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2014 budget includes inbound financing and anti-treaty shopping measures

Contacts

Janice Russell
jarussel@deloitte.ca

Sandra Slaats
sslaats@deloitte.ca

Charles Taylor
charlestaylor@deloitte.ca

Mark Dumalski
mdumalski@deloitte.ca

Canada's 2014 federal budget, tabled in the House of Commons on 11 February 2014, contains two proposals that will have a significant impact on inbound investment into the country: (1) a proposed anti-treaty shopping rule, and (2) proposed amendments to the thin capitalization and withholding tax rules with respect to third-party financing backed by loans or asset pledges of non-arm's length nonresidents.

Inbound financing: Back-to-back arrangements

The thin capitalization rules currently do not apply to a loan from an arm's length nonresident lender (third party) except in limited circumstances where such a loan is made because a non-arm's length nonresident made a loan to the third party. Interest paid to third parties generally is exempt from withholding tax even where a back-to-back loan is deemed to exist for purposes of the thin capitalization provisions. The budget contains proposals to expand the scope of the existing back-to-back loan rule in the thin capitalization rules and to add such a rule to the nonresident withholding tax rules. The breadth of the expansion may be larger than initially appears obvious in the budget explanation. The rules are proposed to be effective for taxation years beginning after 2014 in the case of the thin capitalization rules and in respect of interest paid or credited after 2014 for nonresident withholding tax.

The proposed back-to-back loan rule generally will apply where a taxpayer has a debt owing to an intermediary, the intermediary has been pledged a property by a nonresident person as security for the debt, is indebted to a nonresident person under a limited recourse debt or has received a loan from a nonresident person on condition that it make a loan to the taxpayer. In such cases, the debt may be treated as owing to the nonresident 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. One can see situations in which this is a logical extension of the back-to-back loan provisions to other situations in which there is an effective intermediation by a third party which formally avoids the thin capitalizations provisions as currently enacted. The same logic may reasonably be applied to interest payments that would have been subject to withholding tax if paid directly to a foreign shareholder.

However, the proposed measures, particularly their application to situations where assets are pledged, appear to be excessively broad. It is common for third party lenders to require that assets of related persons be pledged as security. In certain cases, the property in question actually is 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 technically be subject to the proposed rules in respect of its borrowings from a nonresident lender to the extent it has pledged the assets of its foreign affiliates to secure the borrowing.

We understand that the Department of Finance is aware of these issues and we hope that the scope of the proposals will be significantly reduced before they come into effect. The Department has clearly acknowledged that guarantees without security should be carved out of the new rules. If the impact of the foreign credit enhancement merely reduces financing charges to the consolidated group, it may be logical to extend the carve-out.

The proposed withholding tax provisions also are broad enough to apply to loans from non-arm's length lenders where similar back-to-back arrangements are considered to exist and could cause the interest to be deemed to be paid to a nonresident person that is subject to a higher rate of withholding tax than the direct lender.

Anti-treaty shopping

The anti-treaty shopping proposal is designed to target "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 tax benefits." While no draft legislation has been released, it is clear that the views of the Department of Finance have solidified since it released the initial consultation paper on treaty shopping on 12 August 2013. The government has requested comments on the new proposals within 60 days. The OECD is expected to release a report with respect to treaty shopping in September 2014 and, while the budget indicates that those recommendations "will be relevant in developing a Canadian approach to treaty shopping," the government did not accept many recommendations received in response to the 12 August 2013 consultation paper to defer the release of proposals until after the OECD's report.

Overview of the proposed rule: The budget proposes a broad purpose test that is limited by supporting rules that are somewhat similar to those used in the limitation on benefits (LOB) articles of US tax treaties. The approach encompasses four main elements: a general "one of the main purposes" test, a conduit presumption, a safe harbor presumption and a relieving provision.

The limitation on treaty shopping is proposed to be effected through an amendment to the Income Tax Conventions Interpretation Act, rather than through the renegotiation of Canada's tax treaties. The rule would apply to tax years commencing after its enactment. The government is requesting input from stakeholders as to whether transitional relief for existing arrangements is appropriate.

