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

Back-to-Back Arrangements
In a Cross-Border Context

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Introduction

- B2B arrangements are addressed in various provisions of the ITA/treaties, e.g.:
  - Subsection 18(6) (thin cap)
  - Subsections 17(2), (3) and (11.2) (imputed interest income)
  - Subsection 90(7) (upstream loans)
  - Subsection 95(2)(a)(ii) (FA transactions)
  - Subsections 212.3(23) and (24) (FA dumping)
  - Treaty concept of “beneficial ownership”

Introduction

- Two categories of rules:
  - Anti-avoidance rules that target the use of B2B arrangements for tax avoidance purposes
  - “Supporting” rules that address certain negative tax consequences of genuine commercial B2B arrangements

Introduction

- No single concept, definition or test
  - The relationship required for a B2B arrangement to exist depends on the context

Back-to-Back Financing Arrangements

Budget 2014

- Introduced two significant changes impacting "back-to-back" financing arrangements
  - Thin-capitalization rules (proposed 18(6.1) ITA)
  - Part XIII interest withholding tax (proposed 212(3.1)-(3.3) ITA)

Thin Cap Recap

- Thin cap rules are designed to discourage non-residents from capitalizing Canadian entities with excessive amounts of debt and thus repatriating excessive amounts of Canadian profits via deductible interest payments
- But for the thin cap rules, the interest expense would reduce Canadian profits subject to Part I tax and would instead be subject to withholding tax at a lower (treaty-reduced) rate

Thin Cap Recap

- Thin cap rules apply where “outstanding debts to specified non-residents” exceed equity (generally retained earnings, contributed surplus and PUC of shares held by specified non-resident shareholders) by more than permitted ratio
- Maximum thin cap ratio recently reduced from 2:1 to 1.5:1
- Equity/Debt generally measured on monthly basis and averaged for the year
- Only debts in respect of which interest would otherwise be deductible are included in the debt portion of the ratio
- If thin cap rules apply, interest on the excess debt is non-deductible
- If multiple loans, the denied interest is attributed proportionally to each debt

Thin Cap Recap

- The interest deduction is not denied where the interest income is included in the Canadian corporation's income as FAPI
- This could arise where a CFA loans to its direct or indirect Canadian shareholder (Canco)
- If Canco is owned by a specified shareholder, CFA would be a "specified non-resident" because it would not deal at arm's length with the specified shareholder
- Upstream loan rules could also apply to such a loan

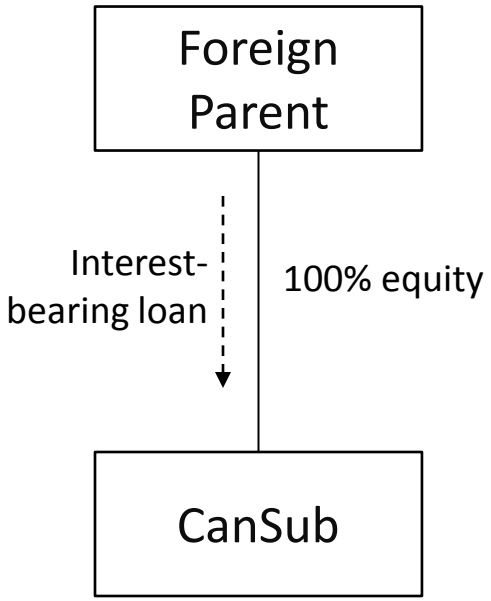
Thin Cap Recap

- Non-deductible interest paid or payable in respect of the year (other than compound interest) is re-characterized as a dividend
- Deemed payment immediately before year-end will trigger withholding taxes
- Where lender is not U.S. Resident, withholding rate may actually decrease from 10% to 5% (if lender has sufficient share ownership)

Thin Cap Recap

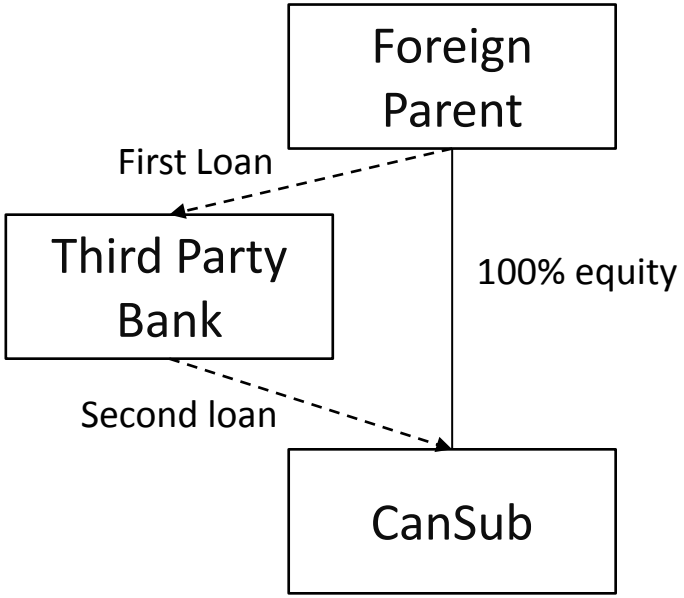
- Budget 2012 extended the application of thin cap rules to partnerships with corporate members
- Budget 2013 extended the application of thin cap rules to Canadian resident trusts and Canadian branches of non-resident corporations

Thin Cap and B2B Arrangements



- Thin cap 1.5:1

Targeted Arrangement



- No thin cap except for conditional loans under current 18(6)

Thin Cap and B2B Arrangements

- Current Subsection 18(6)
- Applies to a loan (the "**first loan**"):
  - made by a specified non-resident shareholder or a non resident person who does not deal at arm's length with a specified shareholder (resident or non-resident)
  - "on condition" that a loan (the "**second loan**") will be made by any person to a corporation resident in Canada
- Result:
  - Disregard intermediary to treat as direct loan to Canadian taxpayer (CanSub)
  - Denied interest re-characterized as dividend

