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PRACTITIONERS' CORNER

Canada Unveils Significant Amendments to Thin Cap Regime

by Michael Friedman and Andrew Stirling

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Canada has enacted a detailed set of statutory provisions, commonly referred to as the thin capitalization rules, that restrict the deductibility of interest payments made to certain connected, nonresident lenders. On March 29, 2012, the Canadian federal government unveiled its annual budget in which it announced that the Canadian thin cap rules would be further tightened to protect the Canadian fiscal base and to more closely align the Canadian rules with those found in other jurisdictions.

Overview

Canada's thin cap rules are in subsections 18(4) to (6) of the Income Tax Act (Canada). The thin cap rules generally prohibit a Canadian resident corporation from deducting interest expenses in respect of the portion of its ''outstanding debts to specified nonresidents'' that exceeds two times the corporation's nonconsolidated retained earnings plus equity contributed by, or attributed to shares owned by, ''specified nonresident shareholders.'' Interest deductions denied under the thin cap rules are permanently disallowed and may not be carried forward to reduce income earned in subsequent tax years.

The thin cap rules were designed to protect the Canadian fiscal base by discouraging the capitalization of Canadian resident corporations with interest-bearing debts from significant offshore shareholders, or persons who do not deal at arm's length with such shareholders, in a manner that would otherwise permit an undue proportion of the corporations' profits to escape full Canadian taxation.

The thin cap rules generally apply only when a Canadian resident corporation owes interest-bearing obligations to a specified nonresident shareholder of the corporation or a nonresident person who does not deal at arm's length with a ''specified shareholder'' of the corporation (collectively, specified nonresidents).[1]

In 2000 the government amended the thin cap rules by reducing the applicable debt-to-equity ratio from 3 to 1 to 2 to 1. At the time of the amendments, the government also indicated an intention to continue to consult with stakeholders on further refinements to the thin cap rules.

In December 2008 the Advisory Panel on Canada's System of International Taxation, a panel of experts mandated by the government to recommend ways to improve the competitiveness, efficiency, and fairness of Canada's international tax system, made recommendations to the government regarding the thin cap rules.[2] The advisory panel recommended that:

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[1]A ''specified non-resident shareholder'' of a corporation is defined to include a ''specified shareholder'' of the corporation who is, at that time, a nonresident person. A specified shareholder of a corporation generally captures a person who either alone, or together with persons with whom the person does not deal at arm's length, owns shares representing 25 percent or more of the votes attached to, or the fair market value of, the issued and outstanding shares of the corporation.

[2]The advisory panel's final report is available at http://www.apcsit-gcrcfi.ca/07/cp-dc/pdf/finalReport_eng.pdf.

- the operative debt-to-equity ratio under the thin cap rules be reduced from 2 to 1 to 1.5 to 1; and
- the application of the thin cap rules be expanded to capture debtors constituted as partnerships, trusts, and Canadian branches of nonresident corporations.

The advisory panel also observed that even when an interest deduction was disallowed under the thin cap rules, some withholding tax advantages still accrued to the Canadian resident corporate debtor by virtue of the payments continuing to be characterized as interest for nonresident withholding tax purposes. For instance, since the enactment of the fifth protocol to the Canada-U.S. tax treaty, conventional interest payments made by a Canadian resident debtor to a related U.S. resident lender may typically be made free of Canadian withholding tax. By contrast, if the amounts were paid to the nonresident as a dividend, Canadian withholding tax would generally be levied at a rate of at least 5 percent. Canada also generally no longer assesses withholding tax on conventional interest payments made to nonresident lenders that operate at arm's length to the payer corporation, regardless of the residency of the nonresident lender.

Budget 2012: Thin Cap Proposals

Budget 2012 proposes a number of substantive amendments to the thin cap rules, including:

- the reduction of the operative debt-to-equity ratio from 2 to 1 to 1.5 to 1;
- extending the application of the thin cap rules to debts of partnerships of which a Canadian resident corporation is a member;
- deeming interest expenses disallowed under the thin cap rules to be dividends for nonresident withholding tax purposes; and
- enacting certain relieving rules that will prevent double taxation from arising in certain circumstances where a Canadian resident corporation borrows money from a controlled foreign affiliate of the corporation.

Debt-to-Equity Ratio Reduction

Studies conducted by the advisory panel, and thereafter confirmed by the government, have suggested that:

- average debt-to-equity ratios in most industries in the Canadian economy are lower than the 2-1 debt-to-equity ratio inherent in the current thin cap rules; and
- the debt-to-equity ratio upon which the thin cap rules are based is high relative to comparable global standards.

Accordingly, Budget 2012 proposes to reduce the operative debt-to-equity ratio under the thin cap rules from 2 to 1 to 1.5 to 1.

The application of a debt-to-equity ratio as the functional limit on the use of some cross-border debt financing has the virtue of providing a relatively certain and readily ascertainable capitalization restriction.[3] However, the trade-off for such administrative simplicity is the unequal effect that a reduction in the debt-to-equity ratio may have across different industries. Although the advisory panel and the government found that most industries in the Canadian economy operate at lower debt-to-equity ratios than 1.5 to 1, some other industries, or particular corporations within industries, may have higher debt capacity or valid nontax business reasons for exceeding this ratio.

