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International tax alert

New proposed legislation on cross-border financing and foreign affiliate dumping

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The February 11, 2014 Canadian federal budget contained two proposals relating to inbound investment into Canada: an anti-treaty shopping rule and amendments to the thin capitalization and withholding tax rules with respect to debt owed to an intermediary that is backed by loans or certain asset pledges (that may be characterized as the economic equivalent of loans) of non-arm's length non-residents. Both proposals were the subject of extensive consultations.

On August 29, 2014, the Department of Finance released draft legislation to implement the back-to-back financing proposals and numerous other budget measures and to revise its August 16, 2013 draft amendments to the foreign affiliate dumping rules. However, the Department announced that after consultations on the proposed anti-treaty shopping rule, the government "will instead await further work" by the Organisation for Economic Co-operation and Development and G-20 in relation to their base erosion and profit shifting (BEPS) initiative. BEPS proposals are scheduled to be released on September 16, 2014. It is unclear whether the government has decided to shelve its domestic law proposals or merely to fine tune them once the BEPS proposals are further advanced (even though there was little to no support for a domestic law approach in the BEPS draft report on the treaty abuse action item).

Back-to-back arrangements

Currently, the thin capitalization rules do not apply to a loan to a taxpayer from an arm's-length lender (intermediary) except in limited circumstances where such a loan is made because a non-arm's-length non-resident made a loan to the intermediary on condition that the intermediary make a loan to the taxpayer (back-to-back loans). Interest paid to an arm's length lender is generally exempt from withholding tax even where a back-to-back loan is deemed to exist for purposes of the thin capitalization provisions. The budget contained proposals to expand the scope of the existing back-to-back loan rule in the thin capitalization rules and to add a similar rule to the non-resident withholding tax rules.

The expansion was larger than initially appeared obvious in the budget explanation. The budget proposed that the back-to-back loan rule would generally apply where a taxpayer has a debt owing to an intermediary in circumstances where the intermediary has received a loan from a non-resident person on condition that it make a loan to the taxpayer (the existing rule), the intermediary is indebted to a non-resident person under a limited recourse debt or the intermediary has been pledged a property by a non-resident person as security for the debt. In such cases, the debt would be treated as owing to the non-resident person for purposes of the thin

capitalization rules and interest may be treated as having been paid to such person for purposes of the withholding tax rules.

The budget measures, particularly their application to situations where assets are pledged, were excessively broad. It is standard practice for third party lenders to require that assets of related persons within a corporate or commercial group be pledged as security. In certain cases, the property in question is actually the shares of the Canadian debtor since this makes it easier for the lender to enforce its rights as creditor to the Canadian entity. Even a Canadian multinational could be subject to the proposed rules in respect of its borrowings from a third party lender to the extent that the assets of its foreign subsidiaries have been pledged to secure the borrowing.

The new proposals are more restrictive in one respect. They expand the existing conditional loan rule to apply to a loan made by the intermediary that is dependent on loans received by the intermediary (rather than vice versa) and to circumstances where it is reasonable to conclude that the loan would not have been made to the taxpayer (or the terms and conditions of the loan would not have been the same) if the intermediary was not provided the support of the non-resident(s), whether through a loan or the provision of a specified right, as described below.

However, the proposed rules with respect to the provision of security to an intermediary by a non-resident have been significantly narrowed. Under the new draft legislation, the provision of security will only invoke the back-to-back rules to the extent the intermediary has the right to “use, mortgage, hypothecate, assign, pledge or in any way encumber, invest, sell or otherwise dispose of, or in any way alienate, the property” (defined as a specified right).

Because the nature of a specified right is such that the intermediary could obtain financing on the security of the property or dispose of the property, the explanatory notes accompanying the draft legislation characterize this as the economic equivalent of a loan but provide that the mere provision of a security interest in a property of a non-resident will not constitute a specified right (presumably on the basis that absent default on the debt by the taxpayer, the intermediary cannot encumber or dispose of the property).

In addition, the existence of the specified right must be required under the terms and conditions of the debt, or it must be reasonable to conclude that in the absence of the specified right, the debt would not be outstanding or would contain different terms and conditions.

Finally, a new de minimis rule proposes to prevent the application of the back-to-back rules if the amount of support provided by the non-resident(s) for the borrowing through a back-to-back loan or the granting of a specified right is generally less than 25% of the total of the taxpayer’s borrowing. For example, if the taxpayer has borrowed $100 million from the intermediary and the intermediary has received a loan and/or specified right from the taxpayer’s non-resident parent company in an amount of less than $25 million, the back-to-back rules will not apply. The de minimis rule also takes into account circumstances in which the taxpayer and the intermediary are parties to a credit facility involving multiple related borrowers. If the support provided by the parent, for example, is less than 25% of the total of the taxpayer’s debt and debts of the other non-arm’s length borrowers under the facility, the rules will not apply.