Thin Cap and B2B Arrangements

- The 2000 Budget proposed to extend s. 18(6) to arrangements involving guarantees but rules heavily criticized and never enacted
- The 2008 Advisory Panel encouraged the government to review the scope of the thin capitalization rule governing B2B back-to-back loans “while ensuring that any changes in this area do not affect bona fide business transactions”

Thin Cap and B2B Arrangements

- Budget 2014 introduced new subsection 18(6.1) which extends scope of back-to-back arrangements
- Applies where a taxpayer has a outstanding interest-bearing obligation owing to an intermediary (the "particular amount"), and as part of a transaction, or series of transactions, that includes the taxpayer becoming obligated to pay the particular amount, the Intermediary (or a NAL person):
  - has an interest in property that secures payment of the particular amount which interest was provided directly or indirectly by a specified non-resident
  - has an amount outstanding to a specified non-resident for which recourse is limited to the taxpayer's obligation
  - has an amount outstanding to a specified non-resident under an obligation which was entered into on the condition that the taxpayer's obligation be entered into (similar to current 18(6))
- Exception if the intermediary is a specified NR

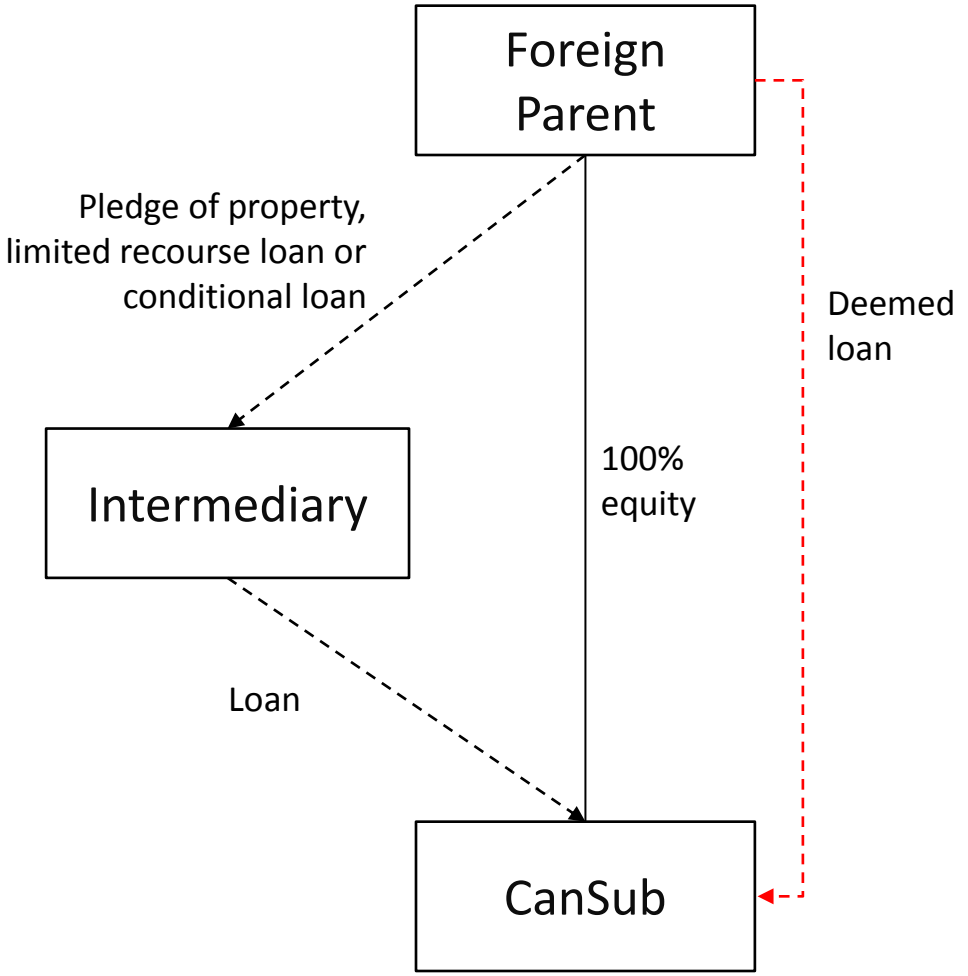
Thin Cap and B2B Arrangements

- Budget states that a **guarantee**, in and of itself, would not be considered a pledge of property
- However this effect would apply to the extent of the FMV of any property of the relevant NR person in which the intermediary is given an interest or right that secures the payment of the taxpayer's debt
- What is not clear is whether the measure would apply where the property is used as security for the NR's obligation under a guarantee rather than as security for the taxpayer's debt as such

Thin Cap and B2B Arrangements

- Where subsection 18(6.1) applies, the debt or obligation and the interest paid or payable thereon is deemed to be owing by the taxpayer to a "specified non-resident person" for purposes of the thin cap rules
- The taxpayer is deemed to owe an amount that is equal to the lesser of:
  - The outstanding amount of the obligation owing to the intermediary;
  - FMV of the pledged property, outstanding amount of the limited recourse debt or conditional loan, as the case may be
- Application in respect of taxation years that begin after 2014

