin cap rules is the lesser of the debt owing to the intermediary and the fair market value of the pledged property in the case of (i) above and the outstanding amount of the credit advanced to the intermediary in the case of (ii) and (iii) above.

The Department of Finance has proposed similar amendments to the withholding tax rules so that if the conditions of a back-to-

back loan as outlined above are satisfied, and the withholding tax payable is less than it would have been if credit was advanced directly by a non-resident, the Canadian corporation is deemed to have paid a specified amount to the non-resident.

The proposed new rules are uncontroversial to the extent they apply to prevent taxpayers from circumventing the thin cap rules or withholding tax through a true back-to-back arrangement. Unfortunately, in their effort to prevent taxpayers from utilizing creative structures to avoid the thin cap and withholding tax rules, the Department of Finance has made the rules too broad and has caught many innocent arrangements.

It is not unusual for a lender in advancing credit to a corporation, to not only take security over the assets of the corporation, but to insist that the shareholders of the borrower pledge the shares of the borrower as additional security for the credit. In response to the frustrated cry of the borrower that this is overkill, the lender usually responds that the pledge of the shares may assist it in realizing on the other security in the event of default. In any event, the arrangement is not intended to and does not avoid the application of the thin cap rules or defeat the policy of the thin cap rules or the withholding tax rules. However, if the shareholder of the Canadian corporation is a non-resident, not only will the interest on the loan be non-deductible (assuming it results in the 1.5 to 1 thin cap debt equity ratio being exceeded), the interest will be subject to withholding tax (assuming there is no treaty relief), notwithstanding that no interest or other benefit is received by the non-resident.

The new amendments are stated to be applicable to taxation years that commence after 2014 in the case of the thin cap rules and payments made after 2014 in the case of the withholding tax rules. If the Department of Finance does not revise these proposed amendments, it will be imperative for non-resident

shareholders of Canadian corporations to review their security arrangements for the Canadian corporation's credit facilities to ensure that they do not run afoul of these bizarre rules.

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a cautionary note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.