Practitioners' Corner

Canadian Subsidiary Guarantees for Foreign Parent Borrowings

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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 affected by the parent of a corporate group that, 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 if guarantor parties reside outside of the borrower's taxing jurisdiction. This article discusses various tax implications potentially arising when a Canadian subsidiary provides a guarantee or other form of security for its foreign parent company's borrowing. Alternative arrangements, such as share pledges, are also briefly explained.

Canadian Tax Implications

Shareholder Benefit/Deemed Dividend

A Canadian corporation's guarantee, or pledge of security, regarding a borrowing undertaken by its foreign parent can potentially be construed as a "shareholder benefit" to the foreign parent under the Canadian Income Tax Act (the Tax Act). Under the applicable rules, that type of benefit is treated as a dividend and is subject to nonresident withholding tax. The withholding tax rate is 25 percent, subject to reduction under a treaty, which, in most circumstances, applies a withholding rate of 5 percent or 10 percent. 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 in section 247 of the Tax Act that operate to impute arm's-length prices to cross-border transactions between related parties. Specifically, the transfer pricing rules apply to a particular guarantee or other security arrangement if:

- the terms of the arrangement differ from those that would have been agreed to between persons dealing at arm's-length; or
- 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 those circumstances subsection 247(2) of the Tax Act "adjusts" 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 foreign parent to its Canadian subsidiary (and a resulting Canadian subsidiary income inclusion).

But there is a strong argument 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 because 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.[1] Unfortunately, little guidance beyond those statements has been offered to date.

One possible valuation methodology would be to determine what an arm's-length financial institution would charge in those circumstances. This could, however, 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.[2]

Despite the uncertainties that exist, it would seem 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 or arguments may exist to minimize or eliminate the impact of the concerns noted above. 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 when the financial strength of the borrower significantly exceeds that of the guarantor or when the Canadian corporation's guarantee is but one of many provided by other corporate group members.

If the lender is agreeable, the Canadian tax concerns could be dispensed with altogether by replacing the guarantee with a pledge of the Canadian corporation's shares by the foreign parent.

An argument against the shareholder benefit altogether may be available when the Canadian guarantor receives "comparable consideration" from the foreign parent, such as a guarantee fee or an on-loan of the borrowed funds by the foreign parent to the Canadian guarantor. Finally, if the lender is agreeable, which in many instances it would 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 foreign parent. That, however, may have adverse tax implications in the foreign jurisdiction, as discussed below.

Payment of Guarantee Fees

Guarantee fees paid by a foreign parent company to its Canadian subsidiary may be subject to foreign withholding tax in the foreign jurisdiction. But a Canadian foreign tax credit may be available to offset, or partially offset, the withholding tax.

Payments Under a Guarantee

While the case law 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 nonresident lender on account of or in lieu of payment of interest — owing under the original borrowing agreement — generally retains the character of interest.[3] On that basis a guarantee payment could, at least in part, be subject to Canadian withholding tax, despite the fact that interest payments by the borrower (the foreign parent) would not be. To address those 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, af-

[1]CCRA Documents #9206635 and #9205665.

[2]Babette B. Barton, "Economic Fables/Tax-Related Foibles: On the 'Cost' of Promissory Notes, Guarantees, Contingent Liabilities and Nonrecourse Loans" (1999), Vol. 45, No. 4 *Tax Law Review* 471-525 at 517.

[3]Information Circular IC 77-16R4, "Non-Resident Income Tax," 11 May 1992.

ter any applicable withholdings, equal to the guaranteed payment.

In many cases a Canadian subsidiary's loss incurred in honoring a guarantee or similar arrangement is treated on capital account. For Canadian tax purposes, "allowable capital losses" may only be applied against "taxable capital gains." But to claim that 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 in which capital loss recognition could be denied, including, for example, when the Canadian subsidiary guarantor did not receive adequate consideration for giving the guarantee.[4]

Also, a Canadian subsidiary may be faced with interest deductibility concerns when it borrows money to honor its guarantee on the basis that the direct use of borrowed money to honor a guarantee granted outside the ordinary course of business is generally not for an income-producing purpose. The Canadian revenue authorities, however, have suggested that that interest may be deductible when the Canadian subsidiary charged a guarantee fee or received an on-loan of the borrowed funds from the foreign parent.[5]

Foreign Tax Implications

A Canadian corporation's guarantee, or pledge of security, regarding a borrowing undertaken by its foreign parent may also result in adverse tax consequences in the foreign jurisdiction. In the United States, for example, the use by a U.S. parent of its Canadian subsidiary's assets or credit in the context of a U.S. parent financing transaction can result in a deemed distribution of the Canadian subsidiary's "earnings and profits" under section 956 of the Internal Revenue Code.[6] With exceptions, the amount of that deemed distribution is included in the U.S. parent's income and, while U.S. foreign tax credits may be available to substantially offset the resulting U.S. tax liability, that is often not the case.[7]

Also, tax-efficient solutions from a Canadian tax perspective may have substantial negative tax consequences in the foreign tax jurisdiction. For example, contrary to the negligible impact under Canadian tax rules, the pledge of a Canadian subsidiary's stock by a U.S. parent can trigger similar deemed distribution concerns as those noted above.

Summary

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

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[4]Interpretation Bulletin IT-239R2, "Deductibility of Capital Losses From Guaranteeing Loans for Inadequate Consideration and From Loaning Funds at Less Than a Reasonable Rate of Interest in Non-Arm's Length Circumstances," 9 February 1981.

[5]*Id.*

[6]The negative consequences from section 956 can be avoided when 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 U.S. tax purposes; section 956 only applies to controlled foreign corporations. But the use of an NSULC as a means of avoiding section 956 may carry disadvantages. Consequently, a review of the specific facts of each case is necessary before an appropriate course of action can be determined.

[7]Bruce Sinclair and Robert Kopstein, "Guaranteed To Enlighten: The Impact of Guarantees on Financing Arrangements," *Report of Proceedings of Fifty-Second Tax Conference*, 2000 Tax Conference (Toronto: Canadian Tax Foundation, 2001), 22:1-37.