Thin-Cap and B2B Arrangements



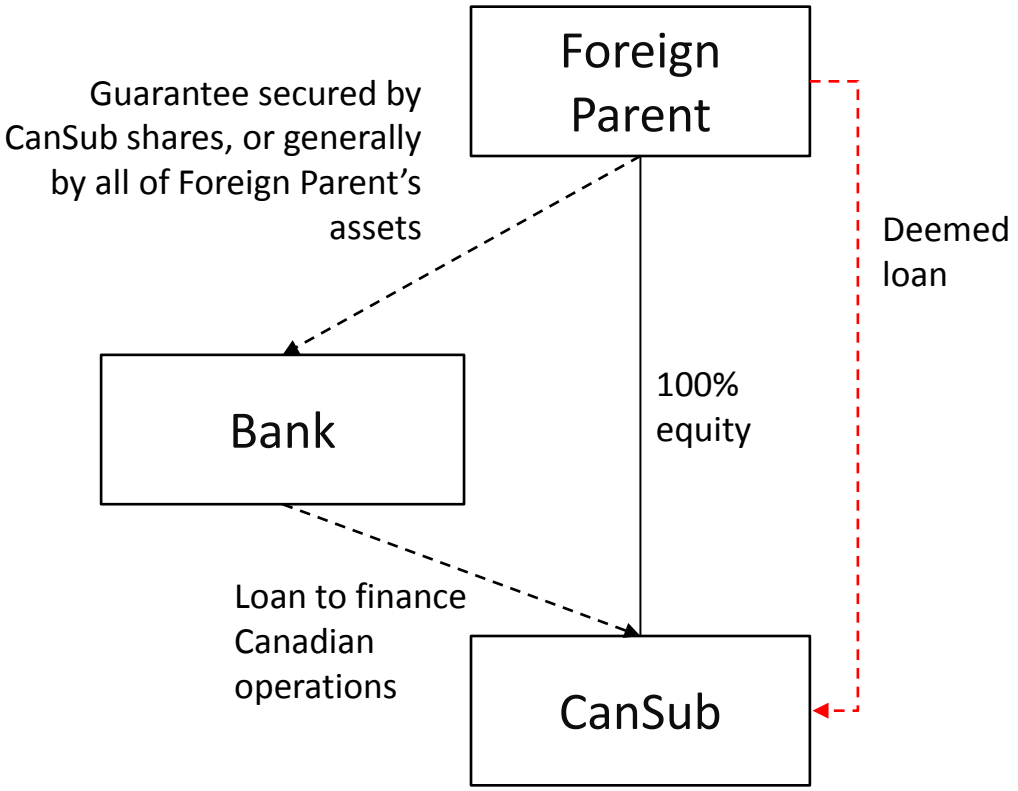
- Thin cap proposals apply to deem the amount of the loan from the Intermediary to be an amount owing to a specified non-resident shareholder
- All or a portion of the interest expense could be disallowed, depending on equity held by Foreign Parent

Thin Cap and B2B Arrangements

- Rules broadly drafted
- No distinction between liquid assets and illiquid assets, such as shares of operating subsidiaries or even shares of the Canadian borrower
- No distinction between support from a shareholder and support from a subsidiary
- No distinction between resident and non-resident intermediaries, and related and unrelated intermediaries (although there is a specific exception for an intermediary that is a specified NR)
- As a result, many ordinary commercial lending transactions and cash management arrangements could cause the application of thin cap rules

Thin Cap and B2B Arrangements

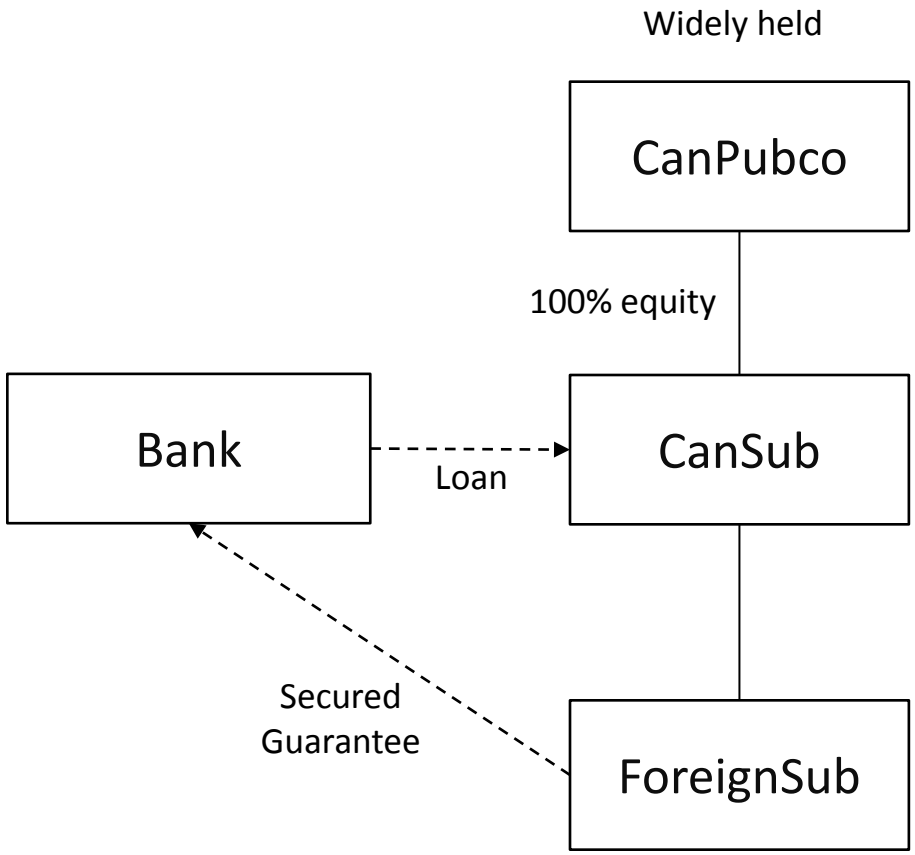
Example 1 – Guarantee secured by Canco assets



- Thin cap proposals would apply because the guarantee is provided by a specified non-resident shareholder (Foreign Parent)
- No distinction even if no recourse to the guarantee prior to CanSub's default
- No distinction even if its "Canadian assets" that guarantee CanSub's borrowing to finance its operations

