

IFA Canada – YIN Webinar

Expansion of the Back-to-Back Rules

Presenters

Andrew Spiro

Blake, Cassels & Graydon LLP, Toronto

Ilia Korkh

EY Law LLP, Vancouver

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Agenda

Intro

Background & Issues

Perceived Abuse

Enacted Measures: Thin Cap and Part XIII

Proposed Measures: Expansion of Part XIII

Proposed Measures: Shareholder Loans

Background and Issues

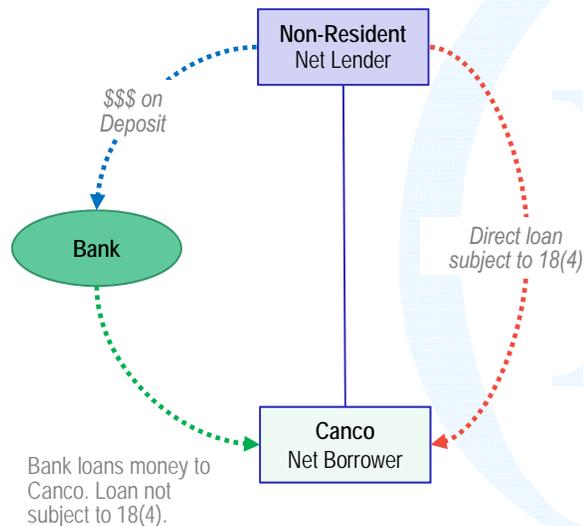
- ▶ Thin capitalization rules in s.18(4) are intended to prevent the erosion of the Canadian tax base by limiting the deductibility of interest on debts owing by corporations, trusts, and partnerships to certain specified non-resident persons where the debt exceeds a 1.5 to 1 debt-to-equity ratio.
- ▶ The shareholder loan rules in s.15(2) are intended inter alia to prevent avoidance of dividend withholding tax (“WHT”) to non-arm’s length (“NAL”) non-residents on repatriation of Canadian-sourced profits.
- ▶ Part XIII generally imposes WHT on interest and “rents, royalties and similar payments” paid by a Canadian resident to non-residents, subject to a broad exception for NAL payments in the case of interest.
- ▶ The Department of Finance has become concerned that certain financing structures may inappropriately circumvent these rules.

Legislative Measures

- ▶ 2014 Federal Budget introduced so called “back to back” (“B2B”) measures to curtail perceived abuses in the thin capitalisation and Part XIII interest WHT contexts. These measures were implemented later that year.
- ▶ 2016 Federal Budget introduced additional measures that would apply the B2B framework to shareholder loans and WHT on rents, royalties and similar payments. In addition, the existing B2B measures in Part XIII were proposed to be expanded to capture a number of perceived deficiencies.
- ▶ On 29 July 2016, the Department of Finance released for public comment a package of draft legislative proposals and explanatory notes relating to the Budget 2016 including the expanded B2B measures.

Perceived Abuse Thin Capitalization

Secured Loan Example



Thin Capitalisation Rules

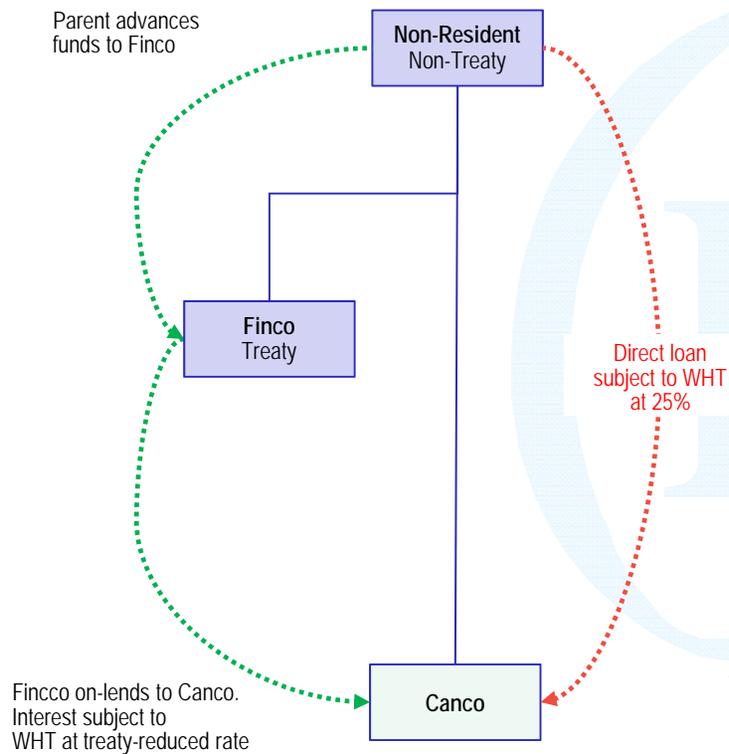
- ▶ Generally, s.18(4) applies where a Canadian resident corporation has *outstanding debts to specified non-residents*. (Analogous rules apply to trusts and non-resident corporations with branches in Canada.)
- ▶ *Outstanding debts to specified non-residents* are debts owing to a *specified non-resident shareholder* or a non-resident person NAL with a *specified shareholder*.
- ▶ *Specified non-resident shareholder* is a *specified shareholder* who is non-resident. *Specified shareholder* is a person who, either alone or together with NAL persons, owns 25% or more of the votes or value of the Canadian debtor.
- ▶ If the total *outstanding debts to specified non-residents* exceeds a 1.5-to-1 debt-to-equity ratio, the excess interest deduction will be permanently disallowed and treated as a dividend distribution to the non-resident, subject to Canadian WHT.

Perceived Abuse

- ▶ The non-resident may place money or property on deposit with a bank.
- ▶ Bank makes a loan to Canco. The loan is not subject to s.18(4) as it is from an arm's length financial institution.

Perceived Abuse Reduction of WHT

Treaty Shopping Example



WHT on NAL Interest

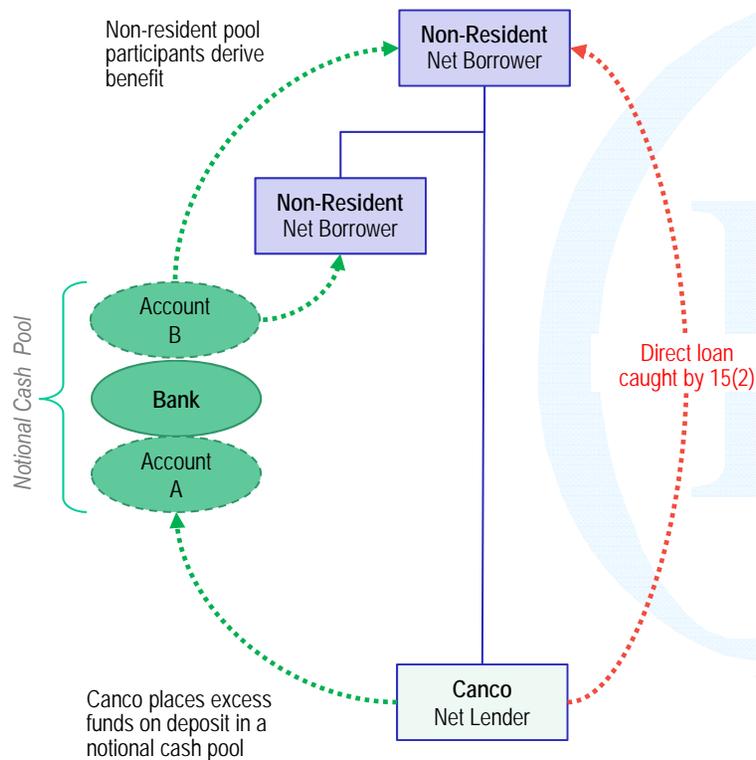
- ▶ Generally speaking s.212(1) imposes WHT of 25% on any amount paid or credited by a Canadian taxpayer account to a related non-resident as on account or in lieu of payment of, or in satisfaction of, interest.
- ▶ Where the lender is eligible for benefits under an income tax treaty, the WHT rate is reduced to 15%/10%/0%.

Perceived Abuse

- ▶ Directing inbound financing through a Finco located in a favourable treaty jurisdiction would allow a non-resident lender located in a non-treaty country (or a lender not eligible for benefits under a treaty) to reduce the Canadian WHT rate.

Perceived Abuse Shareholder Loans

Notional Cash-pool Example Shareholder Loan Rules



- ▶ Generally, s.15(2) and s.214(3)(a) apply to deem a loan made by a Canadian corporation to a non-resident shareholder or a non-resident person or partnership connected with the shareholder to instead be a dividend paid to such borrower.

