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International tax alert

International measures in federal budget, including expansion of “back-to-back” rules

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On March 22, 2016, the Minister of Finance, Bill Morneau, introduced the first budget of the new Liberal government. We refer you to our **March 22 alert** which summarizes all of the tax measures contained in the budget.

The budget contained limited measures with respect to international tax, including a modest response to the Organisation for Co-operation and Development’s base erosion and profit shifting (BEPS) project. However, certain budget measures that are proposed to be effective next year are particularly important since they will require foreign parents of Canadian subsidiaries to examine the cross-border arrangements for financing and licensing property to those subsidiaries. In addition, new shareholder loan rules that are proposed to be effective immediately require an examination of the use of the excess cash of those subsidiaries through arrangements like cash pooling as well as the security provided by those subsidiaries to third party lenders in respect of group finance arrangements. These “back-to-back” measures are discussed below.

Response to BEPS proposals

The government outlined its intentions with respect to the OECD’s BEPS project. An **alert** from our Transfer Pricing group discusses the introduction of country-by-country reporting and the government’s view of the OECD’s revised Transfer Pricing Guidelines.

With respect to other BEPS proposals, the government response was limited. The government will adopt the minimum standards recommended in the Action 6 report. In particular, to address treaty shopping, tax treaties should include either a principal purpose test or a limitation on benefits rule. This will be achieved through bilateral treaty negotiations or the proposed multilateral instrument that is currently being negotiated by a working group of which Canada is a member. There was no mention of the prior government’s proposals to introduce a domestic anti-treaty shopping rule, which had been placed on hold pending the outcome of the BEPS initiative, although it is possible this proposal could reappear if no agreement can be reached on a multilateral instrument. Note, however, that the budget proposals to greatly expand the existing “back-to-back” rules are effectively anti-treaty shopping rules. These proposals are discussed below.

The budget announced that Canada will also adopt the minimum standard for the exchange of certain tax rulings. The Canada Revenue Agency subsequently announced that such exchanges would begin as of April 1, 2016. A revised Information Circular with further details will be released soon.

No other BEPS proposals (other than country-by-country reporting) were specifically mentioned, including the proposals concerning interest deductibility, controlled foreign corporations and hybrid arrangements. The budget documents stated that “the government is continuing to examine the recommendations pertaining to the other aspects of BEPS”.

Back-to-back proposals

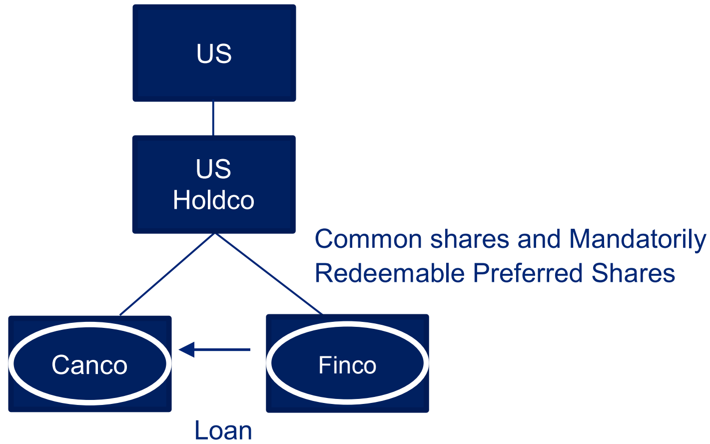
Expansion of existing back-to-back loan rules

The existing back-to-back loan rules address loans to or debts owing by a Canadian taxpayer where the creditor is an “intermediary”, and the intermediary is itself indebted to a “non-resident” or has been provided with certain “specified property” by a non-resident because it entered into the arrangement with the Canadian taxpayer. If the rules apply, the Canadian taxpayer may be deemed to be indebted to the non-resident for purposes of the thin capitalization rules, and may be deemed to have paid interest to the non-resident in circumstances where the withholding tax rate in respect of interest paid to the non-resident is higher than the rate applicable to interest paid to the Intermediary.

The withholding tax rules are proposed to be expanded in a number of respects:

- They will also apply to rents and royalties (royalties) where there is sufficient connection between each “leg” of the transaction:
    - the amount paid by the intermediary to the non-resident is computed by reference to the royalty paid to the intermediary or the value or financial performance of the property that is the subject of the royalty, or
    - one leg of the transaction would not, generally, have been entered into or permitted to remain in effect without the other. The fact that both legs of the transaction are in respect of the same property, however, will not generally be sufficient on its own to cause this test to have been satisfied.
- They will be extended to arrangements where the legal nature of the payments is not the same, such as an interest payment made to the intermediary and a royalty paid to the non-resident, or vice versa. **The proposed rule may also apply where interest or a royalty is paid to the intermediary and the intermediary has been funded by equity issued to the non-resident rather than debt or a license.** This may be the case if the intermediary has an obligation to pay dividends or the shares are redeemable or cancellable. Perhaps the objective is to target arrangements in which the equity return is deductible since that may effectively avoid material taxation in the intermediate foreign jurisdiction.
- The application of the rules in the context of multiple intermediaries will be clarified. It is proposed that the rules will deem a payment from the taxpayer to the ultimate non-resident recipient in such cases.

