International Fiscal Association (Canadian Branch)
Association Fiscale Internationale (Section Canadienne)

Thin Capitalization: Present, Past and Future

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A presentation of the Young IFA Network (YIN)

Outline

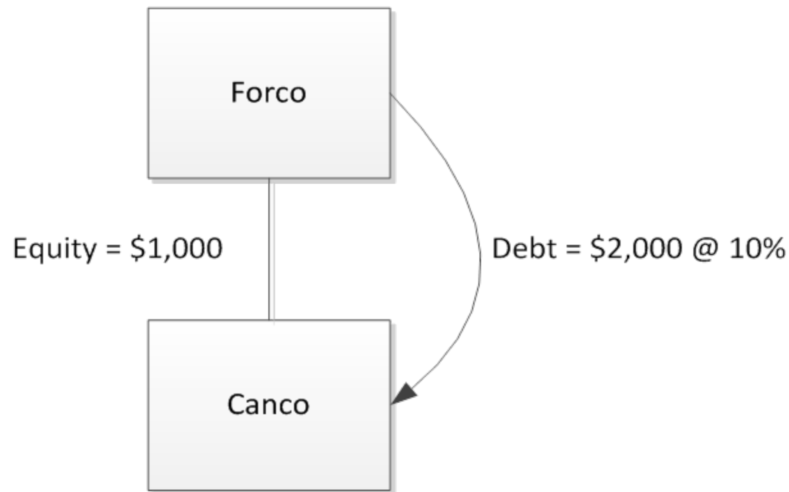
- Overview
- 2012 Budget Changes
  - Ratio Change
  - Extension to Partnerships
  - Deemed Dividend Treatment
  - FAPI Exemption
- 2013 Budget Changes
  - Extension to Canadian Resident Trusts
  - Extension to Non-Resident Trusts and Corporations

General Rule

- Subsection 18(4) of the ITA disallows a deduction for interest expense paid to certain closely related non-resident persons on that portion of debt that exceeds 1.5 times the Canadian company's equity.
- **Purpose**: to protect the Canadian tax base from erosion through excessive interest deductions in respect of debt owing to certain closely related non-resident persons.
- **Relevant Debt:** rules only applies to "outstanding debts to specified non-residents"
  - amounts outstanding on account of a debt or other obligation to pay an amount to certain closely related non-resident persons where interest paid or payable on the amount is (assuming the thin-cap rules did not apply) deductible in computing the corporation's income.
  - does not apply to: (a) third party debt; or (b) guaranteed debt.
- **Which closely related non-resident persons?**

1. "specified non-resident shareholders" - meaning non-resident persons who are "specified shareholders" of the corporation.
   - a "specified shareholder" is a person who either alone or together with persons with whom that person does not deal at arm's length, owns shares of that corporation representing at least 25 percent of the votes that may be cast at an annual shareholders' meeting or representing at least 25 percent of the FMV of all issued and outstanding shares of that corporation.
   - includes 251(5)(b) type rights in determining whether the above test has been satisfied.
2. non-resident persons who do not deal at arm's length with a "specified shareholder" of the corporation.

Simple Example



- With a permitted debt-to-equity ratio of 1.5-to-1, Canco has $500 of total excess debt – that is, ($2,000 – 1.5 x $1,000)/2,000, or 1/4, of $2,000.
- This 1/4 ratio is applied to interest on the debt owed directly to Forco by Canco. Accordingly, 1/4 of the interest deductions in respect of the $2,000 loan from Forco will be denied (i.e., 1/4 of the $200 or $50).

Computational Rules

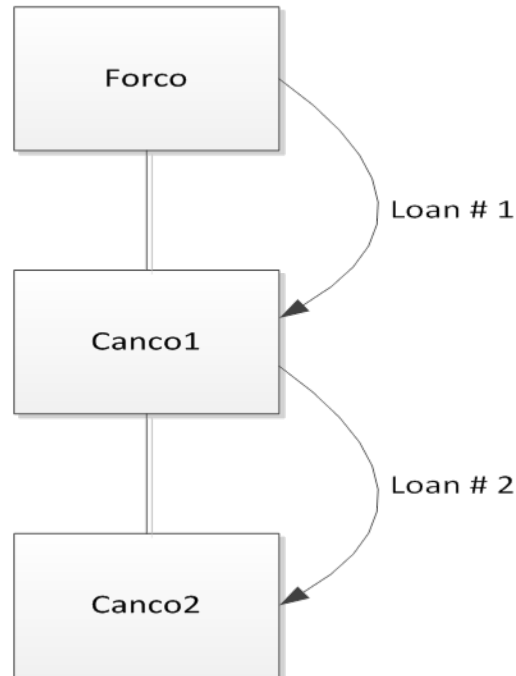
Debt:

- The amount of debt of the Canadian corporation is determined by averaging the highest amount of debt owed by the corporation at any time during each calendar month that ends in its taxation year for which the computation is being made.

Equity:

- In general terms, the "equity" of the Canadian corporation is equal to the sum of its:
  - (i) retained earnings of the corporation at the beginning of the taxation year;
  - (ii) average of the corporation's contributed surplus at the beginning of a calendar month that ends in the taxation year (to the extent such amounts were contributed by a specified non-resident shareholder); and
  - (iii) average of the corporation's paid-up capital at the beginning of a calendar month that ends in the taxation year (to the extent it relates to shares owned by a specified non-resident shareholder)
- CRA Administrative Position re "Beginning of a Calendar Month"
  - 2010 – 0365371R3 – Amalgamations
  - ITTN 38 – Newly Incorporated Companies

Tiered Example



- As paid-up capital and contributed surplus are only relevant to the thin-capitalization ratio to the extent they relate to shares owned by a specified non-resident shareholder (or were contributed by a non-resident shareholder), it is generally necessary to make the loan to Canco1 not to Canco2.
- If financing is required for Canco2, Forco should lend the money to Canco1, which would, in turn, lend it to Canco2.

Tiered Example – Cont'd

- Pursuant to subsection 18(6) a loan (the "**first loan**") made by a specified non-resident person to another person "on condition" that the other person make a loan (the "**second loan**") to a third person resident in Canada will be treated as a loan by the first person to the third for the purposes of the thin capitalization rules.
- 2010-0366541C6 – CRA will not apply subsection 18(6) provided that: (a) the first loan is subject to subsection 18(4) (i.e., the lender is a specified non-resident in respect of Canco1); and (b) Canco1 and Canco2 are related (otherwise than as a result of 251(5)(b) rights).
  - Previous CRA administrative policy was that (i) the two loans must be in the same amount; (ii) the second loan must bear interest at a higher rate than the first loan; and (iii) the specified non-resident shareholder must have *de jure* control over both Canadian subsidiaries.

Budget 2012 Amendments

- In its report was released on December 20, 2008, the Advisory Panel on Canada's System of International Taxation ("**Advisory Panel**") made several recommendations. In response to this recommendation by the Advisory Panel, the 2012 federal budget included the following amendments to the thin capitalization rules:
  - Lowered the debt-to-equity ratio from 2:1 to 1.5:1.
  - Extended the application of the thin capitalization rules to partnerships that have a Canadian corporation as a member.
  - Re-characterized interest expense that is denied under the thin capitalization rules is treated as a dividend for Canadian withholding tax purposes.
  - Provided relief from the thin-capitalization rules for interest that is included in the income of a Canadian corporation through the application of the foreign accrual property income rules.

Lowering Debt-to-Equity Ratio

- Effective for taxation years that begin after 2012, the debt-to-equity ratio is reduced from 2:1 to 1.5:1.
  - Before the February 28, 2000, the ratio was 3:1.
- Debt Capitalization Issues:
  - Retained earnings
  - Debt forgiveness issues
  - Commercial considerations

Extension to Partnerships

- Before 2012 Budget changes, position was that where partnerships with Canadian corporate partners borrowed from specified non-resident shareholders of the Canadian corporate partners the thin capitalization rules did not apply since the debt was not borrowed by a corporation resident in Canada (see CRA View 922921); however, CRA indicated they would look to apply GAAR if the partnership's formation was primarily to avoid application of ss. 18(4).
- In *Wildenburg Holdings Ltd.,* court found that for the purposes of Ontario income tax, thin cap rules would apply to partnership debt where partner's risk with respect to the debt was contractually limited (i.e. several, not joint)
- CRA indicated in 1998 Roundtable that it would apply thin cap in situations similar to *Wildenburg* (see ITTN 16).