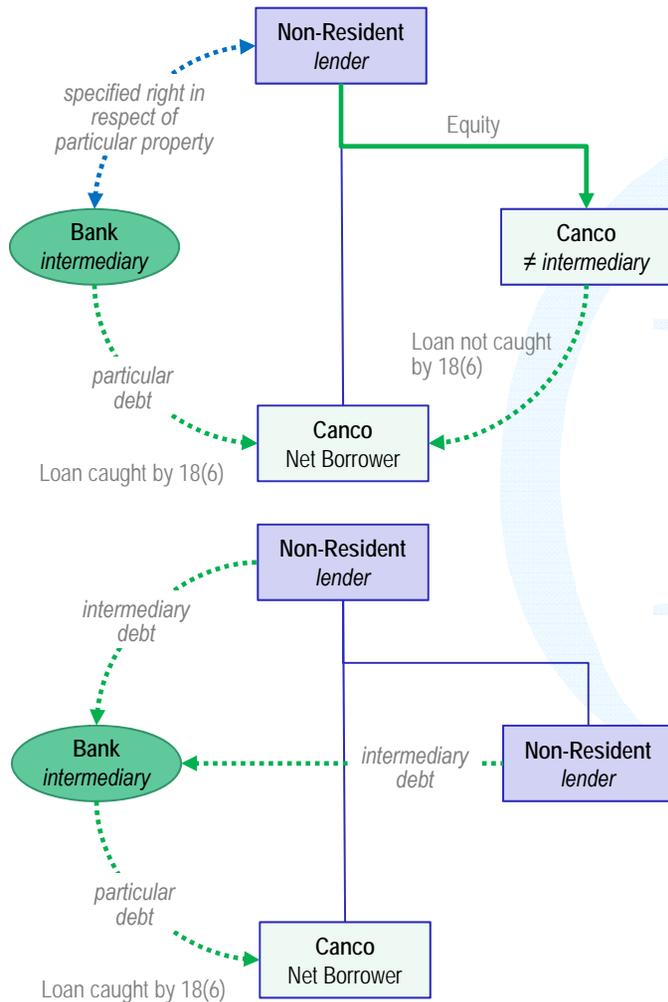
Perceived Abuse

- ▶ Notional cash pooling is a mechanism whereby the participants maintain separate bank accounts with a financial institution, but the interest on the combined debit and credit balances in each of the accounts is calculated based on the consolidated balance of all the participants, including both positive and overdraft positions.
- ▶ Under a physical or "zero sweep" pooling, the transfers of cash among participant accounts create a *debtor-creditor* relationship among the participants, giving rise to intercompany loans for tax purposes.
- ▶ No transfer of funds among the accounts takes place in a notional cash pool, but each pool participant is able to take advantage of a single, centralised liquidity position - often a reduced interest rate, since the interest otherwise payable on the overdraft accounts is reduced through the notional use of funds from other participants' accounts.
- ▶ In the example, Canco, in a net lender position places excess funds on deposit in Account A. This allows related non-residents to access credit positions (often at improved rate of interest) in Account B. Subsection 15(2) does not generally apply, because notional cash pools should not give rise to any intercompany balances among the participants and the indebtedness that arises in a notional cash pool take place between Canco and the bank (an arm's length entity).
- ▶ Notional cash pooling could also be used to avoid thin capitalisation rules.

Enacted Measures

- ▶ 2014 Federal Budget proposed to extend the thin capitalization rules and expand the withholding tax rules in s.18 and s.212 to capture B2B loans (and similar arrangements) made to a Canadian resident by a relevant non-resident person through an “intermediary.”
- ▶ Department of Finance released draft technical bill in connection with these measures in August 2014, and following some updates resulting from the consultation process, Bill C-43 (2014, c.39) introduced amended s.18(6) and 18(6.1) and new s.212(3.1)-(3.3).
- ▶ Bill C-43 (2014, c.39) received royal assent on December 6, 2014.
- ▶ Although the Part XIII measures (s.212(3.1)-(3.3)) are currently proposed to be amended, the B2B rules in the context of thin capitalization as set out in s.18(6) and 18(6.1) as well as the 2014 version of the B2B WHT rules are in force.

Enacted Measures Thin Capitalization

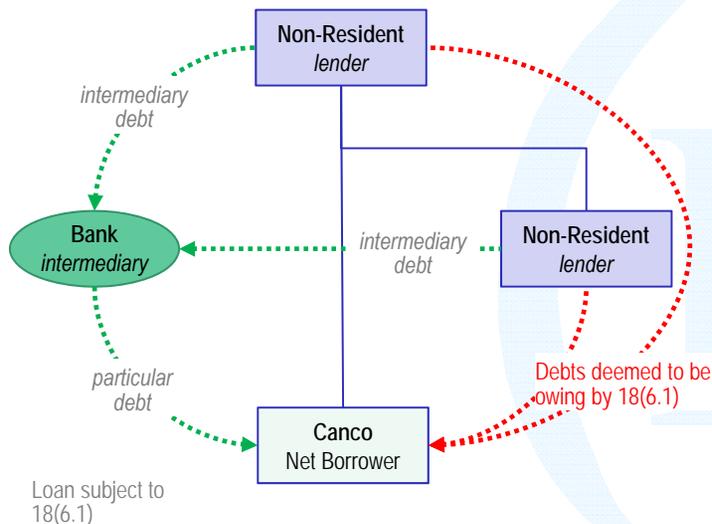


Application Rule: s.18(6)

The B2B rules in s.18(6.1) apply where:

- ▶ (a): taxpayer has a *particular debt* owing to a person (the *intermediary*).
- ▶ (b): the *intermediary* is not a NAL person resident in Canada and is not a person a debt to whom is otherwise already subject to s.18(4). This precludes double taxation in inbound multi-Canco financing.
- ▶ (c): the *intermediary* or someone NAL with the *intermediary* :
 - ▶ (i) has a debt owing to a person who is a *specified non-resident* for purposes of s.18(4) (the *lender*) that meets any of the following conditions (the *intermediary debt*):
 - ▶ (A) recourse in respect of the *intermediary debt* is limited to the *particular debt*.
 - ▶ (B) it can reasonably be concluded that a portion of the *particular debt* became owing or remained owing because (I) all or a portion of the *intermediary debt* arose or remained owing, or (II) the *intermediary* anticipated the above to happen.
 - ▶ (ii) has a *specified right* in respect of a *particular property* that was granted directly or indirectly by the *lender* and the existence of which was required by the terms and conditions of the *particular debt*, or it could be reasonably concluded that all or a portion of the *particular debt* arose because of the *specified right* was granted or was expected to be granted.
- ▶ (d) the *intermediary debt* or FMV of *particular property* is at least 25% of the total of:
 - ▶ (i) the *particular debt* and
 - ▶ (ii) the total of all other debts of the taxpayer and NAL persons to the *intermediary* under the same or connected agreement as the *particular debt* in certain cross-collateralized arrangements.
- ▶ The causal connection test in s.18(6)(c) should be interpreted broadly (2015-0581531C6).
- ▶ Notably, unlike the new rules, s.18(6) seems to be limited to single-tier B2B structures.

Enacted Measures Thin Capitalization



- ▶ *Specified right* is defined in s.18(5) as a right at that time to, use, mortgage, hypothecate, assign, pledge or in any way encumber, invest, sell or otherwise dispose of, the property, unless it is established by the taxpayer that all of the proceeds that would be received, from exercising the right must first be applied to reduce the obligation or certain other cross-collateralized obligations. Thus, the *intermediary* will generally not have a *specified right* solely by virtue of having a security interest in property securing the Canadian debt (except possibly in the case of cash collateral).
- ▶ Cash on deposit may be a property in respect of which the *intermediary* has a *specified right*. Alternatively, CRA has stated in 2015-0614241C6 that deposit positions of non-resident participants in a notional cash pool should be considered *intermediary debts* for the purposes of s.18(6) and s.212(3.1).

Consequences of Application: s.18(6.1)

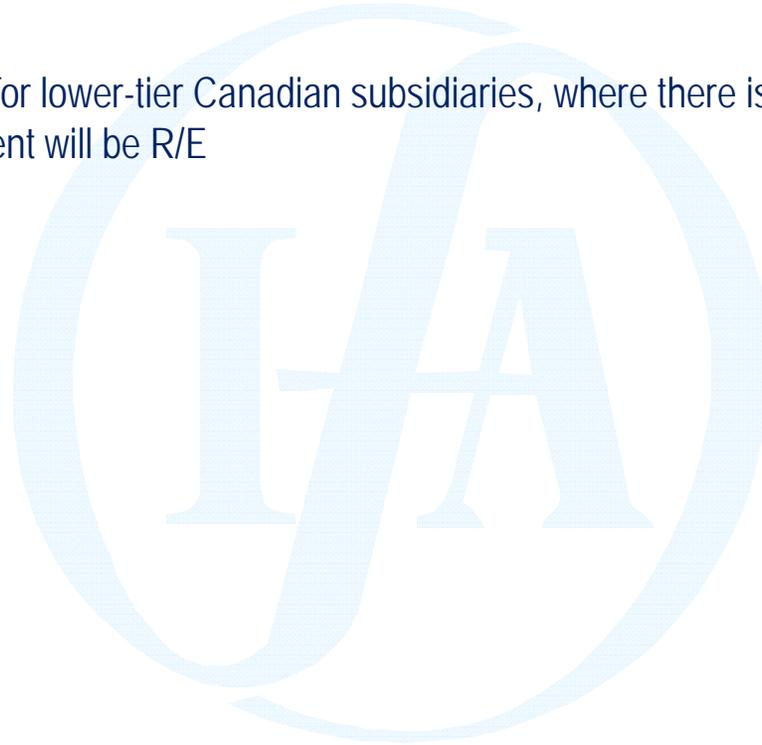
Where s.18(6.1) applies in respect of a *particular debt*:

- ▶ (a): a portion of the *particular debt* is deemed to be an amount outstanding as or on account of a debt or other obligation to pay an amount the *lender* and not to the *intermediary*.
 - ▶ That portion is determined, in general terms, as the amount of the *intermediary debt* and the FMV of the *particular property*, pro-rated for multiple *lenders*, where necessary.
 - ▶ As such, this amount is included in the taxpayer's *outstanding debts to specified non-residents* for the purpose of computing the thin capitalisation ratio in subsection 18(4). Similarly, a portion of the interest paid by the taxpayer is deemed to be paid to the *lender*, rather than the *intermediary*.
- ▶ (b): the non-deductible portion of the interest deemed to be payable on the *intermediary debt* is subject to s.214(16) and (17), with the result that the amount is treated as a deemed dividend for WHT purposes.

