

# **Tips & Traps in a Cross Border Financing Context**

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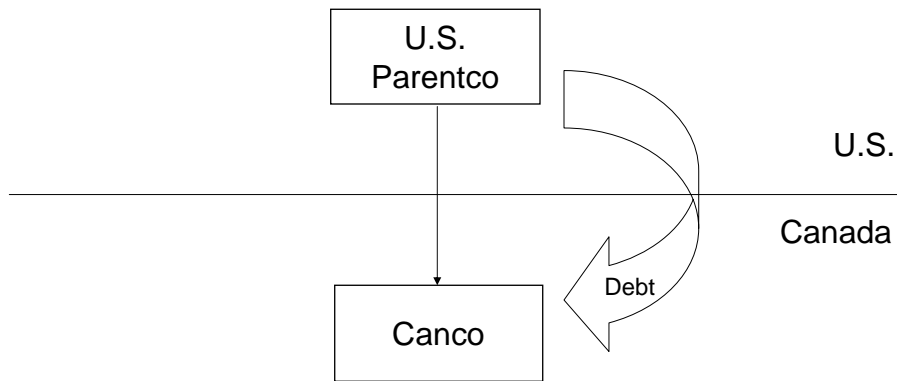
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## **Overview**

- **Debt Financing**
  - **Canadian & U.S. Perspectives**
  
- **Guarantee Fees**
  - **Canadian & U.S. Perspectives**

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## Debt Financing Canco (Sub) - Borrower



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## Debt Financing - Canco (Sub) Borrower Debt Denominated in CDN Currency

- Debt denominated in CDN dollars: No FX issues for Canco.
- U.S. Parentco may have exposure under its domestic rules.
  - IRC section 988(a):
    - Any foreign currency gain or loss attributable to a "section 988 transaction" is computed separately and treated as ordinary income or loss.
    - A "section 988 transaction" is defined to include the acquisition of a debt instrument or becoming an obligor under a debt instrument.

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**Debt Financing - Canco (Sub) Borrower  
Debt Denominated in CDN Currency  
U.S. Tax Implications**

- Regs. Section 1.988-2(b)(5):
  - Holder of a debt instrument generally realizes an exchange gain or loss with respect to the principal amount of the instrument on the date that the principal is received from the obligor ...
  - OR
  - ... there is a disposition of the instrument (including a deemed disposition arising as a result of a modification of the debt).

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**Debt Financing - Canco (Sub) Borrower  
Debt Denominated in CDN Currency  
U.S. Tax Implications**

- Principal amount of debt instrument = the holder's purchase price in units of non-functional currency.
  - Exchange gain or loss is calculated by translating the units of non-functional currency principal at the spot rate on the date payment is received or there is a disposition of the instrument and reducing such amount by translating the units of non-functional currency principal at the spot rate on the date the holder acquired the instrument.
- Generally, such exchange gain is not characterized as interest. Special rules are provided with respect to the translation of non-functional currency interest income or expense.

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## Debt Financing - Canco (Sub) Borrower Foreign Currency Denominated Debt

- *Imperial Oil and Inco* (SCC)
  - Decisions may imply no gain or loss when borrower repays the very thing borrowed (such as a foreign currency debt).
- 2006 CTF Conference: CRA “intends to continue with this interpretation of the law [i.e., ITA 39(2) gain / loss arising on repayment] while it studies the Supreme Court decisions and invites submissions.”
  - Note: Should CRA decide to change its administrative position: No certainty – re: grandfathering term.

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## Debt Financing - Canco (Sub) Borrower Commodity Based Loans / Exchangeable Debentures

- *Imperial Oil and Inco* (SCC)
  - Uncertainty regarding the application of ITA 20(1)(f) to losses – Re: commodity based loans and exchangeable debentures.
- 2006 CTF Conference: CRA confirmed that “commodity based loans and exchangeable debentures financings currently in place will still be eligible for the [sic] 20(1)(f)(ii) treatment” [Emphasis added].
  - Caution: statements made in *Imperial Oil and Inco* raise serious doubt as to the continued merit of CRA’s position on this issue.
  - What does “currently in place” mean? New financings clearly not protected.