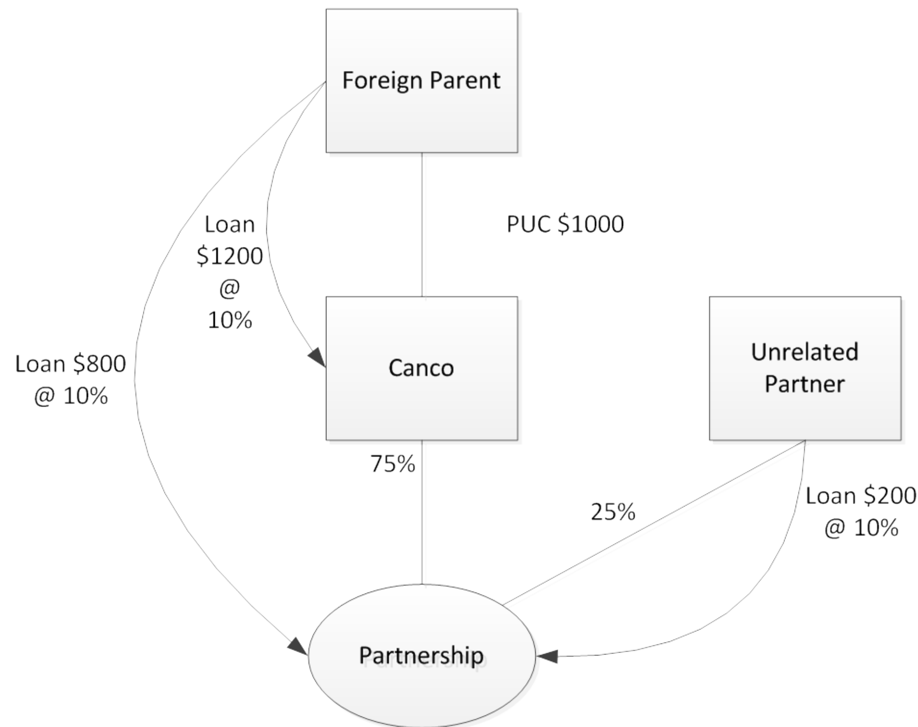
Extension to Partnerships

- For taxation years beginning after March 28, 2012, ss. 18(7) now applies to extend the thin capitalization rules to include a Canadian corporation's share of debts of a partnership of which the corporation is a partner.
- Subsection 18(7) deems that (for the purposes of the thin cap rules)
  - each member of the partnership owes its share of the debt of the partnership to the creditor
  - the member has paid the interest that is deductible to the partnership with respect to the debt amount

Extension to Partnerships

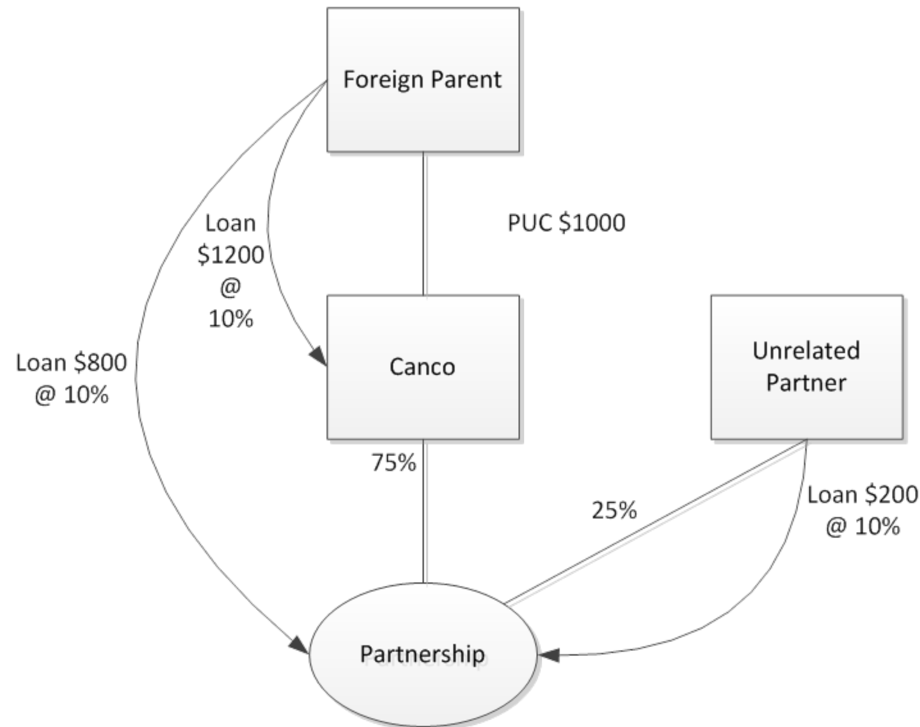
- The partner's share of the debt amount is based on its "specified proportion" – being the partner's share of income of the partnership for the last fiscal period of the partnership ending at or before the member's taxation year end.
- Where it is the first year of the partnership, the amount is based on the proportionate FMV of the partnership interest.
- Since the member of the partnership is deemed to owe the amount to the creditor, it is at each member level that the determination is made as to whether debt is "outstanding debt to specified non-residents".
- Where there is excess debt for thin capitalization purposes, interest deduction at the partnership level is not denied but the corporate partner includes in income an amount equal to interest on excess debt under paragraph 12(1)(l.1).