Enacted Measures Thin Capitalization

Comments and Issues

- Particularly problematic for lower-tier Canadian subsidiaries, where there is no cross-border PUC, such that only *equity* component will be R/E



Enacted Measures WHT on Cross-Border Interest

Application Rule: s.212(3.1)

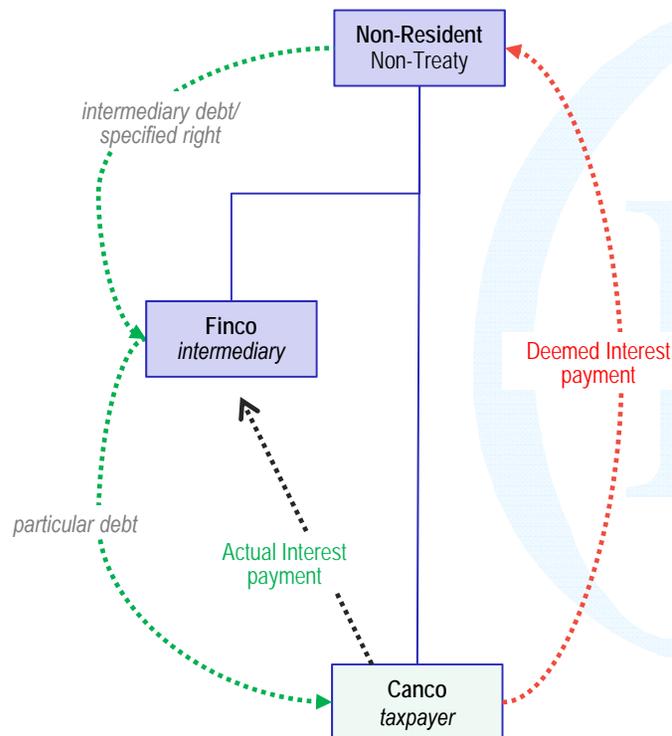
Application rule substantially similar to B2B thin capitalization rules,

- ▶ (a) Interest is paid to an *intermediary*
- ▶ (b) *Intermediary* is not a NAL person resident in Canada or a partnership each member of which is an NAL person
 - ▶ No carve-out for related non-residents
- ▶ (c) *Intermediary debt/Specified right* concepts the same as in the thin capitalization rules
- ▶ (d) Additional requirement that WHT if interest were paid to the person advancing the *intermediary debt* or granting the *specified right* is greater than WHT on interest paid to the *intermediary*

Consequences of Application s.212(3.2)

Where s.212(3.2) applies to a taxpayer:

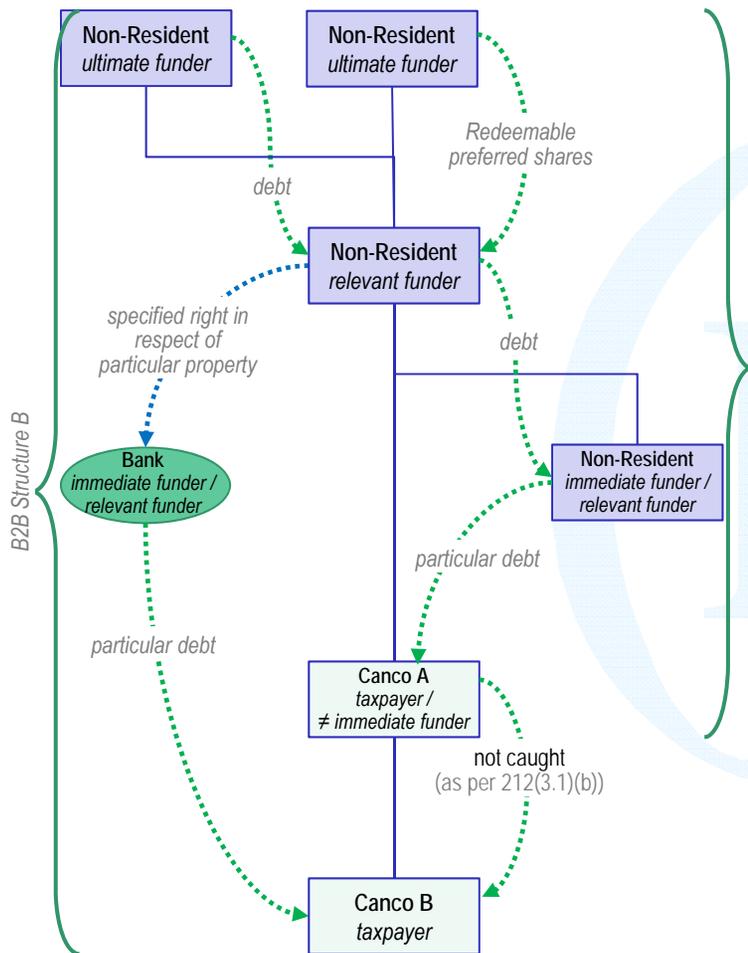
- ▶ The taxpayer is deemed to make a fictional interest payment to the person advancing the *intermediary debt* or granting the *specified right*
 - ▶ Deemed interest payment is subject to WHT
- ▶ No impact on character of actual interest payments on the *particular debt*



Proposed Measures

- ▶ 2016 Federal Budget proposed to expand the B2B WHT rules to apply to multiple intermediary and character substitution structures. In addition, new B2B rules were proposed for shareholder loans and WHT under s.212(1)(d) on rents, royalties and similar payments.
- ▶ On July 29, 2016, the Department of Finance released for public comment a package of draft legislative proposals and explanatory notes relating to the Budget 2016 measures including B2B arrangements.
- ▶ These include:
 - ▶ New s.15(2.16) – 15(2.192) that include B2B measures in the context of shareholder loans;
 - ▶ Amended s.212(3.1)-(3.3) to clarify the manner in which the B2B rules apply to arrangements that include two or more intermediaries.
 - ▶ New s.212(3.6) and (3.7) include "character substitution" rules for Part XIII. These rules are intended to prevent the avoidance of the B2B loan rules through the substitution of an economically similar arrangement of a different legal character from a debt (e.g., a royalty agreement or an equity investment), between an intermediary and another party to the arrangement.
 - ▶ New s.212(3.9)-(3.94) include B2B measures for rents, royalties and similar payments.
- ▶ Consultation period closed on September 29, 2016. Implementing legislation expected before the end of the year.

Proposed Measures Withholding Tax: Interest

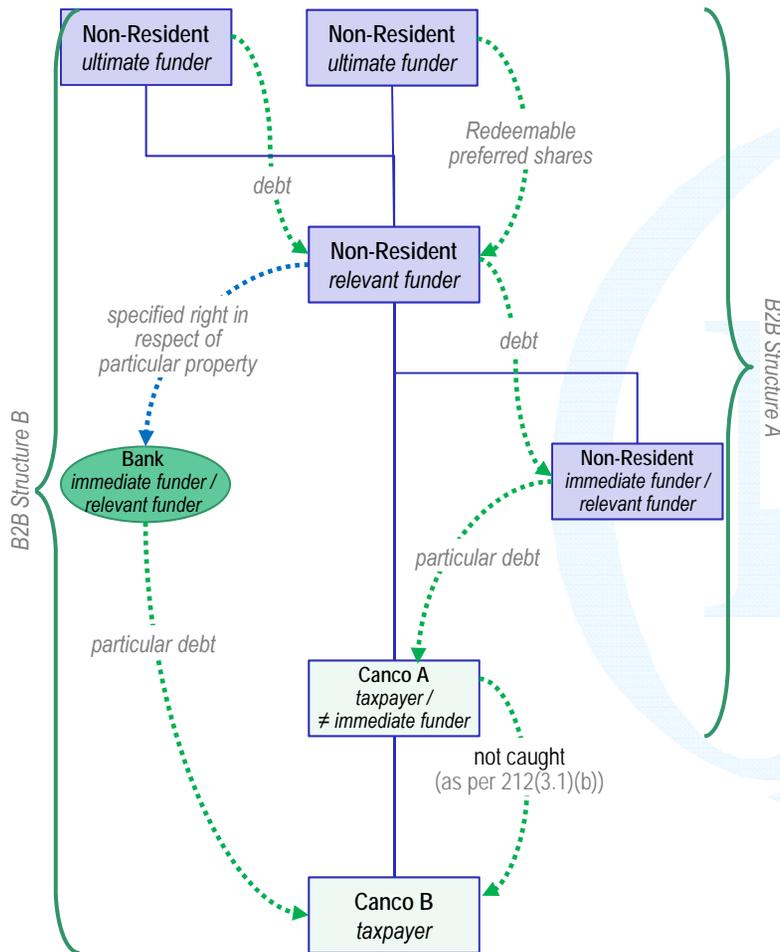


Definitions

Certain key definitions in s.212(3.8):

- ▶ *Particular debt* is a debt of the taxpayer on which the taxpayer pays an amount on account of interest.
- ▶ *Relevant funding arrangement* means:
 - ▶ (a) the *particular debt* (i.e. bottom “leg” of the structure)
 - ▶ (b) each debt owing by or specified right granted to a *relevant funder* if such are “connected” under 212(3.1)(c) in respect of a *relevant funding arrangement*; and
 - ▶ (c) *specified shares* issued by a *relevant funder* that are “connected” under 212(3.1)(c) in respect of a *relevant funding arrangement*.
- ▶ *Specified share* is any share that has a right to redemption or retraction, or that can be converted or exchanged into such a share. Intent is to treat certain “debt-like” equity interests as debt for B2B purposes.
- ▶ *Relevant funder* in respect of a *relevant funding arrangement* means:
 - ▶ (a) the *immediate funder*, that is the person or partnership to whom the *particular debt* is owed (i.e. bottom lender). Note if a NAL Canco is an *immediate funder*, then 212(3.1)(b) will not be met.
 - ▶ (b) the creditor in respect of a debt or a grantor of the specified right in the middle legs of the structure;
 - ▶ (c) a person or partnership NAL with (a) or (b) above and who deals at arm’s length with the taxpayer.
- ▶ *Ultimate funder* is defined as any relevant funder that is not a debtor or a holder of a specified right under a relevant funding arrangement (i.e. the top lender).
- ▶ Note that there is no NAL requirement for the *relevant funder* or the *ultimate funder*, but if the ultimate funder is not NAL, then 212(3.1)(d) generally will not be met.