Thin Cap and B2B Arrangements

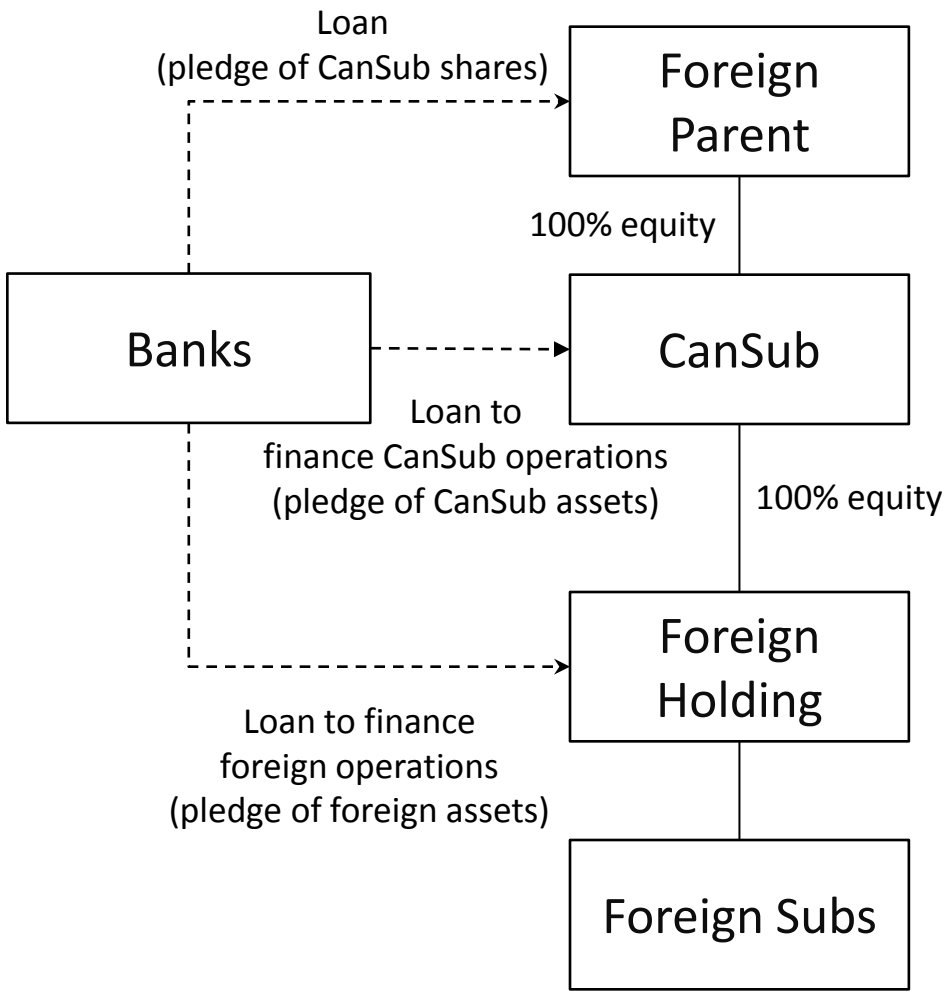
Example 2 – Secured Guarantee by Foreign Sub



- ForeignSub is a non-resident person that does not deal at arm's length with the specified shareholder (CanPubco)
- If there was no specified shareholder (e.g. CanPubco was the borrower) thin cap proposals would not apply
- Loan is deemed to be owing by CanSub to a specified non-resident shareholder rather than to Bank
- CanSub's paid up capital and contributed surplus are not relevant
  - Therefore, "equity amount" only includes unconsolidated RE
- 18(8) would have excluded an actual loan from Foreign Sub from thin cap if interest were FAPI

Thin Cap and B2B Arrangements

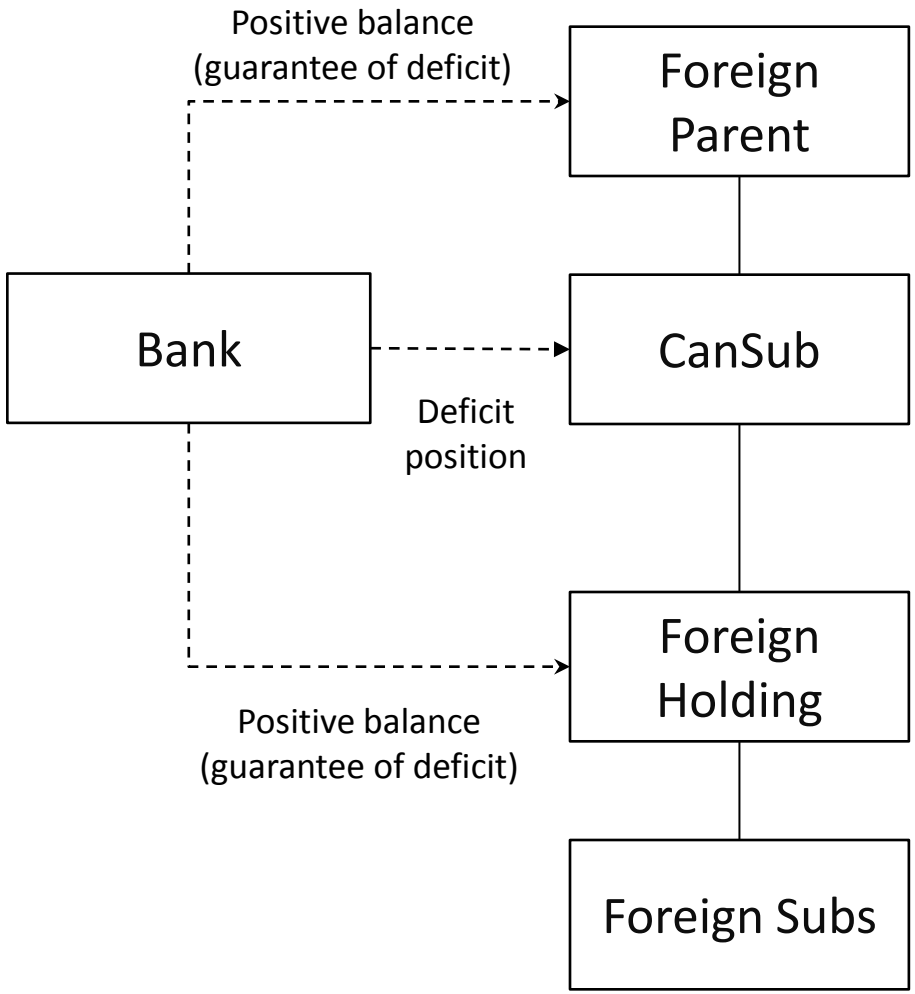
Example 3 – Secured Group Borrowing Facility