Extension to Partnerships



- Canco owes $1200 to Foreign Parent
- Under 18(7) Canco also deemed to owe $600 (75% x $800) to Foreign Parent and $150 (75% x $200) to Unrelated Partner .
- Total outstanding debts to specified non-residents = $1800 ($1200 + $600) (75% of debt deemed owed to Unrelated Partner ignored since Unrelated Partner not a specified non-resident shareholder).

Extension to Partnerships



- Excess debt of $300 (PUC of $1000 supports $1500 of debt)
- $120 x $300/$1800 = $20 of denied interest owing under 18(4) (owing to Foreign Parent)
- $60 x $300/$1800= $10 income inclusion under paragraph 12(1)(l.1)
- Total of denied interest and income inclusion of $30 produces expected result.

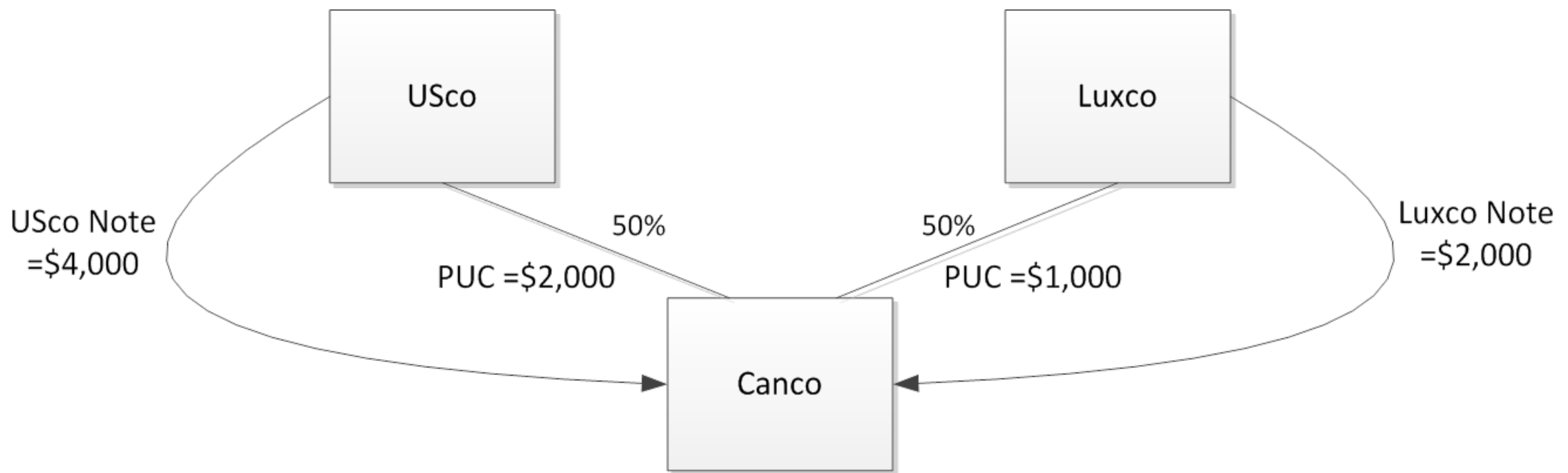
Deemed Dividend Treatment – General Rule