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## Debt Financing - Canco (Sub) Borrower Thin Capitalization Rules

### Thin Cap Rules – ITA 18(4) to 18(6)

- **Related party debt only; to the extent that Canco's related debt-to-equity ratio is in excess of 2 to 1.**
  - Rules not applicable to arm's length debt even if owing to NRs.
  - Generally N/A to trust or partnership debt.
  - NIB debt not included in thin cap formula at all.
    - **Cliff effect:** But if the debt bears even a very low interest rate, it is included in formula.
  - No carry-forward of the disallowed interest.

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## Debt Financing - Canco (Sub) Borrower Thin Capitalization Rules

- "Specified shareholder" – ITA 18(5)
  - *Either alone or together with other NAL person owns shares of Canco that represent either:*
    - 25% or more of the votes of Canco, or
    - 25% of more of the value of Canco
- Deeming provisions
  - **Option Rule:** count and apply one holder at a time in determining deemed ownership.

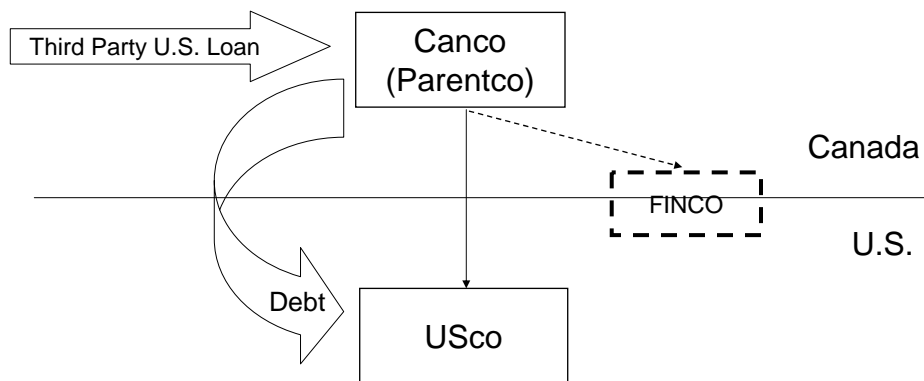
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## Debt Financing - Canco (Sub) Borrower U.S. Parentco as Guarantor

- Canco borrows from arm's length lender; debt guaranteed by U.S. Parentco.
  - **Guarantee Fee:**
    - Treated as "interest" for Canadian WHT purposes [ITA 214(15)(a)] - Not treated as "interest" for Part I of the ITA - therefore NOT subject to thin cap rules.
    - **Current Rules:** where interest on the debt is exempt from WHT [ITA 212(1)(b)(vii)], the related guarantee fee is also exempt from WHT.
  - **Definition of "interest" - Article XI(4) of the Treaty:** *Income assimilated to income from money lent.*
    - WHT rate currently reduced from 25% to 10% under Treaty.
  - **Guarantee fees no longer subject to Canadian WHT (following new Treaty's entry-into-force – re: NAL interest).**

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## Debt Financing USco (Sub) - Borrower



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## Debt Financing USco (Sub) Borrower The CDN Perspective - ITA Subsection 93(2)

### FINCO Structures (Capital to Finco; Loan to Opco)

- ITA 93(2) – Canco can offset a loss arising from the disposition of its shares of a FA with a FX gain arising in respect of an obligation issued or incurred to acquire the shares.
  - Rules can be problematic (e.g., tracing, different tiers).
- Alternative: Use non-interest bearing (“NIB”) USD loan; FX loss not reduced by any exempt dividends received on the shares.
  - Note: new interest disallowance rules will apply.
- If NIB loan to USco, U.S. imputed interest risk! [IRC § 7872-5]

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## Debt Financing USco (Sub) Borrower The U.S. Perspective - IRC Section 163(j)

### IRC Section 163(j) - Earnings-Stripping Rules:

- Limit a corporation’s interest expense deduction for interest paid to related persons exempt from U.S. tax.
- Apply only in those years during which there is excess interest (the excess of the corporation's net interest expense over 50% of its "adjusted taxable income") and the debt-to-equity ratio of the corporation exceeds 1.5.
- Note: numerous proposals have been made to extend the scope of the rules and expand their application further.
- Disallowed interest may be carried forward and treated as “disqualified interest” in succeeding years.
  - Disqualified interest: defined as interest paid or accrued by the taxpayer, either directly or indirectly, to a related person if the IRC does not impose an income tax on such interest.