Proposed Measures Withholding Tax: Interest

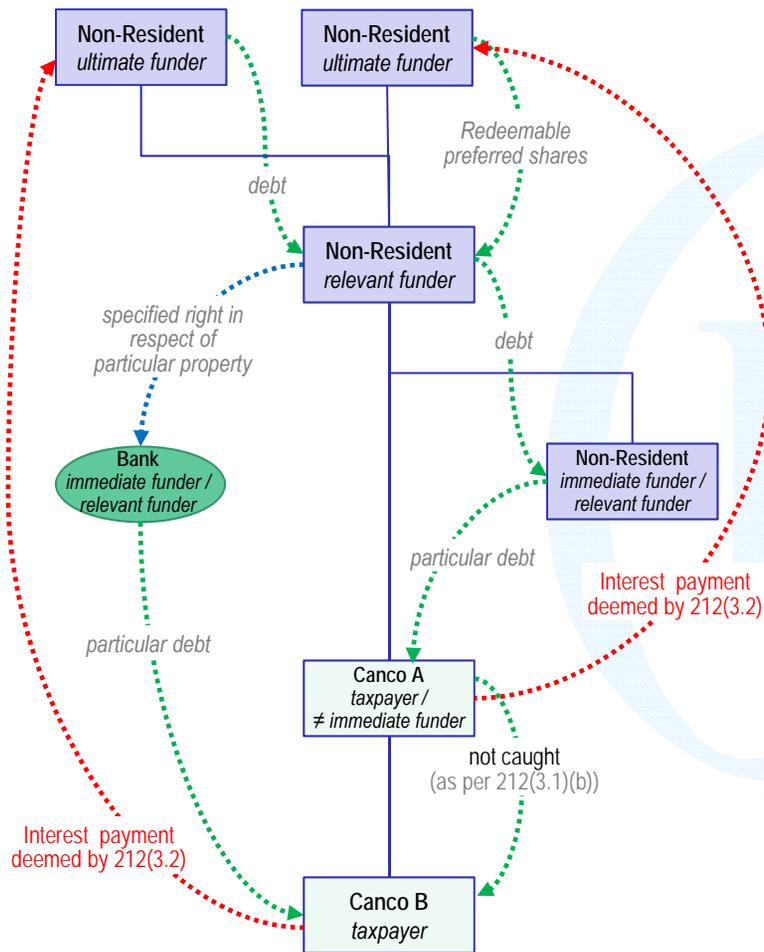


Application Rule: s.212(3.1)

Conditions for application of s.212(3.2), where:

- ▶ (a): a taxpayer pays or credits an amount of interest in respect of a *particular debt* owed to an *immediate funder*;
- ▶ (b): the *immediate funder* is not a person resident in Canada NAL with the taxpayer.
- ▶ (c): during the period of interest accrual a *relevant funder*, in respect of a particular *relevant funding arrangement*:
 - ▶ (i) has a debt to pay an amount to a person which debt meets any of the following conditions:
 - ▶ (A) recourse in respect of the debt is limited to a *relevant funding arrangement*.
 - ▶ (B) it can reasonably be concluded that a portion of the *relevant funding arrangement* arose or was permitted to remain outstanding because (I) all or a portion of the debt arose or remained owing, or (II) the *relevant funder* anticipated the above to happen.
 - ▶ (ii) has a *specified right* in respect of a particular property that was granted directly or indirectly by a person or partnership and the existence of which was required by the terms and conditions of the *relevant funding arrangement*, or it could be reasonably concluded that all or a portion of the *relevant funding arrangement* arose because of the *specified right* was granted or was expected to be granted.
- ▶ (d): Part XIII tax payable in respect of interest would be greater if the interest was paid to any *ultimate funder*, rather than the *immediate funder*.
- ▶ (e): the debt owed by the *immediate funder* or FMV of *particular property* is at least 25% of the total of:
 - ▶ (i) the *particular debt* and
 - ▶ (ii) total of all other debts of taxpayer to the *immediate funder* under the same or connected agreement as the *particular debt* in certain cross-collateralized arrangements.

Proposed Measures Withholding Tax: Interest



Consequences of Application: s.212(3.2)

- ▶ Where s.212(3.2) applies, for the purposes of s.212(1)(b), the taxpayer is deemed to pay interest to each *ultimate funder*, determined (for each particular *ultimate funder*) by the formula below.

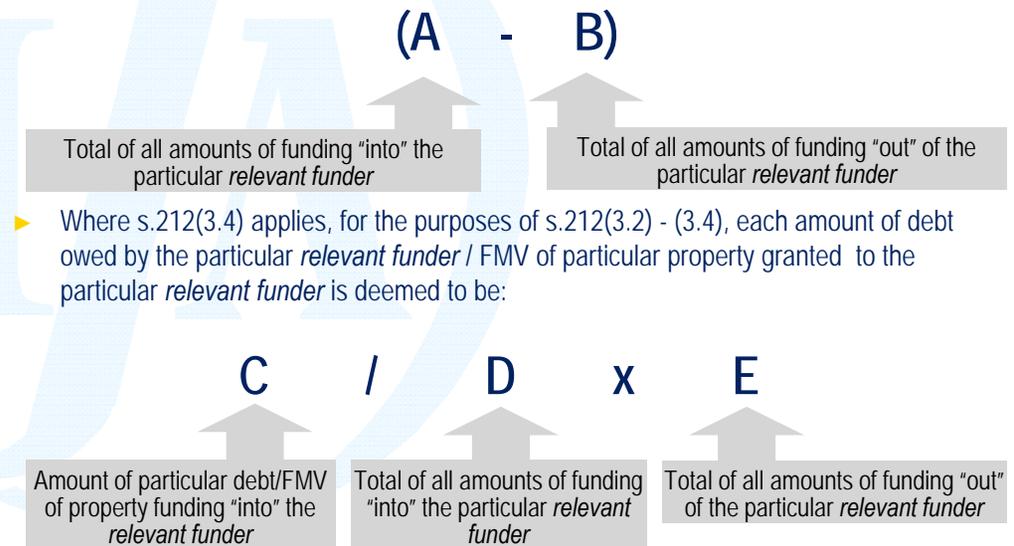
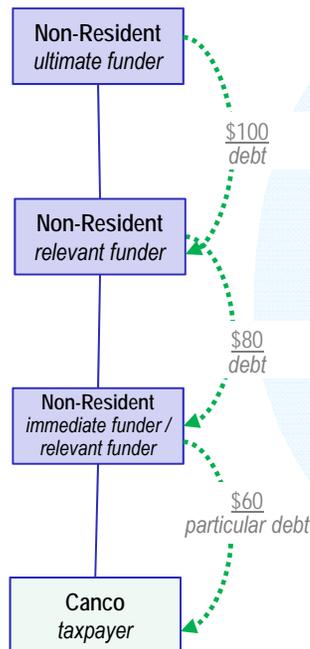
$$\begin{array}{c}
 \text{Particular amount of interest paid} \\
 \text{Lesser of (a) particular debt and (b) debt / FMV of particular property owned by a relevant funder to the particular ultimate funder} \\
 \text{Total of all amounts of debt / FMV of particular property owed by the particular ultimate funder} \\
 \text{Actual Part XIII WHT rate imposed on the interest paid by taxpayer to the immediate funder} \\
 \\
 (A) - (B) \times \frac{(G - H)}{D} \times \frac{(E - F)}{E} \\
 \\
 \text{Portion deemed by s.214(16) to be paid as a dividend} \quad \text{Average of all amounts of the particular debt throughout the interest accrual period} \quad \text{Part XIII WHT rate that would be imposed if paid by taxpayer to the particular ultimate funder}
 \end{array}$$

- ▶ Variable C is not shown here, represented by (G-H). The proportion C/D represents the proportion of the *particular debt* that is ultimately funded by the particular *ultimate funder*. The relationship (G-H) in effect backs out the portion of the amount funded through the particular *ultimate funder* that is funded by another *ultimate funder*.
- ▶ Variable F backs out the amount of WHT actually paid.