- Pursuant to subsection 214(16), disallowed interest expense (including for this purpose any amount that is required to be included in computing the income of a corporation in respect of an amount deductible by a partnership of which the corporation is a member) is treated as a dividend for non-resident withholding tax purposes.
- Dividend is deemed to have been paid by the Canadian corporation even in respect of interest which is paid by a partnership.
  - Non-resident lender is entitled to apply for a refund of any excess withholding tax remitted by, or on behalf of, the non-resident lender.
- Interest which is payable (other than compound interest) by a corporation or partnership in respect of a taxation year of the corporation but that is not paid or credited in the year, is deemed to have been paid immediately before the end of the year and not to have been paid or credited at any other time (see 214(17)(a)).

Deemed Dividend Treatment – Proportionate Allocation

- Any interest expense that is disallowed under the thin-capitalization rules for a taxation year is allocated pro rata to all of the corporation's debts that are outstanding to specified non-residents.
  - In other words, Canco is not able to choose to which lenders the interest expense will be recharacterized in order to minimize withholding taxes.
- Pursuant to paragraph 214(16)(b), the corporation can designate in its return of income for a taxation year which payments of interest in the year are to be recharacterized as dividends. Absent a designation, the appropriate portion of each interest payment would be deemed to be a dividend.
  - The relevant withholding tax is due at the time that it would have been due if the deemed dividend had been paid at the time the disallowed interest expense was paid or deemed to have been paid.
  - Subsection 227(8.5) provides that there will not be a penalty under subsection 227(8) unless the taxpayer would have been liable for a penalty for failing to withhold on the payment of interest which is deemed to be a dividend.

Deemed Dividend Treatment - Example

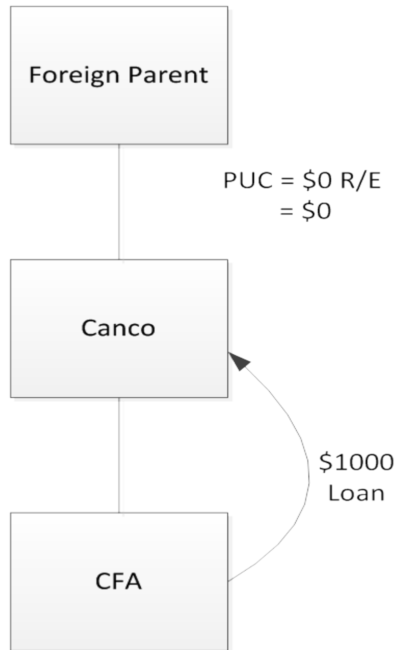


- The USco Note and the Luxco Note both bear interest at a rate of 10% per annum which is payable on a quarterly basis.

Deemed Dividend Treatment - Example

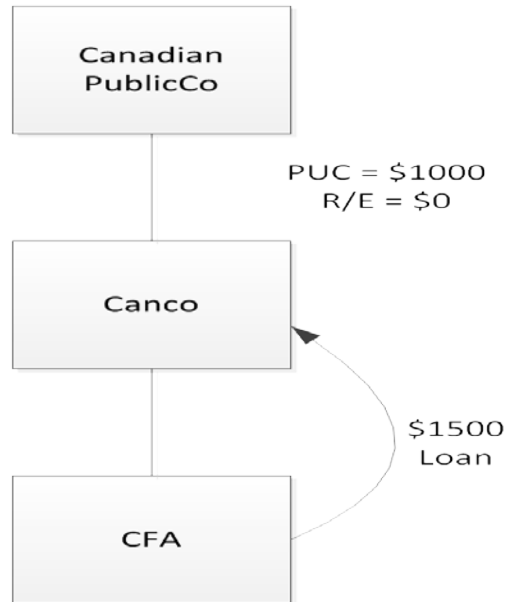
- Canco has equity of $3,000 and is considered to have outstanding debts to specified non-residents of $6,000.
- With a permitted debt-to-equity ratio of 1.5-to-1, Canco has $1,500 of total excess debt – that is, ($6,000 – 1.5 x $3,000)/6,000, or ¼, of $6,000.
- Accordingly, ¼ of the annual interest deduction in respect of the USco Note and the Luxco Note is denied under the thin-capitalization rules. That is, ¼ of the $400 (i.e., $100) of annual accrued interest on the USco Note and ¼ of the $200 (i.e., $50) of annual accrued interest on the Luxco Note will be denied.
- Canco is entitled to designate at any time before its filing due-date for the taxation year, which interest payments paid to USco and Luxco will be recharacterized as dividends. In this case, Canco would designate the final interest payments in the year (i.e., the payments of $100 of interest to USco and $50 of interest to Luxco) to be recharacterized as a dividend for withholding tax purposes.
- Example illustrates that dividend recharacterization is not always negative.
  - Canada-Luxembourg Treaty: interest 10%, dividends 5%

