FINANCING ISSUES

THE THIN CAPITALIZATION RULES

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THIN CAPITALIZATION RULES*

The so-called thin capitalization rules are found in subsections 18(4) to 18(8) of the *Income Tax Act* (Canada).[1] These rules are designed to discourage a non-resident from capitalizing its Canadian corporation ("**Canco**") with a disproportionate amount of debt and thereby repatriating a disproportionate amount of Canco's profits in the form of interest. Were it not for these rules, such interest would generally be deductible by Canco in computing its income[2] and would therefore reduce the amount of income on which Canco would be required to pay Part I tax by the amount of the interest so paid. Such interest would instead be taxed under Part XIII of the Act at the lower withholding tax rates that apply to interest payments made to non-residents.

I. DENIAL OF INTEREST DEDUCTION

The thin capitalization rules address the foregoing problem by denying Canco the right to deduct a portion of the interest otherwise deductible by it in a particular year (the "**Non-Resident Interest**"), where such interest is paid or payable on "outstanding debts to specified non-residents"[3] (the "**Non-Resident Debt**") and the amount of such Non-Resident Debt exceeds a certain debt-to-equity ratio. In order to determine the non-deductible portion of the Non-Resident Interest, one must first determine the following amounts:

A. The average of the greatest amount of Canco's Non-Resident Debt at any time in each

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1 RSC 1985, c.1, (5th Supp.), as amended. Unless otherwise stated, all statutory references in this paper are to the Act.

2 Assuming that such interest is incurred for the purpose of earning income and is reasonable in the circumstances (paragraph 20(1)(c) and subsection 67).

3 Subsection 18(4). By denying Canco a deduction for this interest portion, the thin capitalization rules *effectively* treat such interest portion as a dividend paid by Canco. This interest portion, however, is not actually deemed to be a dividend but, rather, retains its interest characterization. Accordingly, withholding tax on any such interest payment will be imposed at the rate applicable to interest, not to dividends, which will be disadvantageous to the non-resident recipient where the withholding tax rate applicable to interest is greater than that applicable to dividends (as may be the case, for example, under the *Canada-U.S. Tax Treaty*).

month that ends in the particular year;[4]

B. Canco's retained earnings at the beginning of the particular year, excluding any such earnings of another corporation - that is, Canco's retained earnings determined on an unconsolidated basis;

C. The average of Canco's contributed surplus at the beginning of each month that ends in the particular year, to the extent that it was contributed by a "specified non-resident shareholder" of Canco (the definition of "specified non-resident shareholder" is discussed below); and

D. The average of Canco's paid-up capital at the beginning of each month that ends in the particular year, excluding the paid-up capital of Canco's shares owned by anyone other than a specified non-resident shareholder of Canco.[5, 6]

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4 For taxation years that commenced prior to 2000, subsection 18(4) looked to the greatest amount of Non-Resident Debt outstanding *at any time in the particular years*, rather than the average of the greatest amount of Canco's Non-Resident Debt outstanding *at any time in each month of the year*. This new averaging concept allows Canco to reduce the Non-Resident Debt component of the debt-to-equity ratio provided for in subsection 18(4) if it pays down Non-Resident Debt at any time during the year.

5 For taxation years that commenced prior to November 12, 1981, this exclusion of paid-up capital attributable to shares owned by persons other than specified non-resident shareholders did not apply. Accordingly, if, for example, a U.S. parent wished to capitalize its Canadian operating company ("**Canco 1**") with debt sufficient in amount to fund both the operations of Canco 1 as well as the operations of a Canadian subsidiary of Canco 1 ("**Canco 2**"), and such debt capitalization would have exceeded the (old) 3:1 debt-to-equity ratio provided for in subsection 18(4), the U.S. parent could instead capitalize Canco 1 on a 3:1 basis, have Canco 1 then invest those funds as equity in Canco 2 and then lend to Canco 2 up to three times the equity invested in Canco 2 by Canco 1, thereby effectively doubling the 3:1 debt-to-equity cap.

