## Banking and Finance Bulletin

*Tax Bulletin – February 2004*

### Cross-Border Guarantees and Similar Arrangements – Tax Pitfalls

Requests by lenders for multijurisdictional corporate group member guarantees and similar arrangements have become increasingly common in today's commercial lending environment. In many cases, borrowings are effected by the parent of a corporate group which, in turn, advances all or a portion of the borrowed funds to its various subsidiaries by way of share capital or otherwise. Difficult tax concerns can potentially arise where guarantor parties reside outside the borrower's taxing jurisdiction, and the Canada-US context is no exception.

This bulletin summarizes various tax implications potentially arising where a Canadian subsidiary provides a guarantee or other form of security in respect of its US parent company's borrowing. Alternative arrangements, such as share pledges, are also briefly canvassed. Clearly, the issues noted below should be carefully considered and understood in order to avoid unexpected and undesirable results.

### Canadian Tax Implications

#### *Shareholder Benefit / Deemed Dividend*

A Canadian corporation's guarantee (or pledge of security) in connection with a borrowing undertaken by its US parent can potentially be construed as a "shareholder benefit" to the US parent for the purposes of the *Income Tax Act* (Canada) (the "**Tax Act**"). Under the applicable rules, any such benefit is treated as a dividend and subject to non-resident withholding tax. The withholding tax rate is 25%, subject to reduction under the *Canada-US Income Tax Convention* (1980), as amended (the "**Treaty**"), which, in most circumstances, applies a withholding rate of 5%. As noted below, the valuation of the shareholder benefit / deemed dividend is often a difficult task.

#### *Transfer Pricing*

In addition to the "deemed dividend" concerns noted above, a Canadian subsidiary guarantee or other security arrangement may be subject to the transfer pricing rules contained in section 247 of the Tax Act, which operate to impute arm's length prices to cross-border transactions between related parties. Specifically, the transfer pricing rules will apply to a particular guarantee or other security arrangement if:

1) the terms of the arrangement differ from those that would have been agreed to between persons dealing at arm's length, or
2) the arrangement would not have been entered into by an arm's length person in the circumstances and can reasonably be considered not to have been entered into primarily for *bona fide* purposes other than to obtain a tax benefit.

In such circumstances, subsection 247(2) of the *Tax Act* will "adjust" the terms of the arrangement to reflect what would have been agreed to between arm's length persons. The result of any adjustment would likely include an imputed guarantee fee or similar charge from the US parent to its Canadian subsidiary (and a resulting Canadian subsidiary income inclusion).

Commentators have argued that many cross-border guarantee arrangements may, with reference to the above-noted tests, escape the application of the transfer pricing rules in the Tax Act by virtue of the fact that they are driven by commercial (and not tax) motivations and are not the type of arrangements that arm's length parties would enter into in the first instance (on any pricing terms).

>>>

*Quantum*

The Canadian revenue authorities have stated that the valuation of a guarantee (or other security arrangement) is a question of fact that must be decided on a case-by-case basis. Unfortunately, little guidance beyond these statements has been offered to date.

One possible valuation methodology would be to determine what an arm's length financial institution would charge in the circumstances. However, this could yield inappropriate results by virtue of the particular financial institution's credit strength (relative to the Canadian corporate guarantor) and its ability to spread the risks over a number of similar obligations. Other suggested approaches to valuation include a present valuing of the reduced financing costs that arise from the guarantee.

Despite the uncertainties that exist, it would appear that the value of any shareholder benefit or imputed guarantee fee should, for Canadian tax purposes, be limited to the debtor's reduced cost of financing as a result of the guarantee.

*Avoidance / Minimization Techniques*

Various techniques and/or arguments may exist to minimize or eliminate the impact of the above-noted concerns. For example, the guarantee agreement could be drafted on the basis that recourse to the Canadian guarantor be limited until all remedies against the borrower are fully exhausted (thus reducing the value of the guarantee). It may also be possible to establish a low/nominal valuation on the guarantee in circumstances where the financial strength of the borrower significantly exceeds that of the guarantor or where the Canadian corporation's guarantee is but one of many provided by other corporate group members.

An argument against the shareholder benefit altogether may be available where the Canadian guarantor receives "comparable consideration" from the US parent, such as a guarantee fee or an on-loan of the borrowed funds by the US parent to the Canadian guarantor. Finally, if the lender is agreeable (which in many instances it will not be), the Canadian tax concerns could be dispensed with altogether by replacing the guarantee with a pledge of the Canadian corporation's shares by the US parent (this, however, may have adverse US tax implications as discussed below).