Rejecting concerns expressed by stakeholders that such a domestic override may not be perceived favorably by Canada's treaty partners, the budget reiterates comments made in its August 2013 consultation paper that domestic law provisions are not considered by the OECD or the UN to be in conflict with existing treaty obligations where they are designed to prevent abuse. The budget states that “the absence of an anti-treaty shopping rule in a tax treaty does not mean that there is an implicit obligation to provide benefits in respect of abusive arrangements.” Finally, the budget reiterates concerns first expressed in the consultation paper that simply renegotiating a select number of treaties with “conduit” countries, would not prevent the emergence of other conduit countries.

While it may be likely that arrangements that satisfy explicit anti-treaty shopping provisions of an existing tax treaty (in particular, the LOB article in the Canada-US treaty) will be less likely to offend the new provision, no general exemption was mentioned in the budget.

One of the main purposes test: The cornerstone of the new rule is that, “subject to the relieving provision (described in further detail below), a benefit would not be provided under a tax treaty to a person in respect of an amount of income, profit or gain (relevant treaty income) if it is reasonable to conclude that <u>one of the main purposes</u> for undertaking a transaction, or a transaction that is part of a series of transactions or events, that results in the benefit was for the person to obtain the benefit.” In short, this provision will grant or deny treaty benefits having regard to all the facts and circumstances surrounding a particular arrangement. The budget notes that a “main purpose” test is relatively familiar to Canadian taxpayers, since this language appears in numerous domestic tax provisions and certain existing treaties. In response to concerns raised by stakeholders in the course of the consultation process, the budget indicates that although a more specific, LOB-type approach arguably provides a greater level of certainty for both taxpayers and tax authorities, it cannot, in and of itself, prevent all forms of treaty shopping, and thus, a general approach should be more effective at preventing a greater variety of abusive arrangements.

The courts traditionally have interpreted “one of the main purposes” provisions as being subject to a relatively low threshold. The budget contains language assuring readers that this provision will not apply to “ordinary commercial transactions” solely because obtaining a tax treaty benefit was one of the considerations for making an investment in Canada. However, other than some illumination provided by examples included in the budget (discussed below), it is unclear what is within the scope of “ordinary commercial transactions.”

Conduit presumption: The second element of the proposed rule is a rebuttable presumption that the one of the main purposes test is applicable if the relevant treaty income is primarily used to pay, distribute or otherwise transfer, directly or indirectly, at any time or in any form, an amount to another person or persons that would not have been entitled to an equivalent or more favorable benefit had the other person or persons received the relevant treaty income directly. “At any time or in any form” suggests that transactions many years in the future could affect the treaty shopping analysis in a given year. How will taxpayers have reasonable certainty that the conduit presumption will not apply?

Safe harbor presumption: Subject to the conduit presumption, this element provides that, absent proof to the contrary, it will be assumed that none of the main purposes of a particular arrangement is the obtaining of a treaty benefit if any of the following three conditions is satisfied:

1) The person claiming treaty benefits (or a related person) carries on an active business (other than the management of investments) in the treaty country. Where the relevant treaty income is derived from a related person in Canada, the active business also must be substantial relative to the Canadian activity that gave rise to the treaty income for this condition

to be satisfied. This condition is similar to the active trade or business test contained in paragraph 3 of the Canada-US LOB article;

2) The person claiming treaty benefits is not controlled, directly or indirectly in any manner, by another person or persons who would not have been entitled, had the relevant treaty income been received directly, to benefits that are at least as favorable as those being sought by the direct recipient; or
3) The person is a corporation or a trust the shares or units of which are regularly traded on a recognized stock exchange. No guidance is provided as to the manner in which the phrase "regularly traded" would be defined for purposes of this domestic provision. Perhaps the Canada-US LOB test could be imported or referred to for this purpose.

The second condition appears not to be satisfied if any person in a control chain is located in a "bad" jurisdiction, even if all funds ultimately flow to residents of a jurisdiction who would be entitled to comparable benefits under their home country treaty with Canada.