No draft legislation was released with the budget, and the proposals are stated to be generally applicable to payments made after 2016. That should provide time for comment once the legislation is available, and for the restructuring of certain arrangements. For example, consider the following arrangement:



In this example, interest paid by Canco to Lux Finco is subject to a 10% withholding tax under the Canada-Luxembourg tax treaty. In addition, given the existence of the preferred shares of Lux Finco, the proposed rules may deem Canco to have paid interest to US Holdco. Under the terms of Article IV(7)(b) of the Canada-US tax treaty, such an interest payment would be disregarded and thus US Holdco would not be eligible for treaty benefits in respect of the payment. An additional 15% withholding tax would be required in respect of the deemed interest payment, resulting in a total withholding tax rate of 25%, the maximum rate provided for under Canadian domestic law.

Prior to 2017, all inbound finance and royalty structures should be examined to determine whether the back-to-back rules may apply, and whether a higher withholding rate would apply if the interest or royalty payment made by the taxpayer were made to the ultimate non-resident recipient of the back-to-back payments or arrangements.

Extension of the back-to-back rules to shareholder loans

In situations where a Canadian corporation makes a loan or a non-resident shareholder becomes indebted to a Canadian corporation, the amount of the loan or debt may become a deemed dividend to the shareholder, subject to withholding tax. In addition, where insufficient interest is charged, a deemed dividend may arise in respect of a shareholder benefit.

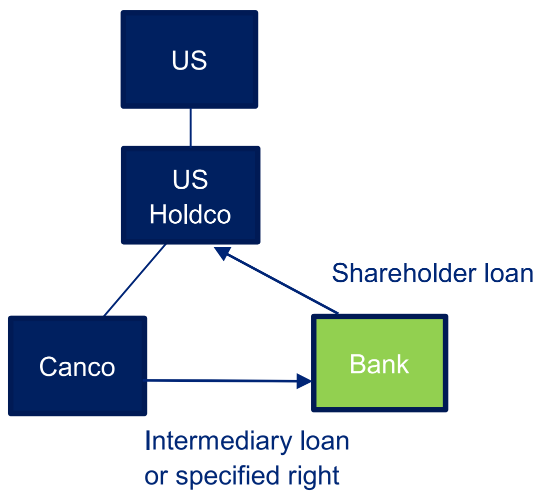
The rules apply quite broadly to debts owed by certain persons connected to shareholders. The budget proposes to extend the rules further to debts owed by a person who is not connected to the shareholder (an intermediary) where, generally,

- The intermediary is owed an amount by the shareholder or connected person (the shareholder debt);
- The intermediary owes an amount to the Canadian resident corporation (the intermediary debt) and either recourse in respect of the intermediary debt is limited to amounts recovered on the shareholder debt or the shareholder debt became owing or remained owing because the intermediary debt was or was anticipated to be entered into; or
- The intermediary has a “specified right” in respect of property granted by the Canadian corporation.

If the rules apply, the shareholder will be deemed to be indebted to the Canadian company in an amount equal to the lesser of the amount of the shareholder debt and the amount of the intermediary debt plus the fair market value of the property subject to the specified right.

In contrast to the financing and licensing proposals described above, the proposed changes in respect of outbound debt are stated to apply to arrangements that exist on March 22, 2016, with the deemed debt considered to have become owing as of that date. No deemed dividend of the amount of the debt arises under the shareholder loan rules in subsection 15(2) if the debt is repaid by the end of the next taxation year after the taxation year of the creditor in which the debt arose. The clock will have started ticking in respect of many loans and debts as of budget date but there is still time to restructure.

In the example, below, Canco has advanced funds to a bank (the intermediary) which has advanced funds to US Holdco. This may have occurred under a cash pooling arrangement, for example, where Canco is a lender into the cash pool and related non-residents are borrowers. Alternatively, Canco has provided security to the intermediary in respect of the US Holdco loan, and such security meets the definition of "specified right". If the rules apply, Canco may be deemed to have made a loan to US Holdco, which may result in a deemed dividend to US Holdco.



No draft legislation has been released, but the budget notes that the current definition of specified right, which applies for the thin capitalization and back-to-back loan rules, will apply to these provisions. The specified right definition was initially very broad, and would have applied to most security provided under group financing arrangements. However, it was ultimately limited to situations where, in very general terms, property is provided to the intermediary that can be dealt with by the intermediary as its own, such as funds placed on deposit with the intermediary. **Nevertheless, all group financing arrangements should be reviewed to ensure that cash pooling arrangements and security provided by Canadian subsidiaries in respect of group debt do not cause a deemed dividend to arise under these proposals.**

PUC planning

The budget proposes to amend the cross-border anti-surplus stripping rules to prevent the application of an exception to those rules where non-resident taxpayers seek to increase the paid-up capital (PUC) of shares of Canadian subsidiaries through certain acquisition and reorganization transactions. PUC can be returned tax-free to non-resident shareholders. The context in which the exception has been relied on applies in situations where there is a “sandwich” structure, namely a Canadian corporation owns shares of a non-resident corporation that owns shares of a Canadian corporation, and the exception is used to unwind the structure without triggering withholding tax. In the government’s view, the exception has been misused in order to obtain an artificial increase in the PUC of Canadian companies. A number of such cases have been challenged under the general anti-avoidance rule, and those challenges will continue for pre-budget transactions. The proposed rules appear to be too broad in a number of circumstances and will no doubt be the subject of consultations.

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