6 As in the case of Non-Resident Debt, subsection 18(4) contained no averaging rule for either contributed surplus or paid-up capital for taxation years that commenced prior to 2000. Rather, the subsection looked to contributed surplus and paid-up capital at the beginning of the year (in the case of contributed surplus) or the beginning or end of the year, whichever was greater (in the case of paid-up capital). The new averaging concept for taxation years commencing after 2000 can work to Canco's benefit or detriment. For example, under the old rules, if Canco was offside the (old) 3:1 debt-to-equity ratio at any time during the year, the problem could be "fixed" by having a specified non-resident, before Canco's year-end, acquire more shares of Canco or contribute capital to Canco (which capital was then added to Canco's paid-up capital) in an amount sufficient to make up the shortfall necessary to meet the 3:1 debt-to-equity ratio. Under the new rules, however, this make-up payment will be averaged down by the lower paid-up capital figures of Canco in earlier months of the particular year. As a result, a greater amount of make-up capital will now be required than was previously the case in order to address an offside ratio problem. On the other hand, the new averaging rules act to Canco's benefit by allowing the contributed surplus component of equity to be increased during the year, which was not the case under the old rules. The Canada Revenue Agency (the "**CRA**") takes the position, however, that equity provided to a corporation at any time during the first day of a month will not be included in equity for that month unless it is

If the Non-Resident Debt exceeds two times the total of the amounts determined under B, C and D (collectively, the "**Equity**"), the portion of the Non-Resident Interest that will be denied deduction is calculated in accordance with the following formula:

$$\text{Non-Resident Interest} \quad \text{X} \quad \frac{\text{Non-Resident Debt - 2x Equity}}{\text{Non-Resident Debt}}$$

In sum, this formula establishes a maximum 2:1 debt-to-equity ratio[7] for funding of Canadian corporations by significant non-resident shareholders (or, as will be seen below, by non-residents related to significant shareholders) before the thin capitalization rules come into play.

There are a number of points to note with respect to this formula:

- As noted in footnote 4 of this paper, for taxation years that commenced prior to 2000, subsection 18(4) looked to the greatest amount of Canco's Non-Resident Debt outstanding *at any time* in the particular year. Accordingly, any Non-Resident Debt, even if it was only outstanding for a moment in time, was required to be included in the calculation of Canco's Non-Resident Debt. It was, therefore, important to ensure that there was no inadvertent increase in the amount of Canco's Non-Resident Debt, however brief. For example, if a debt owing by Canco to its non-resident parent was refinanced, care had to have been taken to

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made at the earliest moment of that day. See "Thin Capitalization", *infra* footnote 23 and "Interpretation of Thin Capitalization Terms", Technical Interpretation of the International and Trust Division, document number 2002-0136985, dated September 9, 2002.

[7] For taxation years that commenced prior to 2000, the debt to equity ratio was 3:1. The reduction in the ratio to 2:1 was originally recommended in the Report of the Technical Committee on Business Taxation, (Jack Mintz, Chairman) Ottawa: Department of Finance, April 6, 1998. That Committee also recommended that the thin capitalization rules (which, as stated above, only apply to loans made to Canadian corporations) be extended to apply to loans made to Canadian branches of foreign corporations as well as to partnerships and trusts. Bill C-22, which reduced the ratio from 3:1 to 2:1, contained no proposals implementing this latter recommendation, although the federal budget of February 28, 2000 (in which various amendments to the thin capitalization rules were first introduced) did contain a statement to the effect that further amendments to extend the thin capitalization rules to these types of entities, as well as to other financing techniques such as leases, would be given consideration after consultation with the public. See, however, *infra* footnotes 25 and 26 regarding loans made to partnerships.

ensure that the existing debt was repaid before the new debt was issued.[8] Now, Non-Resident Debt for a particular taxation year is determined by first ascertaining the greatest amount of such debt outstanding in each *month* of that particular taxation year, and then averaging those amounts. Consequently, while it is still important not to inadvertently increase the amount of Non-Resident Debt in any particular month, the impact of such an inadvertent increase is lessened by the monthly averaging rule.

- Where a specified non-resident simultaneously finances a Canco by way of both equity and debt, the debt will be immediately included in the subsection 18(4) calculation, but the equity will not be so included until the next following month. This is so because Non-Resident Debt is measured at *any time* in a month whereas paid-up capital is measured, only as at the *beginning* of the month. This inconsistency could prove to be a problem where the financing occurs during the last month of Canco's taxation year.