Relieving provision: Even where the main purpose provision applies, a relieving provision would ensure that treaty benefits nevertheless will be provided in whole or in part to the extent they are reasonable having regard to all the circumstances. The inclusion of this fourth element in the rule is consistent with comments in the consultation paper, which suggested that the effectiveness of any measure designed to curb treaty shopping may involve a tightening of objective conditions and "placing greater reliance on discretionary authority of the Minister of National Revenue to grant treaty benefits in appropriate circumstances." It is unclear whether or not a taxpayer would be able to obtain relief under this provision after the fact, or would have to apply to the CRA in advance of a relevant transaction.

Examples: The examples included in the budget indicate that the government is focused on reversing the results of three court cases in which it unsuccessfully attacked treaty shopping, either on the basis of a lack of beneficial ownership or the application of the general anti-avoidance rule (GAAR).

Assignment of income: In the first example, the budget explains how the conduit presumption would be applicable in a fact pattern similar to those in the case of *Velcro Canada*. In short, the example involves a company (ACo) that is resident in a country with which Canada has not concluded a tax treaty, assigning its right to receive Canadian-source royalties to BCo, a company resident in a treaty jurisdiction. BCo must remit 80% of the royalty income to ACo within 30 days of receipt. The one of the main purposes test is presumed to apply due to the conduit presumption and treaty benefits would be denied in the absence of facts to rebut the presumption. It is suggested that the relieving provision could potentially apply in this type of situation, such that treaty benefits may be granted with respect to the 20% of the royalties retained by BCo. Furthermore, the budget indicates that if BCo were to retain 55% of the Canadian-source royalty income, the conduit presumption would not apply, presumably since less than 50% of BCo's income would be distributed to ACo. In that case, it would be a question of fact whether the one of the main purposes provision applied.

Dividend payments: The second example illustrates the application of the proposed rule in a situation similar to that considered in the case of *Prevost Car Inc.* In that case, two companies that were resident in the UK and Sweden, respectively, each chose to hold their shares in a Canadian subsidiary through a Dutch holding company, perhaps to take advantage of the rate of Canadian withholding tax on dividends under the Canada-Netherlands treaty, which was more favorable than the rates then available under the UK and Swedish treaties. In the example, the conduit presumption applies because the holding company remits all dividends received from Canada to the two shareholders pursuant to the terms of a shareholders' agreement. In assessing whether the relieving provision might apply in this situation, the budget indicates that one of the relevant considerations would be whether or not the shareholders are taxable on dividends received from the holding company. If so, treaty benefits may be available to the extent treaty benefits would have been available had dividends been paid directly to the shareholders.

It is not clear whether the lack of a shareholders' agreement would make any difference to the result. Neither is it clear why the domestic tax rules applicable in the shareholders' country of residence should be relevant in determining whether to provide treaty benefits at the rate applicable in Canada's treaties with those countries.

Change of residence: The third example is based on the case of *MIL (Investments) S.A.,* in which a corporation resident in a nontreaty country was continued into a treaty jurisdiction immediately prior to disposing of taxable Canadian property in order to avail itself of the exemption in the treaty from Canadian tax on capital gains. Although the proceeds of disposition are retained by the vender in this example, thus rendering the conduit presumption inapplicable, the budget indicates that the one of the main purposes provision would nevertheless apply, given that it is reasonable to conclude, having regard to all the facts and circumstances, that one of the main purposes for the continuation of the corporation is to obtain the treaty benefit. Had the vendor been a resident of the treaty jurisdiction at the time it acquired the property, the budget indicates that other relevant factors, including the amount of time between the establishment of the corporation and the disposition of the property, would need to be considered.

Bona fide investments: In the fourth example, the conduit presumption is again considered to apply where a widely held trust that is resident in a treaty jurisdiction (State B) manages investments for a large number of investors, the majority of which are resident in nontreaty countries. Shares of Canadian corporations represent 10% of the trust's portfolio, and the trust distributes all of its income (including Canadian-source dividends) to its investors on an annual basis. The investment decisions made by the management of the trust take into account the benefits provided by State B's extensive treaty network. Notwithstanding the application of the conduit presumption, none of the main purposes of the arrangement in this example are considered to be the obtaining of the treaty benefit, due to the fact that the investors' decisions to invest in the trust are not motivated by any particular investments made by the trust, and the trust's investment strategy is not driven by the tax position of its investors. Accordingly, treaty benefits with respect to the Canadian-source dividends are not denied.