Proposed Measures Withholding Tax: Interest

Excess Funding: s.212(3.3) and (3.4)

- ▶ In certain situations a *relevant funder* may receive more funding under a *relevant funding arrangement* than the *relevant funder* has provided under the same arrangement (i.e. funding “into” exceeds the funding “out”).
- ▶ s.212(3.3) contains the application rule to address such situations . The “excess funding” rules apply in respect of a particular *relevant funder* where the amount determined by the following formula is greater than nil:

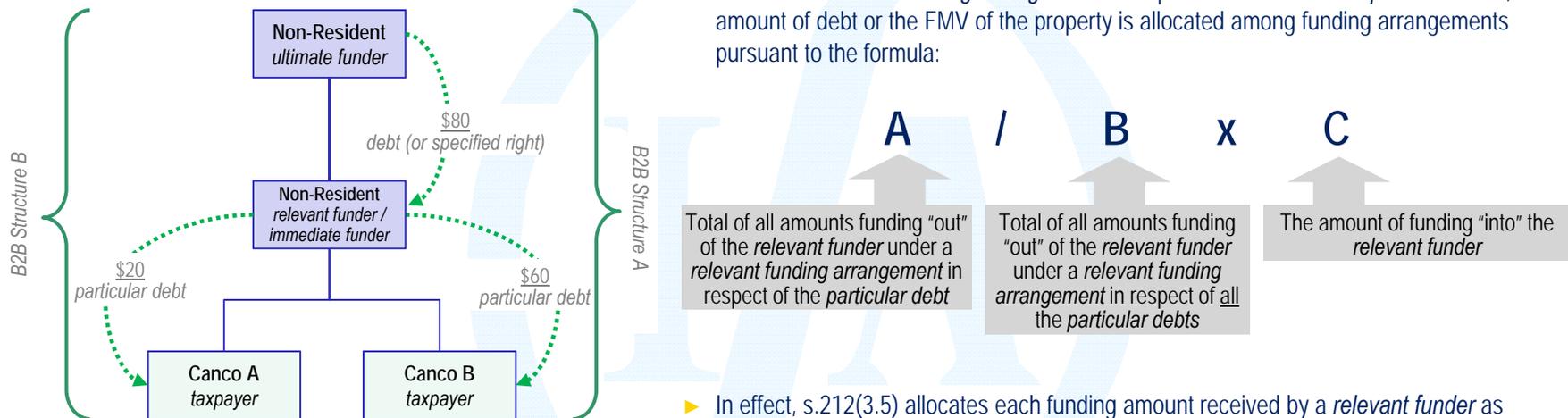


- ▶ This in effect reduces the total amounts of funding “into” the particular *relevant funder* to match the funding coming “out” of the *relevant funder* .
- ▶ Absent s.212(3.3) and (3.4), the aggregate of the amounts that would be determined for variable C in s.212(3.2) in respect of *ultimate funders* (generally representing the funding that *ultimate funders* are, collectively, considered to contribute to the *particular debt*) would generally exceed the amount outstanding on the *particular debt* or other obligation.

Proposed Measures Withholding Tax: Interest

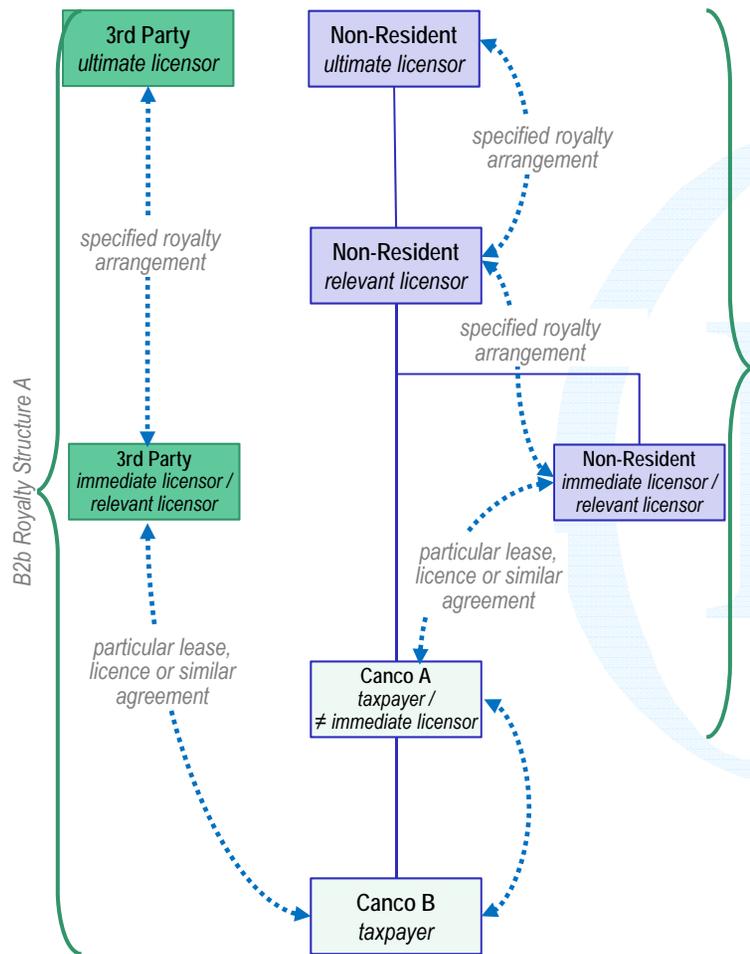
Multiple Funding Arrangements: s.212(3.5)

- ▶ In certain situations a *relevant funder* may be an *immediate funder* in respect of several *particular debts* deriving from the same debt owed by the *relevant funder*.
- ▶ Pursuant to s.212(3.5) where a debt/obligation/specified right owed or held by a *relevant funder* is a *relevant funding arrangement* in respect of more than one *particular debt*, the amount of debt or the FMV of the property is allocated among funding arrangements pursuant to the formula:



- ▶ In effect, s.212(3.5) allocates each funding amount received by a *relevant funder* as between all of the *particular debts* that are part of back-to-back arrangements that include that funding amount.

Proposed Measures Rents, Royalties & Similar Payments

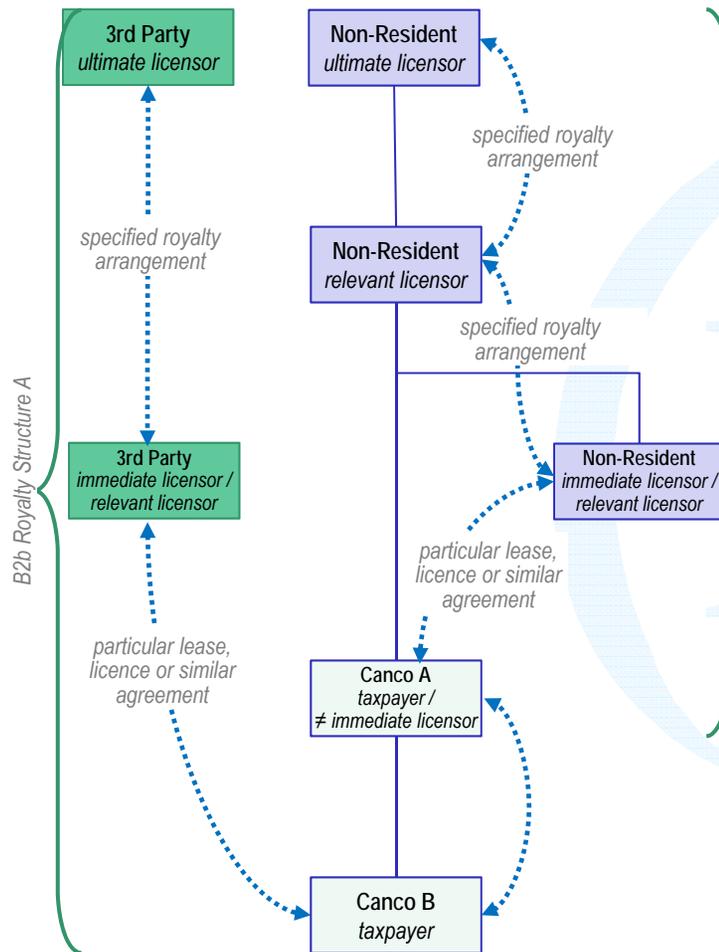


Application Rule: s.212(3.9)

Conditions for application of s.212(3.91), where:

- ▶ (a): a taxpayer pays or credits a *particular amount* of rent, royalty, or *similar payment* in respect of a *particular lease, licence or similar agreement* to a non-resident (the *immediate licensor*);
- ▶ (b): a *relevant licensor* in respect of a particular *relevant royalty arrangement* has an obligation to pay an amount to a person or partnership in respect of a *specified royalty arrangement* and any of the following conditions are met:
 - ▶ (i) the amount is determined by reference to:
 - ▶ (A) an amount paid in respect of a *relevant royalty arrangement*, or
 - ▶ (B) FMV, revenue, profits, income, cash flow, etc. of a particular property if a right in respect of the property is granted under the *particular lease, licence or similar agreement*.
 - ▶ (ii) it can reasonably be concluded that the particular *relevant royalty arrangement* arose or was permitted to remain outstanding because the specified royalty arrangement was entered into or was permitted to remain in effect, or was expected to arise or remain.
- ▶ (c): Part XIII tax payable in respect of the particular amount would be greater if the amount was paid to any *ultimate licensor*, rather than the *immediate licensor*.