FAPI Exclusion



- Controlled Foreign Affiliate is a non-resident person that does not deal at arm's length with a "specified shareholder" (Foreign Parent) of Canco.
- No equity into Canco for thin cap purposes, so all interest deductions are denied, even though interest is FAPI – results in "double" taxation
- Upstream loans were quite common planning techniques to avoid distribution of taxable surplus; however, now need to consider draft upstream loan rules that can result in an income inclusion to Canco for the principal amount of the CFA Loan (see draft subsection 90(6)).

FAPI Exclusion

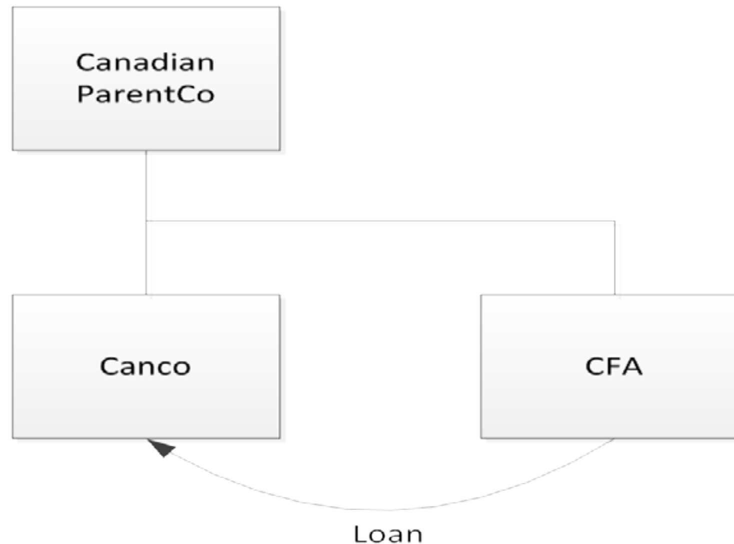


- Controlled Foreign Affiliate is a non-resident person that does not deal at arm's length with a "specified shareholder" (Canadian PublicCo) of Canco.
- Thin cap can apply to loans to Canadian controlled corporations.
- PUC does not count since shares not owned by specified non-resident shareholder; therefore still no equity into Canco for thin cap purposes.
- All interest deductions are denied, even though interest is FAPI.
- Upstream loans rules to consider.