Active business safe harbor: The final example illustrates the application of the safe harbor presumption in a situation where a corporation (ACo) resident in a nontreaty jurisdiction establishes a company (FinCo) in a treaty jurisdiction (B-State) to finance its various subsidiaries in numerous countries, including Canada. In this scenario, the conduit presumption does not apply with respect to Canadian-source interest income earned by the FinCo, due to the fact that the majority of FinCo's income is re-loaned to related companies resident in other treaty countries that have a similar rate of withholding tax applicable to interest as would be applicable if the Canadian borrower had paid interest to lenders in such countries. Because ACo also has an operating subsidiary (BCo) in the same jurisdiction as the FinCo, and because BCo carries on an active business (other than managing investments) in its jurisdiction of residence that is substantial relative to the activity carried on by the Canadian subsidiary in Canada, the safe harbor presumption applies such that, absent any proof to the contrary, the main purpose provision should not apply and treaty benefits should be available in respect of FinCo's Canadian-source interest income.

Note that the proposed rule would be more difficult to satisfy than the active trade or business provision in the Canada-US LOB article, if for example, FinCo was resident in the US, paragraph 3 of the LOB article, if satisfied, ensures that treaty benefits are available, subject to the GAAR. Unlike the proposed domestic rule, it is not subordinate to a conduit presumption, nor does it create a presumption that can itself be rebutted depending on the facts. The Department of Finance raised this issue in its consultation paper, and many interested parties recommended that a domestic anti-treaty shopping rule should not apply if a specific LOB rule applies. However, there is no mention of this issue in the budget documents.

Next steps: As noted above, there is a 60-day consultation period, which ends on 12 April 2014. The government has asked for comments in respect of transitional relief and the specific examples described above. Clearly, there are several other aspects of the proposed rule worthy of comment.

The rule will be difficult to apply with certainty and predictability, given the government's decision to adopt a general purpose test with a relatively low threshold for application. Although the proposed safe harbor provision provides guidance regarding the scope of the rule, it provides only a rebuttable presumption, and does not protect taxpayers if it can nevertheless be established that one of the main purposes for undertaking a transaction, or a transaction that is part of a series of transaction or events, that results in a treaty benefit was for the person to obtain the benefit. Moreover, the safe harbor provision is still subject to the conduit presumption—possibly rendering it even less useful. It also is unclear what factors should be considered in applying the relieving provision, and whether or not taxpayers can apply the relieving provision on a self-assessment basis.

Although the rule is merely proposed and it is likely too soon to understand fully the impact on existing arrangements, it is reasonable to expect that Canada will adopt an anti-treaty shopping rule in the short term that may not be materially different from that proposed. As such taxpayers should start to consider its potential impacts on existing and future arrangements. The following sets out some, but certainly not all, of the things taxpayers may wish to consider now:

- Transitional relief may or may not be available. Consequently, taxpayers should review their existing corporate structures to identify where the rule could be relevant and the potential financial impact. Collective investment vehicles, including private equity and hedge funds, as well as multinational corporations holding or financing their Canadian operations through third country intermediaries, may be particularly affected. The proposed rule also could affect the activities of Canadian taxpayers that raise capital for, sponsor or manage investment funds or other arrangements for nonresidents. Consider as well Canadian institutional investors that co-invest with nonresidents directly or indirectly in Canadian entities.

- The proposed rule is a relevant tax due diligence and pricing consideration for any proposed transaction involving a Canadian investment.

- Tax directors and others may wish to proactively consider the impact the rule could have from a tax accounting perspective and communicate that within their organizations.
- The proposed rule may influence the timing for nonresidents to dispose of their Canadian investments.
- There are a number of important practical considerations, such as how best to document the facts around each transaction and series of transactions that results in a treaty benefit to clearly demonstrate that one of the main purposes was not to obtain the benefit. The proposed rule is yet another example of the importance of determining what constitutes a series of transactions or events.
- The conduit presumption looks to payments, distributions and other transfers, including indirect transfers, of the relevant treaty income at any time or in any form. In some cases the flow of income will be obvious but in other cases, perhaps those involving holding or financing companies with multiple investments, tracing may be required to objectively establish that the conduit presumption does not apply.