The reduction in the applicable ratio will apply to corporate tax years that begin after 2012. As a consequence, corporate groups that have debt obligations to which the thin cap rules would apply should begin analyzing their affairs to make any necessary capitalization adjustments in advance of the tax years of any Canadian corporations in the group that begin on or after January 1, 2013.

Expansion of Thin Cap Rules to Partnerships

The application of the thin cap rules to partnerships has long been a source of debate and uncertainty. Historically, the Canada Revenue Agency had said that the thin cap rules did not apply to the computation of the income of a partnership and that the agency would not automatically look through a partnership to its corporate members when applying the thin cap rules. However, some doubt was cast over the CRA's position by virtue of a provincial tax decision rendered in Ontario in *Wildenburg Holdings Ltd.*[4] In response to *Wildenburg*, the CRA appeared to reaffirm its commitment to its past administrative position by saying that ''if there is a bona fide partnership and the partners are jointly and severally liable for the partnership debts, the [CRA] will view the partnership as the debtor.''[5] Nevertheless, the CRA's comments generated uncertainty regarding the application of the thin cap rules to some partnerships, including limited partnerships (that is, partnerships in which partners are not jointly and severally liable for the debts of the partnership by virtue of the operative limited partnership statute). In fact, an advance income tax ruling released by the CRA in 2005 indicated that the CRA could seek to apply the general

[3]The advisory panel compared the thin cap rules with the approaches adopted by various other countries, including the ''earnings stripping'' model adopted by the U.S., Denmark, France, Germany, and Italy, and the transfer pricing model adopted by the United Kingdom and, to some extent, Australia and Japan.

[4]*Wildenburg Holdings Ltd. v. Ontario (Minister of Revenue)*, (1998) 98 DTC 6462 (Ont. Gen. Div.), *aff'd* (2001) DTC 5145 (Ont. C.A.).

[5]Canada Revenue Agency, *Income Tax Technical News 16* (Mar. 8, 1999), *available at* http://www.cra-arc.gc.ca/E/pub/tp/itnews-16/itnews-16-e.html.

antiavoidance rule in the ITA when a limited partnership was interposed in a corporate structure to preclude the application of the thin cap rules.[6]

Budget 2012 acknowledged that the thin cap rules do not expressly reference interest expenses incurred by partnerships. As a consequence, Budget 2012 proposes to extend the application of the thin cap rules to capture debts owed by partnerships of which a Canadian resident corporation is a member. Under the new proposals, to determine a corporation's debt-to-equity ratio, debt obligations of a partnership of which a corporation is a member will generally be allocated to the corporate member based on its proportionate share of the partnership's total income or loss for the relevant fiscal period of the partnership. When a corporate partner's permitted debt-to-equity ratio under the thin cap rules is exceeded, an amount equal to the interest on the portion of the partnership's debt to specified nonresidents that is allocated to the corporate partner and that exceeds the permitted debt-to-equity ratio will be required to be included in the corporation's income.

Budget 2012 presented the following example to illustrate how the thin cap rules are intended to apply to partnerships:

> Canco 1 and Canco 2 are Canadian resident corporations and are equal partners in a partnership that earns income from a business. Canco 1 is wholly owned by Forco, a non-resident corporation. The Canco 1 shares owned by Forco have paid-up capital of $4,000 but Canco 1 has no other capital for the purposes of the thin capitalization rules. Forco lends $3,000 to the partnership and lends $8,500 directly to Canco 1.
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> Canco 1 has a 50 per cent interest in the partnership and will therefore be allocated 50 per cent of the partnership loan ($1,500) for thin capitalization purposes. Canco 1 has capital of $4,000 and is considered to have outstanding debts to a specified non-resident (Forco) of $10,000 ($8,500 debt owed by Canco 1 to Forco plus $1,500 in debt allocated from the partnership).
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> With a permitted debt-to-equity ratio of 1.5-to-1, Canco 1 has $4,000 of total excess debt — that is, ($10,000 - 1.5 x $4,000)/10,000, or 2/5, of $10,000. This 2/5 ratio is applied to interest on the debt owed directly to Forco by Canco 1 as well as the debt allocated from the partnership to determine how much interest is denied, or added back to income, respectively. Accordingly, 2/5 of the interest deduction in respect of the $8,500 direct loan from Forco will be denied and an amount equal to 2/5 of the deductible interest expense in respect of the $1,500 debt allocated from the partnership will be required to be included in computing the income of Canco 1 from the partnership's business.

The government did not outline any de minimis rule in Budget 2012 that would otherwise limit the proposed application of the thin cap rules to partnerships. Accordingly, as currently proposed, partners could be subject to the thin cap rules even though they have no influence or control over the financing of the partnership and regardless of their percentage interest in the partnership.