FAPI Exclusion

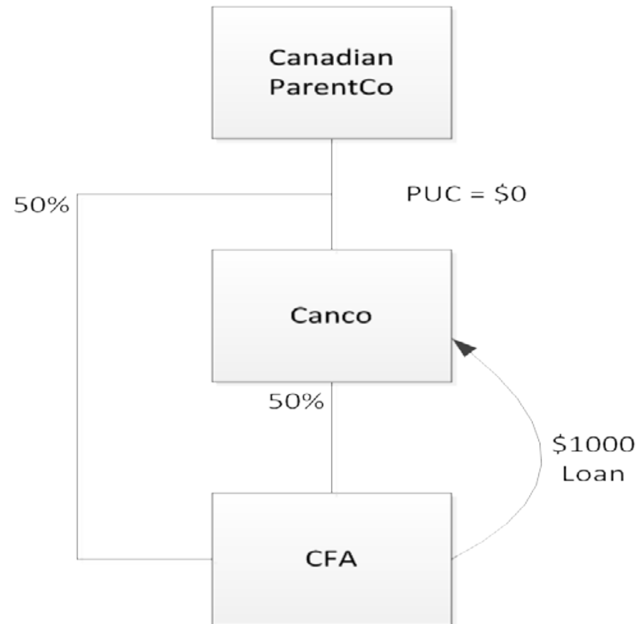
- In the previous examples, subsection 18(8) now permits deductibility of otherwise non-deductible interest under the thin capitalization rules to the extent an amount is included in Canco's income as FAPI which can reasonably be considered to be in respect of the interest.
- The 2012 Budget proposed to limit the deduction to the FAPI inclusion net of any Foreign Accrual Tax paid in respect of the FAPI – this requirement has been eliminated.
- No relief where there is no FAPI inclusion due to the CFA having a FAPL to offset.
- Subsection 18(8) provides relief where FAPI inclusion occurs in the same year as interest deduction or subsequent year – provides relief where Canco and CFA may have different year ends.
- However, some issues with subsection 18(8) still exist……

FAPI Exclusion



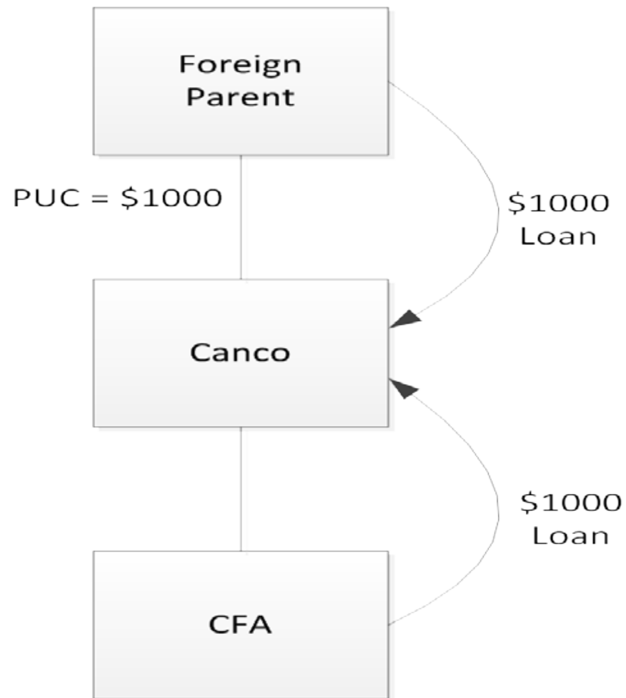
- Loan to Canco is subject to thin cap since CFA does not deal at arm's length with specified shareholder of Canco.
- However, FAPI income included at level of Canadian ParentCo - no relief provided under subsection 18(8) – FAPI must be included in income of same taxpayer.
- This issue was included in submissions to Finance but not addressed in final legislation.
- Interest paid will be deemed to be a dividend (15% if treaty, 25% otherwise)

FAPI Exclusion



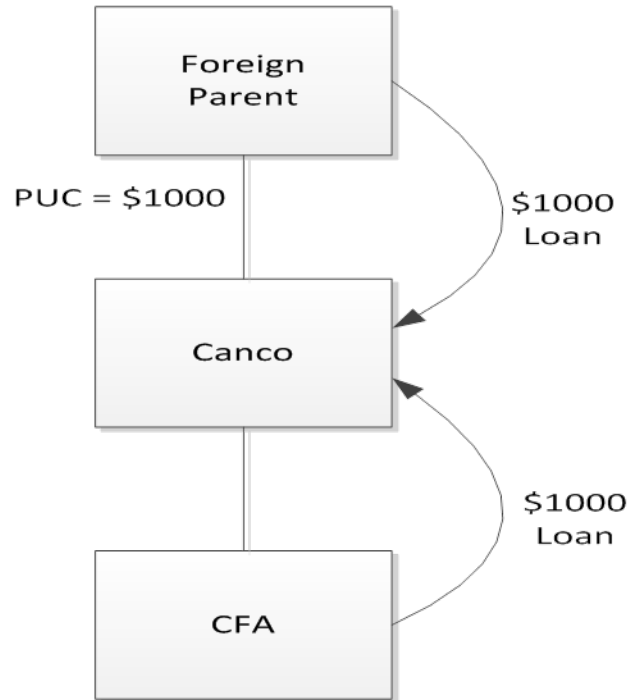
- Similarly, issues can arise when Canco does not own all of CFA.
- While all interest on loan is FAPI, only partial relief under subsection 18(8) (equal to 50% of interest paid).
- 50% of interest denied will be deemed paid as a dividend – (15% or 25%)