*Payment of Guarantee Fees*

Guarantee fees paid by a US parent company to its Canadian subsidiary may be subject to US withholding tax (the general withholding tax rate is 30%). A Canadian foreign tax credit may be available to offset (or partially offset) this withholding tax.

*Payments Pursuant to a Guarantee*

While the caselaw on point is somewhat unclear, the Canadian revenue authorities have repeatedly taken the position that a payment by a guarantor resident in Canada to a non-resident lender on account of, or in lieu of payment of, interest (owing under the original borrowing agreement), will generally retain the character of interest. On this basis, a guarantee payment could (at least in part) be subject to Canadian withholding tax (the withholding tax rate on interest paid to a qualifying US resident lender is 10% under the Treaty), despite the fact that interest payments made by the US parent borrower would not. To address these concerns from a lender's perspective, many guarantees contain a "gross-up" provision, which ensures that the beneficiary of the guarantee receives a net amount, after any applicable withholdings, equal to the guaranteed payment.

In many cases, a Canadian subsidiary's loss in connection with a guarantee or similar arrangement will be treated on capital account (for Canadian tax purposes, "allowable capital losses" may only be applied against "taxable capital gains" in accordance with prescribed rules). However, in order to claim such a loss, it must be concluded that the debt obligation arising from the guarantee was "acquired for the purpose of gaining or producing income." Accordingly, there may be circumstances where capital loss recognition could be denied, including, for example, where the Canadian subsidiary guarantor did not receive adequate consideration for giving the guarantee.

In addition, a Canadian subsidiary may be faced with interest deductibility concerns where it borrows money to honour its guarantee on the basis that the direct use of borrowed money to honour a guarantee granted outside the ordinary course of business is generally not for an income producing purpose. However, the Canadian revenue authorities have suggested that such interest may be deductible where the Canadian subsidiary charged a guarantee fee or received an on-loan of the borrowed funds from the foreign parent.

## US Tax Implications

### *Deemed Inclusion to US Parent*

The use by a US parent of "controlled foreign corporation" ("**CFC**") assets or credit in the context of a US parent financing transaction can result in a deemed distribution of CFC "earnings and profits" under section 956 of the *Internal Revenue Code* (the "**Code**"). With certain exceptions, the amount of any such deemed distribution will be included in the US parent's income, and while foreign tax credits may be available to substantially offset the resulting US tax liability, this will often not be the case. In general terms, a CFC is defined under the Code as a foreign corporation in which more than 50 percent of the voting power or share value is owned by "US shareholders".

In addition, and contrary to the negligible impact under Canadian tax rules, the pledge of a Canadian subsidiary's stock by a US parent can trigger similar deemed distribution concerns, where stock representing at least two-thirds of the total combined voting power of all share classes is pledged.

### *Avoiding Section 956 of the Code*

As suggested above, the deemed distribution rules under section 956 can have substantial negative consequences. These consequences can be avoided where the Canadian subsidiary is a Nova Scotia unlimited liability company ("NSULC"), provided it makes the appropriate election to be treated as a disregarded entity for US tax purposes (section 956 of the Code only applies to controlled foreign corporations).

The use of an NSULC as a means of avoiding section 956 of the Code may carry certain disadvantages. Consequently, a review of the specific facts of each case is necessary before an appropriate course of action can be determined.

## Summary

Cross-border guarantee arrangements in support of a borrowing transaction can present a host of potentially adverse and unanticipated tax consequences. A failure to recognize and address these issues in the structuring stages of a transaction may result in a material increase in the cost of borrowing.

---

*The foregoing provides only an overview. Readers are cautioned against making any decisions based on this material alone. Rather, a qualified lawyer should be consulted.*

---



*For further information, please contact Todd Miller, Ryan Morris or any other member of the McMillan Binch Tax Group listed below:*


| | | |
|---|---|---|
| Michael Friedman | 416.865.7914 | michael.friedman@mcmillanbinch.com |
| Mary-Ann E. Haney | 416.865.7293 | mary.ann.haney@mcmillanbinch.com |
| Mark Lobsinger | 416.865.7107 | mark.lobsinger@mcmillanbinch.com |
| Todd A. Miller | 416.865.7058 | todd.miller@mcmillanbinch.com |
| Ryan Morris | 416.865.7180 | ryan.morris@mcmillanbinch.com |
| David Wentzell | 416.865.7036 | david.wentzell@mcmillanbinch.com |
| Mickey M. Yaksich | 416.865.7097 | mickey.yaksich@mcmillanbinch.com |

McMillan Binch LLP

Telephone: 416.865.7000
Facsimile: 416.865.7048
Web: www.mcmillanbinch.com

BCE Place, Suite 4400, Bay Wellington Tower, 181 Bay Street, Toronto, Ontario, Canada M5J 2T3