- Foreign Parent, CanSub and Foreign Holding are all co-borrowers under a group credit facility with a syndicate of Banks
- All entities provide cross-guarantees of all borrowings with security provided over specific assets such as CanSub shares and assets, and the assets of Foreign Holding and Foreign Sub
- Thin cap proposals would apply because pledge provided by Foreign Parent and Foreign Holding
- The portion of the loan that would be deemed to be owing to a specified NR shareholder would likely be based on FMV of assets pledged by both NRs notwithstanding that CanSub also secures the debt of Foreign Holding
  - No exception for “two-way” security arrangements

Thin Cap and B2B Arrangements

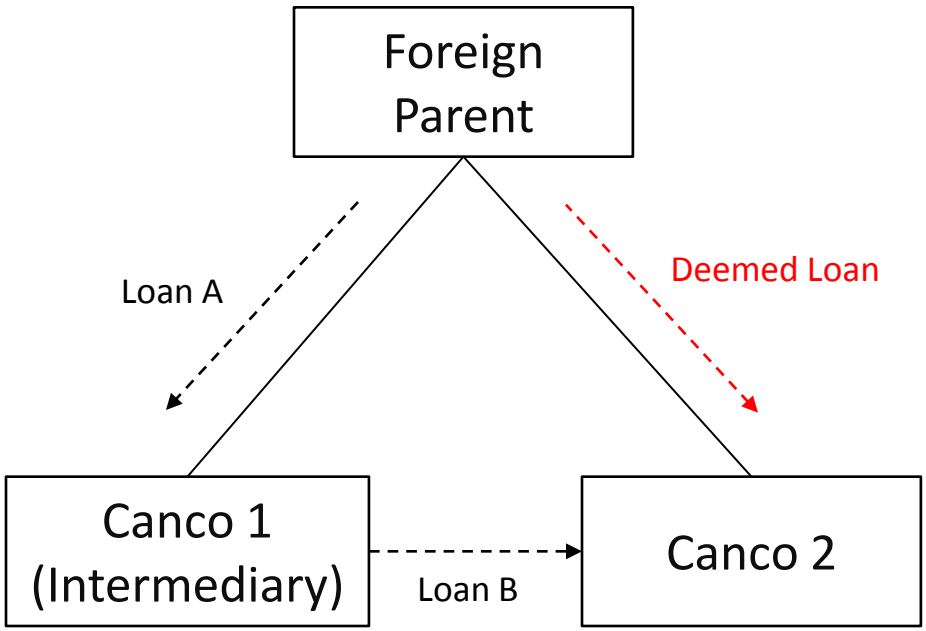
Example 4 – Cash Pooling Arrangements



- One form of cash pooling involves notional netting of negative and positive balances in the group
- There are cross-guarantees so that all the cash in the system is subject to Bank's security interest
- Foreign Parent's and Foreign Holding's positive balances are security for deficit position of CanSub
- Thin cap proposals may apply since Bank has an interest in security provided by Foreign Parent and Foreign Holding

Thin Cap and Back-to-Back Loans

Example 5 – Related Intermediary

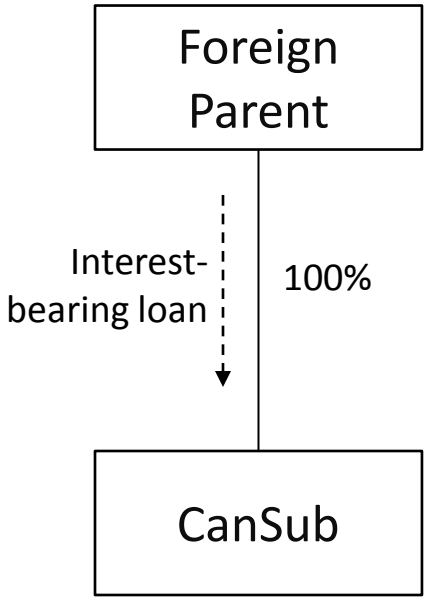


- Conditions of 18(6) would be met if Loan A is conditional on Loan B and Foreign Parent is a specified NR shareholder
- Canco 2 would be deemed to be owing an amount of debt to Foreign Parent
- Thus, thin cap could potentially apply twice in respect of the same funds
- Long-standing CRA administrative policy (para. 3 of IT59R3, 2010-0366541C6) in respect of the existing 18(6) not to apply thin cap to Canco2 if it applies to Canco1
- However, whether this policy would continue under the new measure is unclear

WHT and B2B Arrangements

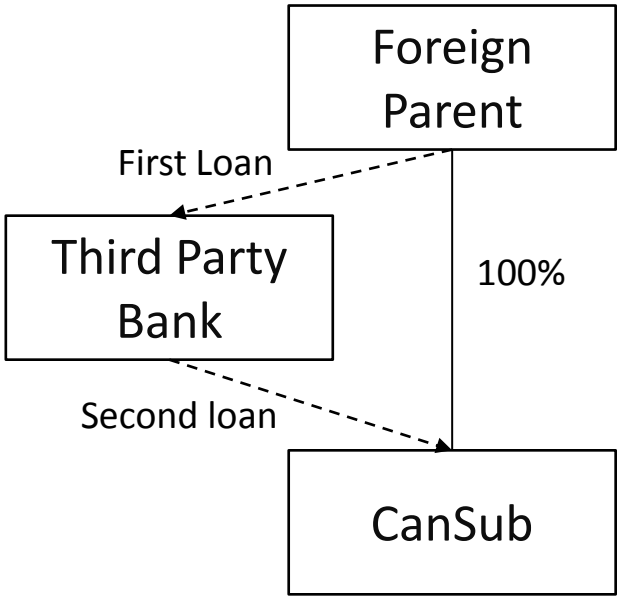
- Budget 2014 introduced a new WHT rule for B2B arrangements
  - Part XIII WHT will generally apply in respect of a B2B arrangement to the extent that it would otherwise be avoided by virtue of the arrangement
  - The non-resident person and the taxpayer will be jointly and severally (or solidarily) liable for the additional withholding tax