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## Debt Financing USco (Sub) Borrower The U.S. Perspective - IRC Section 163(j)

- If a treaty between the U.S. and a foreign country reduces the rate of income tax imposed by the IRC on interest paid or accrued by the corporation, the interest is treated as interest on which no tax is imposed to the extent of the same proportion of such interest as the rate of tax imposed without regard to the treaty, reduced by the rate of tax imposed under the treaty, bears to the 30% WHT rate.
- During such time as the WHT rate on interest paid by USco to its CDN Parentco is 10%, two-thirds ( $\frac{2}{3}$ ) of the interest payable on such debt by USco will be treated for this purpose as "exempt."
  - At such time (as the WHT is eliminated), 100% of the interest payable on such loan will be treated as interest that is exempt from tax.

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## Debt Financing USco (Sub) Borrower [Canco Guarantor] The U.S. Perspective - IRC Section 163(j)

- U.S. earnings-stripping rules function like the CDN thin cap rules – Note, however, that the U.S. rules are much broader.
  - Rules apply not only to debt advanced to USco by a related foreign person, but also to any debt of USco that is guaranteed by a related foreign person even if the loan to USco is from an unrelated U.S. lender.
- Related Person Defined:
  - IRC Sections 267(b) and 707(b)(1) - Such definition includes two corporations that are members of the same controlled group; USco would be treated as a related person to Canco.

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**Debt Financing  
USco (Sub) Borrower [Canco Guarantor]  
The U.S. Perspective - IRC Section 163(j)**

**"Disqualified interest"**

- Includes interest paid or accrued on a loan from an unrelated party that is subject to a "disqualified guarantee" made by a related foreign person if there is no "gross-basis" U.S. income tax imposed on the interest.
- A "gross-basis" tax is a U.S. income tax imposed without regard to deductions, such as the 30% gross WHT imposed on interest paid to a foreign person that is not effectively-connected with a U.S. trade or business.
- The legislative history clarifies that, to the extent that a treaty reduces the general 30% gross WHT, a ratable portion of the interest paid is treated as though it were not subject to a "gross-basis" income tax.

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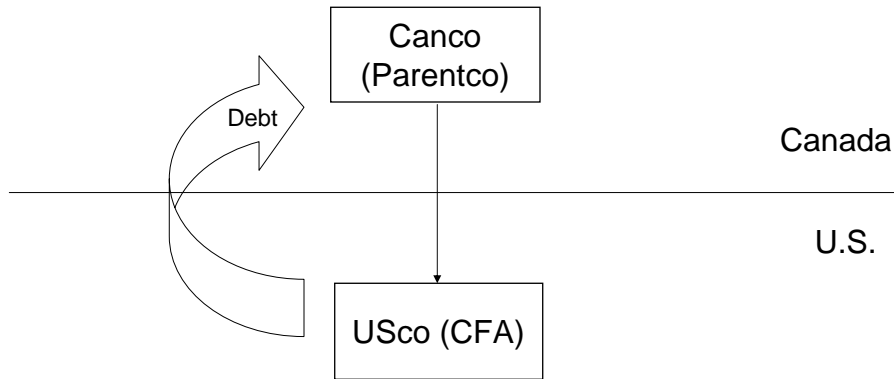
**Debt Financing  
USco (Sub) Borrower [Canco Guarantor]  
The U.S. Perspective - IRC Section 163(j)**

**"Disqualified Guarantee"**

- Does not include a guarantee if the taxpayer owns a "controlling interest" in the guarantor, defined as the direct and indirect ownership of at least 80% of the votes and value of a corporation determined by application of prescribed constructive stock ownership rules.
  - Accordingly, a guarantee by a subsidiary would not be treated as a "disqualified guarantee."
- Impact of the Rules:
  - Existence of the guarantee could severely limit the amount of deductible interest expense available for U.S. tax purposes.