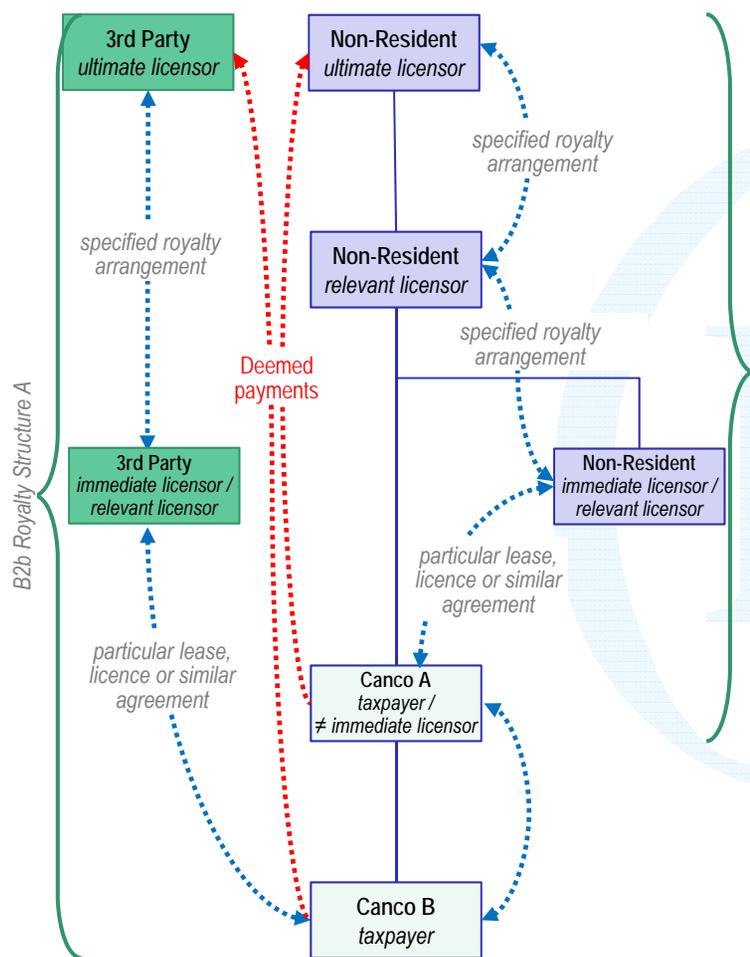
Proposed Measures Rents, Royalties & Similar Payments



Definitions: s.212(3.94)

- ▶ *lease, licence or similar agreement* means any agreement under which a rent, royalty or similar payment is or could be paid.
- ▶ *rent, royalty or similar payment* means amounts described in s.212(1)(d), including with reference to the specific inclusions and exclusions thereunder
- ▶ *specified royalty arrangement* means a lease, licence or similar agreement, an assignment, or an instalment sale.
- ▶ *relevant royalty arrangement* means the *particular lease, licence or similar agreement* and any *specified royalty arrangement* "connected" to it under s.212(3.9)(b).
- ▶ *relevant licensor* in respect of a *relevant royalty arrangement* means the *immediate licensor*, the person that is a lessor, licensor, assignor, seller, etc. and any person NAL with such a person.
- ▶ *ultimate licensor* means a relevant licensor, that is not a lessee, licensee, assignee, or purchaser under a relevant royalty arrangement (i.e. the top licensor)

Proposed Measures Rents, Royalties & Similar Payments



Consequences of Application: s.212(3.91)

Where s.212(3.91) applies in respect of a taxpayer, then for the purposes of s.212(1)(d), the taxpayer is deemed to pay each *ultimate licensor* (or deemed ultimate licensor) an amount of the same character as the payment made to the immediate licensor in the absence of these rules, determined for each particular ultimate licensor by the formula:

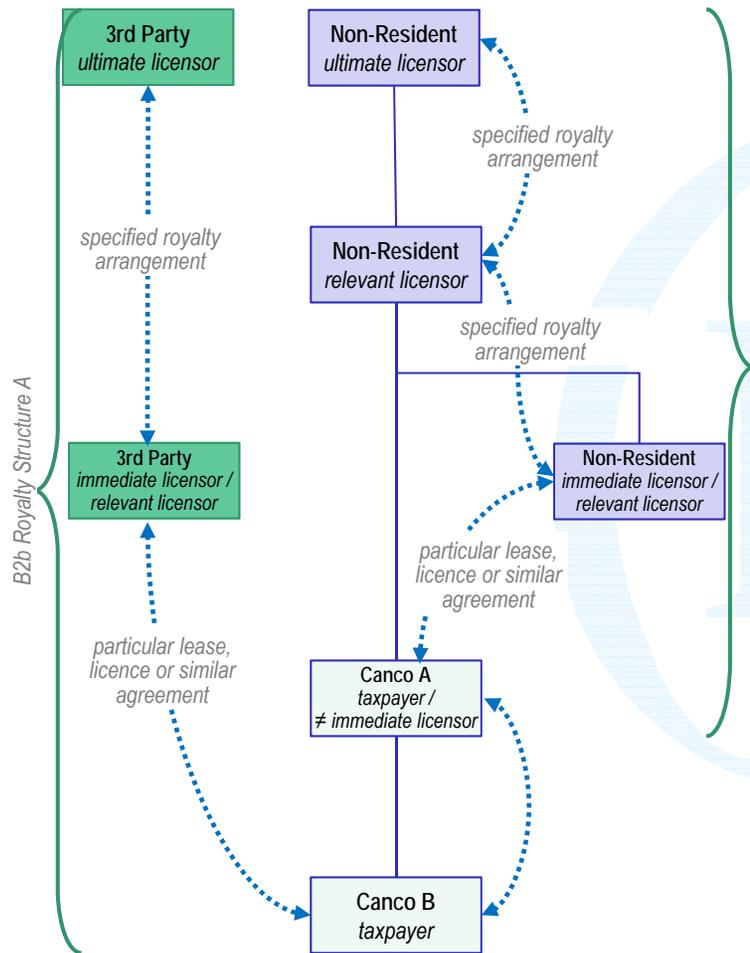
$$\left(\frac{\text{Particular amount paid}}{\text{Total of all allocable amounts that can be demonstrated as per B, otherwise, the number of ultimate licensors}} \right) \times \left(\frac{\text{Actual Part XIII WHT rate imposed on the payment made by taxpayer to the immediate licensor} - \text{Rate}}{\text{Rate}} \right)$$

Where:

- A:** Particular amount paid
- B:** Total of all allocable amounts that can be demonstrated as per B, otherwise, the number of *ultimate licensors*
- C:** Portion of the amount paid that is demonstrated, to the satisfaction of the Minister, to be reasonably allocable to the *ultimate licensor*, or if an amount is not demonstrated, 1
- D:** Actual Part XIII WHT rate imposed on the payment made by taxpayer to the *immediate licensor*
- E:** If an allocable amount is not demonstrated as per B, the highest rate of WHT if paid by taxpayer to the *any* of the *ultimate licensor*, otherwise rate of WHT that would apply if paid to the particular *ultimate licensor*

- ▶ The "reasonable allocation" test is for situations where there is more than one *ultimate licensor* (e.g., because of the co-ownership of licensed property). In such cases, reasonableness of a particular allocation is intended to be determined having regard to relevant factors, such as the relative amounts of payments received by the *ultimate licensors* under *relevant funding arrangements*. If no such allocation is established, to the satisfaction of the Minister, the formula will apply to generally exact the highest amount of WHT.
- ▶ The reasonable allocation is established under variable B, and variables C and D infer their operation from that allocation.

Proposed Measures Rents, Royalties & Similar Payments



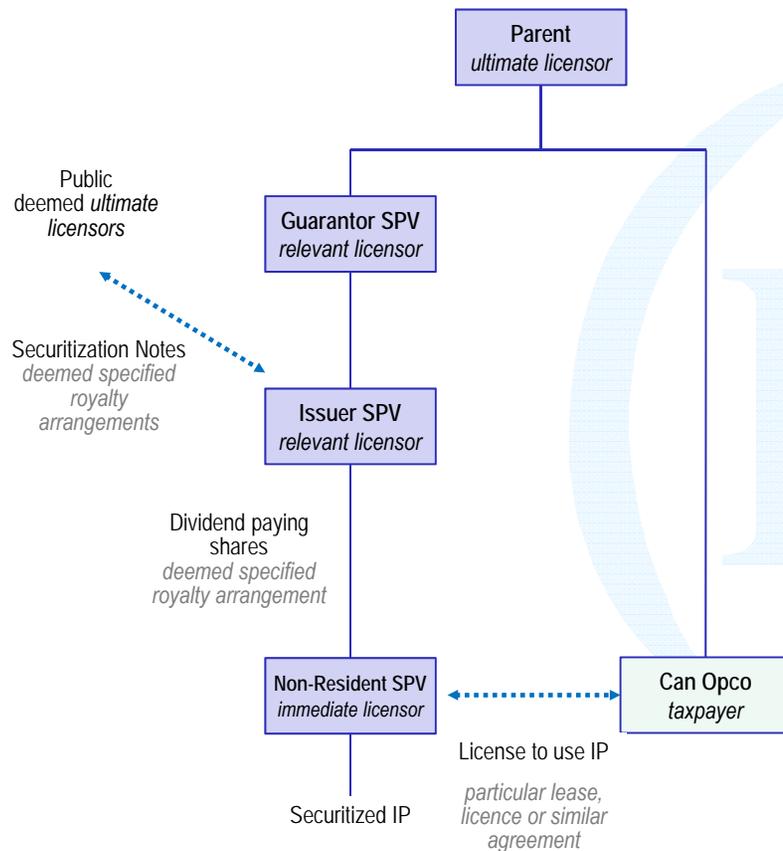
Application to Arm's Length Payments

- ▶ Fundamental difference between rents, royalties and similar payments as compared to interest is that s.212(1)90 does not provide a general exemption for arm's length payments
- ▶ Accordingly arm's length Canadians who license IP fro foreign licensors now need to consider B2B rules
 - ▶ Breadth of the rules makes it difficult to draft sufficiently comprehensive representations to provide comfort
 - ▶ Potential problems for Canadian payor if the non-resident licensor is not willing, or worse still, not able to provide factual confirmation that the rules do not apply
- ▶ Facts required for "Reasonable allocation" may not be available for arm's length scenarios with multiple ultimate licensors – could result in punitive rate of WHT being deemed to apply

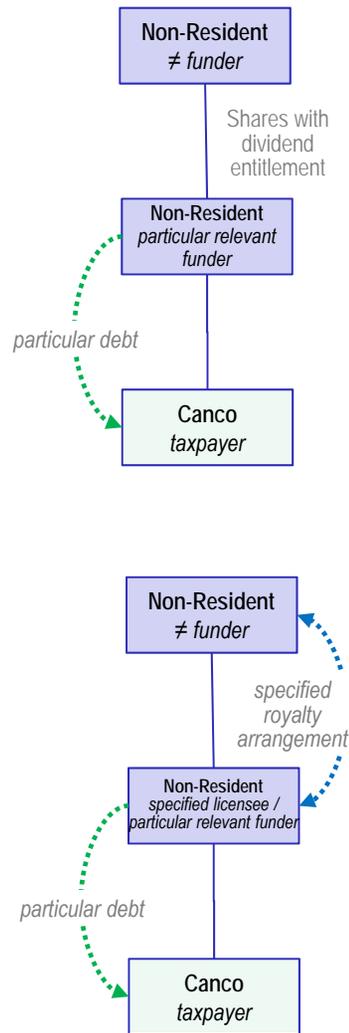
Proposed Measures Rents, Royalties & Similar Payments