WHT and B2B Arrangements



- 25% on NAL interest
- May be reduced to 15/10/0% under a treaty

Targeted Arrangement



- No Part XIII WHT on AL interest
- In 1986, Canadian banks agreed not to make such loans (goes back to 5/25 debt)
- Advisory Panel did not comment on this topic
- CRA's position was that GAAR could apply

WHT and B2B Arrangements

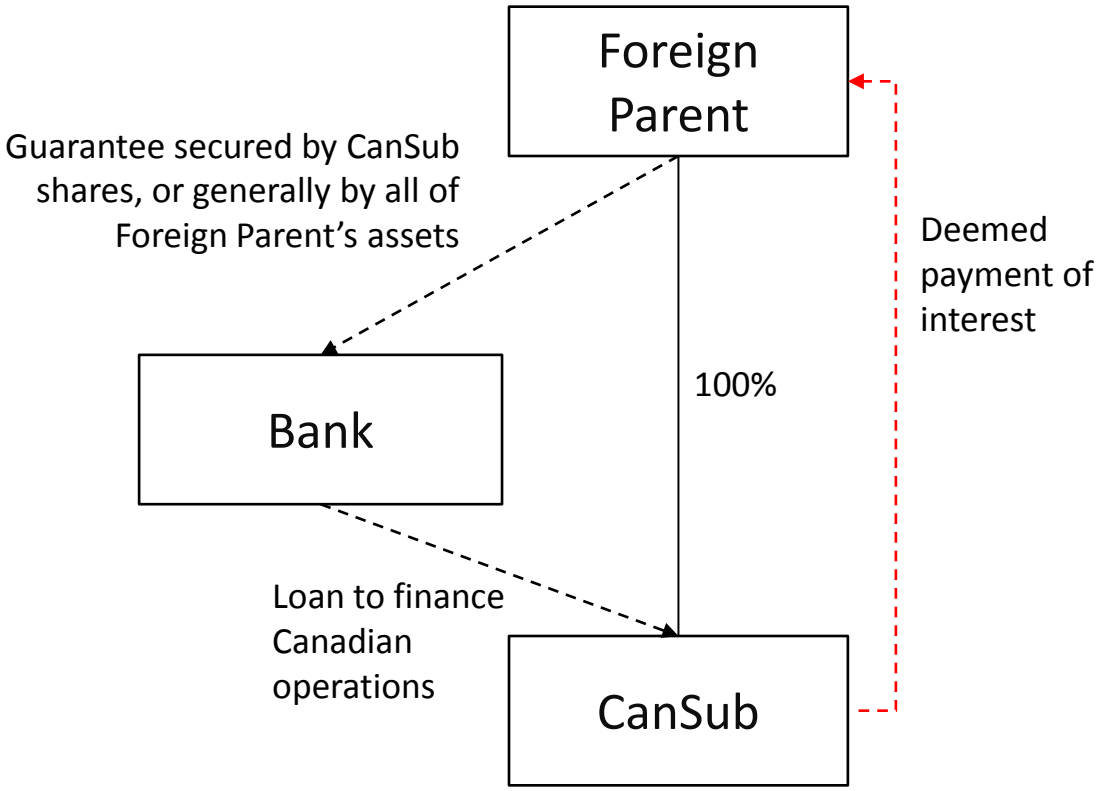
- Proposed subsections 212(3.2) and (3.3) apply if:
  - Taxpayer pays or credits a particular amount of interest to an intermediary (whether or not lender is resident);
  - At any time during which the interest accrued, as part of a transaction, or series of transactions, that includes the taxpayer becoming obligated to pay an amount in respect of the particular obligation, the Intermediary (or a NAL person):
    - has an interest in property that secures payment of the particular amount which interest was provided directly or indirectly by a non-resident person (**not limited to a "specified non-resident" as in thin cap**) ;
    - has an amount outstanding to a non-resident person for which recourse is limited to the taxpayer's obligation;
    - has an amount outstanding to a non-resident person under an obligation which was entered into on the condition that the taxpayer's obligation be entered into.
  - If the amount were paid or credited to the non-resident person rather than the intermediary, there would be a higher amount of Part XIII tax payable

WHT and B2B Arrangements

- If proposed subsections 212(3.2) and (3.3) apply, the taxpayer is deemed to pay interest to the non-resident person rather than to the intermediary (subject to reduced WHT rate under the treaty)
- The amount of deemed interest is calculated based on a formula, essentially as a function of the WHT reduction
- Non-application if the NR person is entitled to the benefits of US-Canada treaty (i.e. 0% WHT on NAL interest)
- Applies to interest paid or credited after 2014