FAPI Exclusion



- CFA Loan and Foreign Parent Loan to Canco are both "outstanding debts to a specified non-resident"
- Based on proportionality 500/2000 (25%) of all interest is denied under subsection 18(4).

FAPI Exclusion



- Relief under subsection 18(8) allows deduction of 25% of interest paid on CFA Loan otherwise denied under subsection 18(4).
- Results in 25% of interest on loan from Foreign Parent being denied (likely subject to 5% withholding tax).
- Submissions to Finance suggested entire amount of CFA Loan should be carved our of “outstanding debts to specified non-residents” however no changes made in final legislation.

Budget 2013 Amendments

- Budget 2013 proposes to further implement the recommendations of the Advisory Panel by extending the application of the thin capitalization rules to:
  - Canadian resident trusts; and
  - Non-resident corporations and trusts that operate in Canada.

Canadian Resident Trusts

- Trust beneficiaries used in place of shareholders to determine whether a person is a specified non-resident in respect of the trust and whether debt owing to that person is included in trust's "outstanding debts to specified non-residents".
- Equity for the trust will consist of contributions to the trust from specified non-residents plus tax paid earnings of the trust, less capital distributions to specified non-residents.
- Thin capitalization ratio of 1.5 to 1 will apply.

Canadian Resident Trusts

- The trust will be able to designate interest that is denied due to the thin capitalization rules as a payment of income of the trust to a non-resident beneficiary (i.e. the recipient of the non-deductible interest).
- Trust will be able to deduct designated payment in computing its income, but the payment will be subject to Part XIII tax and potentially Part XII.2 tax (depending on nature of trust income).
- Rules also extended to partnerships in which a Canadian resident trust is a member.

Canadian Resident Trusts

- Since historic information to compute equity of Canadian-resident Trusts for purposes of the thin capitalization rules may not be available, proposals provide that trusts existing on Budget Day can elect to determine equity based on fair market value of its assets on Budget Day, less liabilities.
- Each beneficiary will be considered to have made a contribution to the trust equal to the beneficiary’s share of this deemed trust equity based on the relative fair market value of their beneficial interest in the trust.

Non-Resident Corporations and Trusts

- Budget 2013 proposes to extend the thin-capitalization rules to non-resident corporations and trusts that carry on business in Canada or that elect to be taxed on their net income pursuant to section 216, with the necessary adjustments to take into account that the branch does not have shareholders or equity for thin capitalization purposes.
- For these purposes, “outstanding debts to specified non-residents” means indebtedness if owed to a either:

  a) a specified non-resident shareholder;

  b) a specified non-resident beneficiary; or

  c) a non-resident who does not deal at arm’s length with a specified shareholder of the corporation or a specified beneficiary of the trust,

where interest paid or payable on such debt is (or would be but for subsection 18(4) be) deductible by the corporation or trust.

Non-Resident Corporations and Trusts

- The concept of equity (i.e., the “equity amount” under the proposed changes) is replaced with an amount determined by reference to the assets and liabilities of the corporation or trust.
- The equity amount of such a corporation or trust is equal to 40% of the amount by which the cost of the property of the corporation or trust used or held by it in carrying on business in Canada (or in the case of a corporation or trust that elects under section 216, the cost of Canadian real property or timber resource property owned by it) exceeds all debts owing by the corporation or trust other than debts owing to specified non-residents of the corporation or trust.
  - It appears that all debts are included in this net asset calculation and not just those related to the Canadian branch.
  - The 40% amount corresponds to the original percentage of equity that would have been required had the company been originally funded on a 1.5:1 ratio.
- In effect, the 1.5:1 debt to equity ratio is replaced with a 3:5 debt to net asset ratio.
- The proposals also extend to partnerships in which a non-resident corporation or trust is a member.