The expansion of the thin cap rules to capture partnerships will apply to debts of a partnership that are outstanding at any time during the tax year of a corporation that begins on or after March 29, 2012. Accordingly, corporate groups that include Canadian resident corporations that are members of partnerships should examine the thin capitalization implications of such holdings before the start of the Canadian corporations' next tax year.

Disallowed Interest Expenses Treated as Dividends

Consistent with the recommendations of the advisory panel, Budget 2012 proposes to deem interest expenses disallowed under the thin cap rules to be dividends for the purposes of the nonresident withholding tax levied under Part XIII of the ITA.[7] Under the proposals, disallowed interest expenses of a corporation for a tax year will be allocated among specified nonresident lenders in proportion to the corporation's debt owing in the tax year to all specified nonresidents.

While straightforward at a high level, the application of the new deeming rule will be operationally complex. The calculations associated with the application of the thin cap rules are required to be made after the end of the relevant corporation's tax year. However, Budget 2012 proposes that specific interest payments made during a particular tax year may be recharacterized as dividends under the new proposals. (As a relieving measure, it is proposed that a corporation be permitted to designate, on or before the corporation's filing due date for the tax year, which interest payments made to a particular specified nonresident in the tax year will be recharacterized as dividends.)

When a particular interest expense, deduction of which has been disallowed under the thin cap rules, has not been paid by the end of the relevant tax year, the disallowed interest expense will be deemed to have been paid as a dividend by the corporation at the end of the particular tax year.

Generally, withholding tax on a dividend (including a deemed dividend) paid to a nonresident is required to

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[6]CRA, Ruling 2005-0123631R3 (Nov. 9, 2005).

[7]Disallowed interest expenses that may be recharacterized as dividends will include any amounts required to be included in the income of a Canadian corporation by virtue of the thin cap rules applying to a partnership of which the corporation is a member.

be remitted to the CRA within 15 days following the month in which the dividend is paid or deemed to have been paid. As a result, it is conceivable that some taxpayers may not become aware that some interest payments have been recharacterized as dividends, subject to nonresident withholding tax, until well after the applicable remittance deadline.

A special apportionment rule will apply to interest expenses, which are recharacterized as dividends, that arise during tax years that include the day of Budget 2012 (that is, March 29).

Whether the recharacterization of disallowed interest expenses as dividends under the proposed amendments to the thin cap rules will result in a higher rate of withholding tax will depend on the individual circumstances of the nonresident lender. For example, U.S. resident lenders eligible to claim the benefits afforded by the Canada-U.S. tax treaty may generally receive conventional interest payments free of Canadian withholding tax but will be subject to a 5 percent (or more) withholding tax if the payments are recharacterized as dividends. Conversely, non-arm's-length lenders eligible to claim the benefits afforded by the Canada-Netherlands tax treaty or the Canada-Luxembourg tax treaty are generally subject to a 10 percent withholding tax on conventional interest payments but may be eligible for withholding tax rates as low as 5 percent on dividends.

The proposed deemed dividend rules will apply to tax years that end on or after March 29. Accordingly, on the assumption that the Budget 2012 proposals will be enacted as proposed, the deemed dividend rule is now in effect. Canadian corporate taxpayers should therefore consider taking immediate steps to establish procedures:

- for determining whether particular interest payments may subsequently be recharacterized as dividends, subject to nonresident withholding tax; and
- to determine, within 15 days following the end of each tax year, whether any accrued interest expense will be deemed to have been paid as a dividend as of the end of the tax year for Canadian withholding tax purposes.

Foreign Affiliate Loans

The thin cap rules can apply to loans received by a Canadian resident corporation from a controlled foreign affiliate. However, special taxation rules apply to the passive income earned by controlled foreign affiliates, which can give rise to required inclusions in the income of Canadian resident shareholders for tax purposes. The combined application of such rules with the thin cap rules can trigger double taxation in some circumstances.

Budget 2012 proposes ameliorative amendments to the ITA that would reduce the incidence of such double taxation. These measures will apply to tax years of Canadian resident corporations that end on or after March 29, 2012. The proposed transitional provisions do not, however, provide relief for any double taxation that occurred in prior tax years.

Conclusion

Budget 2012 proposes material amendments to the existing thin capitalization regime in Canada. Corporate groups should immediately review the capitalization structures of their Canadian corporate members, partnership holdings, and withholding tax management protocols to reduce the possibility that the statutory changes will give rise to unanticipated tax, penalty, and interest liabilities.

Interestingly, Budget 2012 made several express references to recommendations made by the advisory panel that were not acted on. The fact that some of the advisory panel's recommendations were referenced, but not implemented, suggests that the government may have considered, and consciously declined to implement, some proposed changes to expand the scope of the thin cap rules even further. Among the more significant omissions was the decision not to expand the thin cap rules to trusts and branches of nonresident corporations. It also appears that the government heeded the advisory panel's recommendation not to expand the thin cap rules to cover third-party debts and debts guaranteed by related nonresident entities. Although the government did not expressly disavow any plans to expand the thin cap rules to cover those circumstances, it appears that such further structural amendments are not imminent. ◆