
CORPORATE TAX PLANNING

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THE CORPORATE CAPITAL STRUCTURE: THIN CAPITALIZATION AND THE “RECHARACTERIZATION” RULES IN PARAGRAPHS 247(2)(b) AND (d)

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Most Canadian corporations and their shareholders choose an appropriate capital structure on the basis of a number of factors, including tax. Shareholders of a taxable corporation often prefer external and internal intragroup debt. Assuming that the capital structure of a corporation includes internal debt rather than equity, the authors consider the circumstances under which Canada’s transfer-pricing recharacterization rules might permit the recharacterization of interest when the corporation is otherwise compliant with Canada’s thin capitalization rules.

The authors address the history of paragraphs 247(2)(b) and (d) of the Income Tax Act, the applicable interpretive approach, the views of the Canada Revenue Agency (CRA), and the potential interaction between the thin capitalization rules and the recharacterization rules. As a result of an appropriately purposive interpretation of the thin capitalization rules and the relieving nature of Canada’s tax treaties, the types of situations that the CRA would find most concerning are more appropriately dealt with by means of the general anti-avoidance rule than by recharacterizing a taxpayer’s debt as equity. The recharacterization rules require an analysis of whether the transaction or series giving rise to the taxpayer’s debt can reasonably be considered not to have been entered into primarily for bona fide purposes, other than to obtain the interest deduction.

The analysis of the relevant factors in a non-arm’s-length context is by no means straightforward. Some caution is called for before recharacterizing the taxpayer’s debt as equity under Canada’s transfer-pricing rules, and the CRA has exercised such caution

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in the past. There are a number of cases before the Tax Court that raise the application of paragraphs 247(2)(b) and (d), and it will be interesting to see how the court addresses these rules.

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