These changes to the rules should significantly alleviate the concerns of taxpayers with respect to many common borrowing arrangements, at least in circumstances where the taxpayer is not in default.

A number of technical changes have also been made to the proposed rules. It is now clear that if interest is not deductible as a result of the application of the back-to-back rule in the thin capitalization provisions, the rule which deems such interest to be a dividend and subject to dividend withholding tax will take precedence over the back-to-back rule which would have levied withholding tax at the rate applicable to interest. Thus, where the non-resident is a US person, the back-to-back loan rule in the withholding tax context should have no practical effect (provided the person is a qualifying person under the Limitation on Benefits Article in the Canada-US Treaty) except to the extent interest is deemed to be a dividend as a result of the application of the thin capitalization rules. Interest paid to US treaty residents is generally exempt from withholding tax; unlike dividends.

The thin capitalization rules are also proposed to be amended to exclude from the back-to-back rules debt owing to non-arm's-length Canadian residents. This change should eliminate the long-standing need for administrative relief in respect of funds loaned to a Canadian holding company, for example, where those funds are on-lent to a Canadian operating company with which it does not deal at arm's length. If the thin capitalization rules applied to the operating company, in many cases the operating company would not have sufficient equity for purposes of the thin capitalization rules, and a portion of the interest would be disallowed.

While the focus of the consultations has been on third-party financing, the expanded wording in the proposed rules makes it more likely that the back-to-back rules may apply to loans received from related intermediaries (other than non-arm's length Canadian residents). For example, a non-resident parent company may make a loan to a non-resident subsidiary which makes a loan to a Canadian subsidiary. Assume that the withholding tax rate on interest is lower under the treaty between Canada and the country of residence of the intermediary than it is between Canada and the country of residence of the parent company. In this case, the thin capitalization rules would apply in respect of the loan received from the intermediary and the arrangement would not be recharacterized under the back-to-back rules for thin capitalization purposes; however, the back-to-back rules may apply, depending on the terms of the arrangement, to deem the taxpayer to make the interest payments on the loan from the intermediary to the non-resident parent company, and subject the payments to a higher rate of withholding tax. The extended wording of the provision no longer restricts its application to circumstances in which the loan from the parent to the intermediary was made "on condition" that the intermediary make a loan to the Canadian subsidiary.

The proposed changes to the thin capitalization rules are applicable to taxation years that begin after 2014 and the proposed changes to the withholding tax rules are applicable to amounts paid or credited after 2014.

Foreign affiliate dumping

The foreign affiliate dumping rules became law in 2012, effective generally for investments in foreign affiliates made after March 28, 2012. A package of technical amendments to the rules was released for consultation on August 16, 2013. The August 29, 2014 legislation contains revised proposals in response to those consultations. These proposals are quite technical in nature and generally reflect either further refinements to the scope of the rules or new approaches to dealing with certain aspects of the rules.

The foreign affiliate dumping rules generally apply to an investment in a foreign affiliate made by a corporation resident in Canada (referred to as a CRIC) that is or

becomes controlled by a non-resident corporation (referred to as the Parent). The general rule subjects the investment to withholding tax on the basis that it is deemed to be a dividend paid by the CRIC to the Parent, although in some circumstances the dividend can be deemed to have been paid by a related Canadian company (a qualifying substitute corporation or QSC) or the paid-up capital (PUC) of the shares of the CRIC or the QSC can be reduced in lieu of the deemed dividend.

Some of the changes to the proposed legislation include:

- Amendments to clarify whether a deemed dividend arises and the timing of the deemed dividend, particularly in circumstances where the CRIC becomes or ceases to be controlled by a non-resident person over a period of time that includes the investment in the foreign affiliate by the CRIC;
- Substantial revisions to the rules that allow the PUC reduction to occur in lieu of the deemed dividend, including a new anti-avoidance rule to deal with the potential inappropriate enhancement of PUC through the use of holding companies, and the clarification of filing requirements;
- Revisions to the rules that allow the PUC to be reinstated in certain cases upon the unwinding of the investment in the foreign affiliate;
- Revisions to the rules relating to the reorganization of foreign affiliate investments.

In particular, taxpayers should be aware that the PUC reduction in lieu of a deemed dividend is once again, effectively, an elective rather than an automatic provision. The legislation in this respect has changed several times as have the substantive rules. The August 16, 2013 legislation proposed the filing of a prescribed form with the Canada Revenue Agency (CRA), detailing how the reduction of PUC was to be applied, but there were no stated consequences to not filing the form or filing it late, and no form has ever been issued by the CRA. The legislation now specifies that there will be a deemed dividend if the form is not filed on time. However, a mechanism is provided to refund any tax paid if the form is filed late and written application is made to the Minister of National Revenue. Election forms will be deemed to be filed on time if filed within 30 days of this legislation receiving Royal Assent.

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