WHT and B2B Arrangements

Example 1 – Secured Guarantee by Foreign Parent



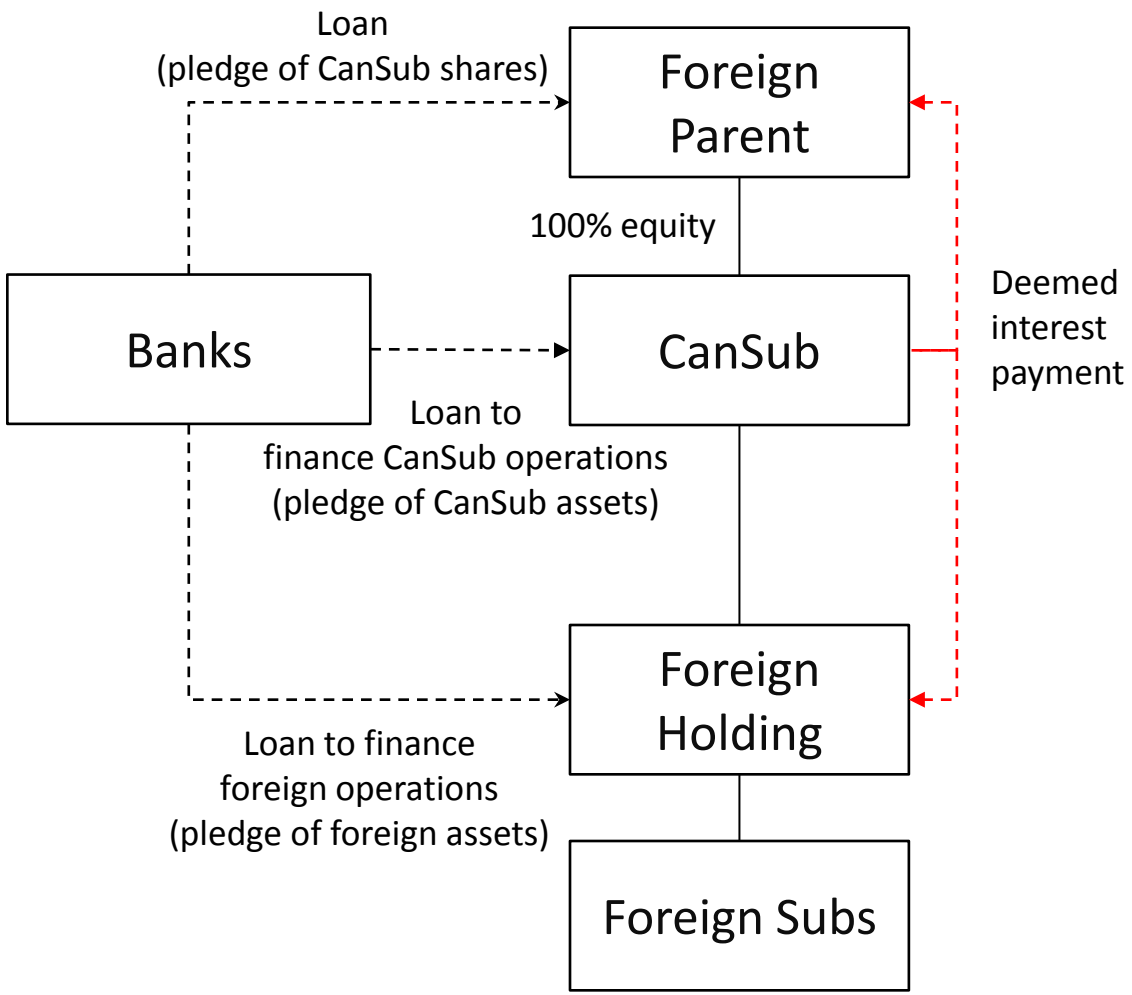
- Conditions in 212(3.1) will be met unless:
  - Foreign Parent is US resident (0% WHT under the treaty)
  - if the intermediary is treaty resident, non-US and NAL with CanSub (i.e. likely no reduction in Part XIII tax in those cases, depending on relevant tax treaties)
- CanSub is deemed to pay interest to Foreign Parent and not to the Bank
- Does WHT make sense in the circumstances where no actual payment to Foreign Parent?
- Treaty application?
- Foreign tax credit?

WHT and B2B Arrangements

- Where there is a group credit facility the taxpayer may be deemed to pay interest to more than one non-resident person in respect of a particular debt if the total security exceeds the particular debt outstanding at that time to the intermediary
- In these circumstances, the taxpayer can choose to "allocate" amounts favourably to treaty *vs.* non-treaty residents as is reasonable in the circumstances
- It appears that no favorable "allocation" can be made if there is no excess of total security over the debt to the intermediary

WHT and B2B Arrangements

Example 2 – Secured Group Borrowing Facility



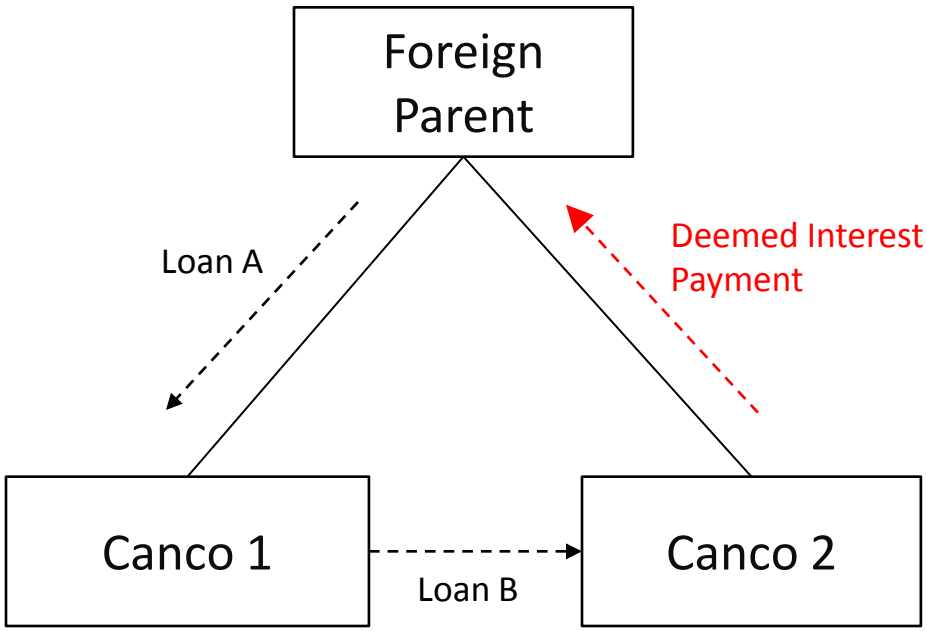
- Conditions in 212(3.1) likely met (see comments in Example 1 above)
- If each of Foreign Parent and Foreign Holding provided security for the full amount of the Bank loan, CanSub can choose to allocate the deemed interest entirely to Foreign Parent or Foreign Holdings (depending on applicable WHT rates)
- However, if the combined value of security is less than the Bank loan, no possibility to allocate favorably among Foreign Parent and Foreign Holding