Arm's Length Payments – Securitization Example

- ▶ Character substitution rules could deem shares of Non-Resident SPV and Securitization Notes to be a specified royalty arrangement
- ▶ In many situations causality test in 212(3.9)(b)(ii) may be satisfied if Note proceeds can be linked with acquisition funding of securitized IP
- ▶ If 212(3.91) applies, Can Opco will be deemed to pay royalties to holders of Securitization Notes – may not be possible to establish entitlement to treaty benefits and applicable treaties may not provide for full exemption from withholding



Proposed Measures Character Substitution Rules



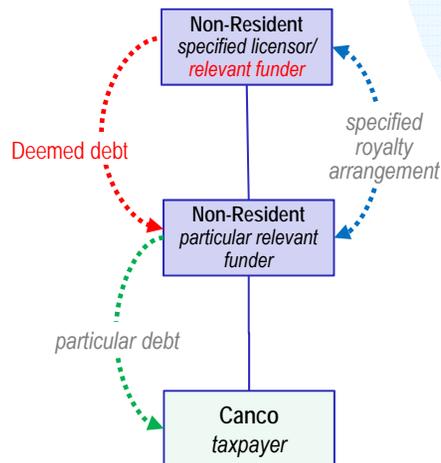
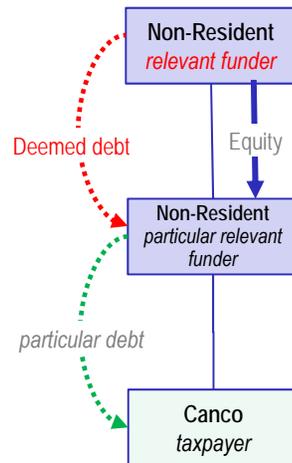
- ▶ These measures aim to catch structures where a B2B funding arrangement is structured with one or more “legs” that are not legally structured as debt, *specified right*, or a rent, royalty, or similar payment.
- ▶ However, there are still some bright lines and not all shares are caught by these rules.

Character Substitution Rules: s.212(3.6) condition for application

The character substitution rule in s.212(3.7) applies in respect of:

- ▶ 212.(3.6)(a) shares of a particular *relevant funder* if the corporation has an obligation to pay a dividend on the shares, and one of the following conditions is met:
 - ▶ (i) the amount of the dividend is determined by reference to the amount of interest paid under a *relevant funding arrangement*, or
 - ▶ (ii) it can reasonably be concluded that a portion of the *relevant funding arrangement* arose or was permitted to remain outstanding because (A) the shares were issued or remained outstanding or (B) it was anticipated that the above happen.
- ▶ 212.(3.6)(b) a *specified royalty arrangement* (if a particular *relevant funder* is a *specified licensee* that has an obligation to pay an amount under the *specified royalty arrangement*) and one of the following conditions is met:
 - ▶ (i) the amount is determined by reference to the amount of interest paid under a relevant funding arrangement, or
 - ▶ (ii) it can reasonably be concluded that a portion of the *relevant funding arrangement* arose or was permitted to remain outstanding because (A) the shares were issued or remained outstanding or (B) it was anticipated that the above happen.
- ▶ A *specified royalty arrangement* is defined in s.212(3.94) to mean a lease, license or similar agreement, an assignment or an instalment sale. A *specified licensee* is defined to mean a lessee, licensee or grantee of a right similar to a right granted under a lease or licence, an assignor or a purchaser.

Proposed Measures Character Substitution Rules



Character Substitution Rules: s.212(3.7) effect of application

If s.212(3.7) applies, it provides the following deeming rules:

- ▶ (a): the *specified royalty arrangement* or the holding of the shares is deemed to be a *relevant funding arrangement*;
- ▶ (b): the specified licensor or shareholder, is deemed to be a relevant funder (and where applicable, the *ultimate funder*);
- ▶ (c): the conditions in s.212(3.1)(c) are deemed to be met in respect of the *relevant funding arrangement*;
- ▶ (d): the *relevant funder* is deemed to be owed by the *particular relevant funder* an amount of debt determined by the formula:

$$\frac{\text{Total of all funding "out" of the particular relevant funder} - \text{Total of all funding "into" the particular relevant funder under the actual relevant funding arrangement}}{\text{The FMV of the shares or the specified royalty agreement}} \times \frac{\text{The total of such FMVs for all relevant funding arrangements that are deemed to exist under s.212(3.7)(a)}}{\text{The total of such FMVs for all relevant funding arrangements that are deemed to exist under s.212(3.7)(a)}}$$

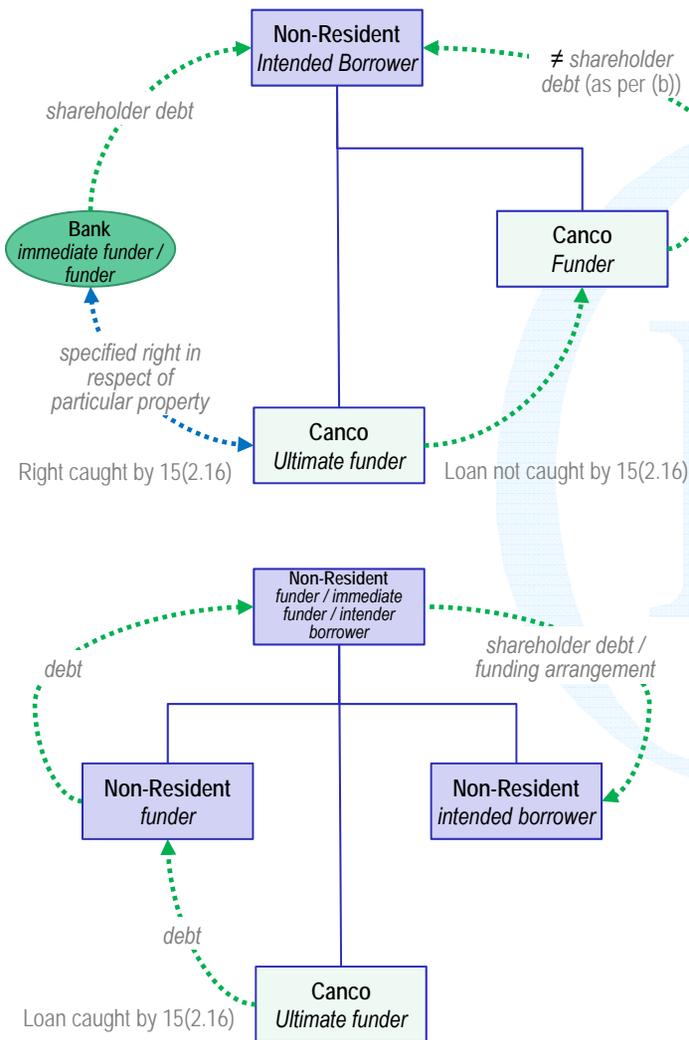
- ▶ The difference (A – B) represents the portion (if any) of the funding provided by the *particular relevant funder* that is sourced from the character substitution structure.
- ▶ This amount is then pro-rated by multiplying by C/D – as between the one or more *relevant funding arrangements* that are deemed to exist under paragraph 212(3.7)(a), in proportion to the relative FMV of the shares or *specified royalty arrangements* underlying those deemed relevant funding arrangements.

Proposed Measures Withholding Tax

Comments and Issues

- The new B2B measures are clearly designed to operate as a mechanical anti treaty-shopping provision.
- There is no tax avoidance purpose test.
- Expansion to rents, royalties and similar payments is particularly problematic because there is no general arm's length exemption
- Foreign jurisdictions may not allow foreign tax credits in respect of Canadian WHT on deemed payments, particularly if Canada is imposing tax in violation of a treaty
- The royalty rules apply to "an assignment, an installment sale", as well as a broader 212(1)(d) items that are not just "rents, royalties, or similar payments".
- Causal connection tests without underlying purpose test may apply in unexpected and unintended circumstances (e.g. securitizations).