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## Debt Financing Canco (Parentco) - Borrower



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## Debt Financing Canco (Parentco) Borrower - FX Issues

- Loan by CFA (USco) to Canco in U.S. dollars:
  - Passive asset - FAPI Loan by definition.
- If the CDN dollar depreciates relative to the US dollar:
  - Canco realizes a capital loss on the repayment
  - USco must use CDN currency in computing gain – ITA 95(2)(f.1)
  - One half of the capital gain realized by USco included in Canco's ordinary income under ITA 91(1)
- Note: No offset available for the capital loss realized by Canco.

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## Debt Financing Canco (Parentco) Borrower - FX Issues

- If the CDN dollar appreciates relative to the US dollar:
  - Canco realizes a capital gain on repayment (½ taxable)
  - USco realizes a capital loss; FAPL
  - No offset available for capital loss realized by USco in respect of the borrowing – FAPLs are not levitated
- Result: Whipsawed!
- Loan to Canco in CDN Currency
  - No Whipsaw [under Canadian Rules]
  - Note: Loan must be payable on demand to avoid gain on repayment (cost limited to FMV – less than face value if not demand)

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## Guarantee Fees Canco (Parentco) - Guarantor of U.S. Sub Debt The U.S. Perspective

- At one point, the IRS characterized a guarantee fee as consideration for the performance of services - Priv. Ltr. Rul. 78-22-005 (March 5, 1978).
  - Under such characterization, the fee would be sourced by reference to that place where the services were performed.
- The IRS no longer characterizes a guarantee fee as such.
- In *Bank of America v. United States*, 680 F2d 142 (Cl. Ct. 1982), the court analogized letter of credit acceptances and confirmation commissions received by a domestic bank from foreign banks as payments for the bank's credit and thus, for sourcing purposes, more analogous to payments of interest on loans. See also, Priv. Ltr. Rul. 81-10-142 (Dec. 12, 1980).
  - Note that in contrast to personal services income, interest payments are sourced by reference to the residence of the obligor.

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## Guarantee Fees Canco (Parentco) - Guarantor of U.S. Sub Debt The U.S. Perspective

- For treaty purposes, guarantee fees are classified as "Other Income."
  - See FSA 2001-47-033 (Aug. 14, 2001), citing *Centel Communications Co. v. Commissioner*, 92 TC 612 (1989), *aff'd* 920 F2d 1335 (7th Cir. 1990).
- Article XXII of the Treaty does not afford any relief to a CDN taxpayer if the source is viewed as U.S. - therefore, 30% WHT.
- It is anticipated that the global dealing regulations (to be re-proposed) will address the sourcing and pricing of guarantee fees.

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## Guarantee Fees Canco (Parentco) - Guarantor of U.S. Sub Debt Canadian Transfer Pricing Concerns

- Per CRA: ITA 247(2) would apply where Canco guarantees the debts of a U.S. subsidiary without charging a guarantee fee – For tax years prior to 1997, former subsection 69(3) would apply.
- Canco deemed to receive a guarantee fee (at FMV) for its guarantee of USco's debt.
  - Subject to proposed subsection 247(7.1) which exempts a guarantee made by a Canadian resident (pursuant to an agreement in writing) of a loan to a CFA, the proceeds of which are used by the CFA in an active business activity.
- Caution: Must be debt, not a performance guarantee.

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## Guarantee Fees

### Canco (Parentco) - Guarantor of U.S. Sub Debt Considerations Relating to Quantum

- Possible to minimize or maximize fee charged:
  - **Minimize:** Limit third party's recourse to the Canadian guarantor until after it has exhausted its remedies against USco (especially if the U.S. subsidiary has significant assets) – Could function to reduce the fee significantly.
  - **Maximize:** Terms of guarantee could facilitate primary recourse to Canadian parent.