WHT and B2B Arrangements

- Denied interest under thin cap rule is deemed paid to non-resident as dividend (s. 214(16)), so thin cap provisions should trump withholding tax rule
  - But rules not well integrated; potential cascading application

WHT and B2B Arrangements

Example 3 – Related Intermediary



- If Loan A is made "on the condition that " Loan B is made, the WHT rule will apply
- Potential for double tax
  - 212(3.2) would deem interest payment from Canco2 to Foreign Parent, with WHT resulting
  - But WHT would still be applicable on actual payment of interest by Canco1 to Foreign Parent
- Same result if Canco 1 is a US resident
  - treaty override?
  - potential application of proposed anti-treaty shopping measures

B2B Arrangements and Anti-Treaty Shopping Proposals

Anti-Treaty Shopping

- Initiative first announced in 2013 budget
- No draft legislation to date, but Budget 2014 contains a lengthy discussion on when and how the rule will apply
- Standard for application is a low threshold with no real safe harbors – creates commercial uncertainty in terms of tax flows
- It is just a framework at present, but it is contemplated that there will be a domestic rule
- No grandfathering provisions announced as of yet
- 60 days to respond to Finance (by April 12th) but likely no further movement until OECD BEPS recommendations arrive in September

Anti-Treaty Shopping

- Budget 2014 defines treaty shopping as:
  - “arrangements under which a person not entitled to the benefits of a particular tax treaty with Canada uses an entity that is a resident of a state with which Canada has concluded a tax treaty to obtain Canadian treaty benefits”

Anti-Treaty Shopping

- Main purpose provision
  - "…reasonable to conclude that one of the main purposes…was for the person to obtain the benefit"
- Conduit presumption
  - "…if the relevant treaty is primarily used to pay, distribute or otherwise transfer…an amount to another person…that would not have been entitled to an equivalent benefit…had the other person…received the…income directly"

Anti-Treaty Shopping

- Main purpose provision
  - "…reasonable to conclude that one of the main purposes…was for the person to obtain the benefit"
- Conduit presumption
  - "…if the relevant treaty is primarily used to pay, distribute or otherwise transfer…an amount to another person…that would not have been entitled to an equivalent benefit…had the other person…received the…income directly"

Anti-Treaty Shopping

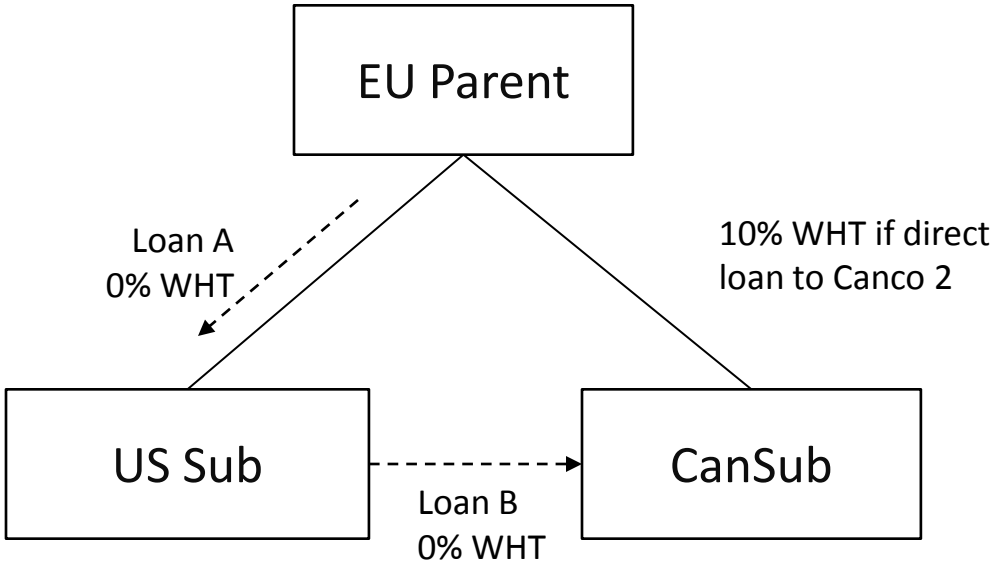
- Safe harbour presumption (subject to the conduit presumption):
  - "the person carries on an active business that is substantial compared to the Canadian business activity"
  - "the person is not controlled by another person that would not have been entitled to a benefit if the other person received the income directly"
  - "the person is regularly traded on a recognized stock exchange"
- Relieving provision
  - "if the main purpose test applies the benefit is still to be provided to the extent that it is reasonable under the circumstances"

Anti-Treaty Shopping

- The anti-treaty shopping proposals are in large part a response to court decisions where back-to-back arrangements withstood the challenge under the “beneficial ownership” test

Anti-Treaty Shopping

Example – Back-to-Back Interest



- The rate of Canadian WHT on interest is reduced from 10%/15% to 5% via a back-to-back arrangement (assuming US Sub qualifies as US treaty resident under LOB)
- If the new WHT rules are enacted, deemed interest payment by CanSub to EU Parent – 10% WHT
- If conduit presumption, it appears that 25% WHT would apply
- Could the relieving provision apply to allow the reduced 10% rate to apply?

B2B Financing Arrangements

- Concluding observations
  - Current proposals may impact a wide-range of customary bona fide financing arrangements and may result in significant additional financing costs
  - Current proposals on thin cap apply in respect of taxation years that begin after 2014, and WHT proposals to interest paid or credited after 2014
  - No grandfathering for existing financing arrangements that may be affected by the proposals
  - If the party providing security is US treaty resident, WHT will not apply, but thin cap may still be an issue
  - Treaty shopping proposals may further impact the effectiveness of existing financing arrangements; no grandfathering in proposals
  - Potential significant costs if restructuring of existing facilities is required

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