Proposed Measures Shareholder Loans



Application Rule: s.15(2.16)

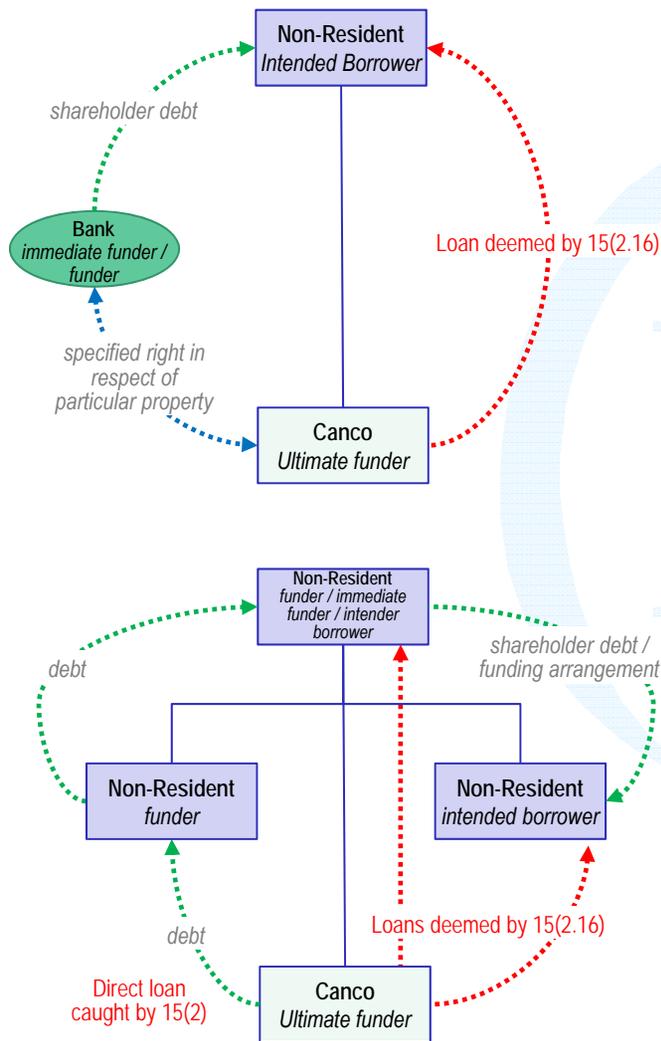
The back to back rules in s.15(2.17) apply where:

- ▶ (a): a person or partnership (the *intended borrower*) has a debt or other obligation to pay (the *shareholder debt*) to a person or partnership (the *immediate funder*)
 - ▶ (b): subsection 15(2) would not otherwise apply to the *shareholder debt*. This precludes double taxation with outbound multi-Canco financing.
 - ▶ (c): a *funder*, in respect of a particular *funding arrangement*:
 - ▶ (i) has a debt/obligation to pay an amount to a person that meets any of the following conditions:
 - ▶ (A) recourse in respect of the debt/obligation is limited to a *funding arrangement*.
 - ▶ (B) it can reasonably be concluded that a portion of the *funding arrangement* arose or was permitted to remain outstanding because (I) all or a portion of the debt/obligation arose or remained owing, or (II) the *funder* anticipated the above to happen.
 - ▶ (ii) has a *specified right* in respect of a *particular property* that was granted directly or indirectly by a person or partnership and the existence of which was required by the terms and conditions of the particular *funding arrangement*, or it could be reasonably concluded that all or a portion of the particular *funding arrangement* arose because of the *specified right* was granted or was expected to be granted.
 - ▶ (d): one or more *funders* is an *ultimate funder*.
- ▶ Notably, there is no *de minimis* threshold equivalent to s.18(6)(d).

Definitions: s.15(2.192)

- ▶ *Funder* in respect of a *funding arrangement* includes the *immediate funder* and a person or partnership NAL with a *funder*.
- ▶ *Ultimate funder* is a *funder* a direct loan from which to the *intended borrower* would be subject to s.15(2).
- ▶ *Funding arrangement* includes the *shareholder debt*, and any debts or specified rights "connected" to it under s.15(2.17)(c).

Proposed Measures Shareholder Loans



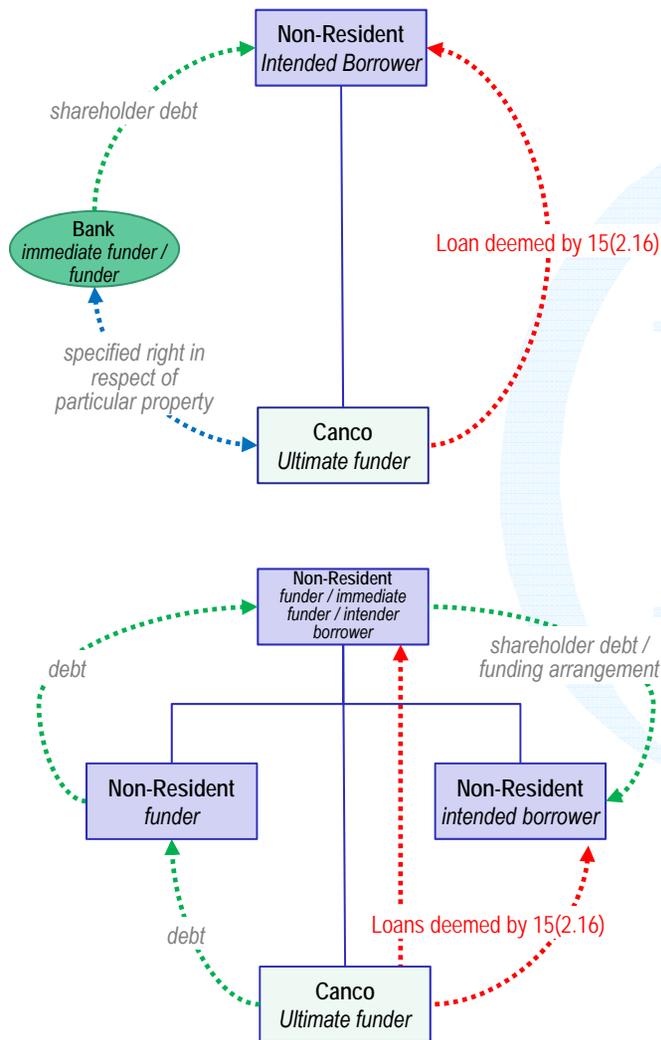
Consequences of Application: s.15(2.17)

- ▶ Where s.15(2.16) applies, then for the purposes of s.15 and s.80.4, the intended borrower is deemed to receive a loan from each particular ultimate funder at the particular time, in the amount determined by the formula:

$$\begin{array}{c}
 \text{Lesser of (a) shareholder debt and (b) amount of debt / obligation owed to FMV of particular property granted by the ultimate funder} \\
 \downarrow \\
 \mathbf{A} \times \mathbf{B / C} - (\mathbf{D} - \mathbf{E}) \\
 \begin{array}{l}
 \uparrow \qquad \qquad \qquad \uparrow \\
 \text{Pro-ration of amount in respect of a particular ultimate funder} \quad \text{Total of all previous deemed repayments under s.15(2.19) re loans in D}
 \end{array}
 \end{array}$$

- ▶ If there are multiple *ultimate funders* that have funded the *shareholder debt*, then s.15(2.17) generally deems the *intended borrower* to receive loans from each of those *ultimate funders*.
- ▶ In calculating variable A, debts owing by one *ultimate funder* to another *ultimate funder* are excluded.
- ▶ Variable D is intended to prevent double taxation. Since a loan arrangement will generally satisfy the conditions in s.15(2.16) at every moment during which it remains outstanding, s.15(2.17) applies at each such moment. Therefore, it is necessary to reduce the amount of the deemed loan under s.15(2.17) by the amount determined for variable D to ensure that, where the funding provided by the particular *ultimate funder* under the back to back arrangement has not changed from moment to moment, that subsection does not deem an additional loan at each moment.

Proposed Measures Shareholder Loans



Deemed Repayments: s.15(2.18) and s.15(2.19)

- ▶ s.15(2.18) sets out application conditions for deemed repayment in s.15(2.19). It applies in respect of an *indented borrower/ultimate funder* where:
 - ▶ s.15(2.17) previously applied in respect of a *shareholder debt*, and
 - ▶ either (i) *shareholder debt* is repaid in whole or in part, (ii) a lower tier debt connected to the *shareholder debt* is repaid in whole or in part, or (iii) the FMV of a connected particular property is reduced or the relevant *specified right* is extinguished.
- ▶ Where s.15(2.19) applies, the *intended borrower* is deemed to repay one or more of the loans previously deemed to have been made, and the amount of the repayment is determined by the formula:

$$\begin{array}{c}
 \text{Total of all amounts previously} \\
 \text{deemed received as a loan from} \\
 \text{the particular ultimate funder} \\
 \hline
 \text{A} \\
 \hline
 \text{Lesser of (a) shareholder debt after the repayment} \\
 \text{and (b) debt/ obligation owed to/ FMV of particular} \\
 \text{property granted by the ultimate funder after the} \\
 \text{repayment} \\
 \hline
 \text{B} \\
 \hline
 \text{Total of all previous deemed} \\
 \text{repayments under s.15(2.19) re} \\
 \text{loans in A} \\
 \hline
 \text{C} \\
 \hline
 \text{Pro-ration of amount in} \\
 \text{respect of a particular} \\
 \text{ultimate funder} \\
 \hline
 \text{E/F} \\
 \hline
 \text{D} \times \text{E/F} \\
 \hline
 \text{A} - \text{B} - (\text{D} \times \text{E/F})
 \end{array}$$

- ▶ In the formula above, variable C is omitted, as it is comprised of (D x E/F), which in effect, represents the amount by which the *intended borrower* is funded, immediately after the time of the deemed repayment, by the particular *ultimate funder* under that same arrangement.
- ▶ The repayment will be considered to occur on a FIFO basis.
- ▶ Need to ensure that the deemed repayment is not part of a *series of loans or other transactions and repayments* to meet the requirement in s.15(2.6).
- ▶ Deemed repayment may also occur where the formula in s.15(2.17) results in a negative amount.

Proposed Measures Shareholder Loans

Comments and Issues

- There is no carve-out for lower “leg” of the loan being subject to 15(2), potentially resulting in double taxation.
- There is no allocation of the deemed loan amounts among *intended borrowers*, potentially resulting in double taxation.
- The B2B rules apply to debts in place as at March 2016 (with certain exceptions), with no grandfathering provisions. This may give some taxpayers with non-calendar year ends very short time to fix their financing to fit into the 15(2.6) “grace period”.
- There is no tax avoidance purpose test.
- The application of the rules in notional cash pools may be extremely complicated, as it will require tracing of funds to each *intended borrower*. This appears to have the effect of penalising Canadian companies that enter into notional cash pooling arrangements.