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## Guarantee Fees

### Canco (Parentco) - Guarantor of U.S. Sub Debt The U.S. Perspective

*Seminal Thriftway, Inc. v. U.S.*, 99-1 USTC ¶ 50,155 (Cl. Cm. Dec. 21, 1998)

- The Claims Court denied a deduction for the payment of a guarantee fee to the shareholder guarantors, treating the fee as a constructive dividend.
- In so doing, the court assigned substantial weight to the fact that the shareholder had failed to impose the fee at the time of the guarantee.
- The court also considered as relevant criteria whether a guarantee was "customary" in a particular industry and whether a fee was "necessary" to induce the shareholders to act as guarantors. See, also, *Tulia Feedlot, Inc. v. U.S.*, 513 F2d 800 (5th Cir. 1975).
- If the implication of these cases is that an explicit guarantee is a constructive dividend, query whether the IRS can logically impute a guarantee fee to a shareholder who fails to charge one under circumstances similar to those in the referenced cases.

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## Guarantees

### U.S. Sub - Guarantor of Canco (Parentco)'s Debt Canadian Benefit Issues

- Per CRA: ITA subsection 15(1) (rather than subsection 247(2)) applied to impute a benefit to Canco.
  - As ITA 247(2) would not apply in this scenario, an amount would not be deemed to have been paid or credited by the CDN parent (i.e., no deduction and no amount paid) for the purposes of ITA 214(15)(a) and accordingly, there would be no WHT.

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## Guarantees

### Canco (Sub) - Guarantor of U.S. Parentco's Debt The U.S. Perspective - IRC Section 956(d)

- IRC section 956
  - 10% or greater U.S. shareholders of a controlled corporation ("CFC") are taxed on their pro rata share of a CFC's investment of earnings in "U.S. property". Effectively, the CFC is treated as having repatriated such earnings.
  - U.S. property is defined to include obligations of a U.S. person, subject to an exception for debt of certain unrelated persons.
- IRC section 956(d)
  - CFC is considered as holding an obligation of a U.S. person if such CFC is a pledgor or guarantor of such obligation.
  - If the assets of a CFC serve at any time (directly or indirectly) as security for the performance of an obligation of a U.S. person, the CFC will be treated as a pledgor or guarantor of the obligation.

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## Guarantees

### Canco (Sub) - Guarantor of U.S. Parentco's Debt The U.S. Perspective - IRC Section 956(d)

- An indirect pledge of stock is treated as an indirect pledge of the CFC's assets if:
  - at least 66 $\frac{2}{3}$ % of the total combined voting power of all classes of stock entitled to vote are pledged;
  - and
  - the pledge is accompanied by one or more negative covenants that effectively restrict the corporation's discretion with respect to the disposition of assets and the incurrence of liabilities other than in the ordinary course of business.

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## Guarantees

### Canco (Sub) - Guarantor of U.S. Parentco's Debt The U.S. Perspective - IRC Section 956(d)

- Tip: Where the third party lender requires a pledge of 66 $\frac{2}{3}$ % or more of the equity of the CDN subsidiary, consideration may be given to recapitalizing the CDN subsidiary with voting and non-voting stock, and pledging more than 66 $\frac{2}{3}$ % of the equity, but less than 66 $\frac{2}{3}$ % of the voting stock of a subsidiary.
- Trap: A pledge by a CFC of any shares of a lower-tier CFC is treated as a direct pledge by the CFC of its assets, and therefore subject to IRC section 956.

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## **Guarantees**

### **Canco (Sub) - Guarantor of U.S. Parentco's Debt The U.S. Perspective - IRC Section 956(d)**

- Where a pledge or a guarantee by the CDN subsidiary results in the application of IRC section 956, a deemed paid FTC calculated under IRC section 902 may be available to U.S. Parentco, subject to the FTC limitation provisions of IRC section 904.
- The implications of IRC section 956 are significant!
  - Special issues regarding multiple pledges and guarantees can exacerbate the problem.
  - In order to avoid the application of IRC section 956 in the context of cross-collateralization, consideration should be given to separate loan facilities for U.S. Parentco and its CDN and other foreign subsidiaries.

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