- Similarly, as noted in footnote 6 of this paper, in determining Equity for taxation years commencing prior to 2000, retained earnings and contributed surplus were measured as at the *beginning* of the particular year whereas paid-up capital was measured as the greater of paid-up capital at the *beginning* of the year and paid-up capital at the *end* of the year. This flexibility with respect to paid-up capital gave rise to certain planning techniques which now do not work as well because of the averaging rule applicable to paid-up capital. (See discussion below regarding Planning Points.)

- The only portion of Canco's contributed surplus that is included in its Equity, is such portion as is contributed by a specified non-resident shareholder of Canco. It is not clear from the wording of subsection 18(4) whether the shareholder in question must be a specified non-resident shareholder at the time that the contribution to surplus is made and/or at some other

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[8] Norman C. Loveland, "Income Tax Impediments to Foreign Investment in Canada," in *Report of Proceedings of the Thirty-Fourth Tax Conference*, 1982 Conference Report (Toronto: Canadian Tax Foundation, 1983), 666-753, at 693. See also Robert F. Lindsay, "Financing of a Canadian Subsidiary by a Non-Resident Parent Corporation," in *Income Tax Considerations in Corporate Financing*, 1986 Corporate Management Tax Conference (Toronto: Canadian Tax Foundation, 1986), 48-80, at 49.

time in the particular year in which the contribution is made.[9]

- Retained earnings and contributed surplus are to be determined in accordance with generally accepted accounting principles. Retained earnings cannot include the retained earning of another corporation, which means they cannot be calculated on a consolidated or equity basis.[10] Retained earnings cannot be a negative figure (that is, a deficit) nor can it include unrealized appraisal surpluses.[11]

- Section 3861 of the CICA Handbook[12] requires retractable preferred shares to be treated as debt under generally accepted accounting principles. The CRA, however, takes the position that, for tax purposes, it is the *legal* nature of the financial instrument that governs its classification and not its *accounting* treatment. Accordingly, notwithstanding their reclassification for accounting purposes, retractable shares are treated as equity for purposes of the thin capitalization rules and the relevant amount of such equity for such purposes is the paid-up capital of such shares.[13] For purposes of calculating retained earnings, however, it is the CRA's position that retained earnings will be reduced if there is a negative adjustment to

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[9] The CRA has adopted the position that the shareholder must be a specified non-resident shareholder at the time that the calculation under subsection 18(4) is made. Accordingly, contributions to surplus made by a person that was a specified non-resident shareholder at the time the contribution was made but that, for example, sold its Canco shares to a Canadian affiliate later in that same year, would not be included in the surplus calculation. See "Thin Capitalization", Technical Interpretation of the Reorganizations and Foreign Division, Rulings Directorate in CCH Tax Window Files [this is an online data base], document number 9521415, dated November 20, 1995. However, for a possible contrary view, see "Capitalization Rules Applicable to Non-Resident", Technical Interpretation of the (French) Reorganization and International Division, Rulings Directorate, in CCH Tax Window Files, document number 1996 - 9523657, dated October 3, 1996.

[10] The inclusion of "retained earnings of another corporation" does not apply to those of a predecessor corporation, when calculating the retained earnings of an amalgamated corporation. See "Thin Capitalization", Technical Interpretation of the Reorganizations and Resources Division of the Rulings Directorate, document number 2005-0121941E5, dated November 29, 2005.

[11] *Interpretation Bulletin* IT-59R3, "Interest on Debt Owing to Specified Non-Residents (Thin Capitalization)," September 26, 1984, paragraph 8.

[12] Section 3861 (formerly CICA 3860) applies to all private corporations unless they can follow Section 1300, Differential Reporting, of the CICA Handbook. To be entitled to do so, a corporation must not have any public accountability and all its shareholders must give their unanimous consent in writing to the application of the differential reporting options prior to the completion of the financial statements.

[13] "The CCRA Forum," in *Income Tax and GST Planning for the Purchase, Sale, and Canada-U.S. Expansion of a Business*, 1996 Corporate Management Tax Conference, 24:1-21, question 6. Toronto: Canadian Tax Foundation, 1996.

retained earnings as a result of the application of Section 3861.[14] Accordingly, in many cases, Section 3861 will result in a denial of interest deductions because retained earnings will be reduced or eliminated and there will be no corresponding increase in the paid-up capital of the relevant shares.[15]

- If Non-Resident Debt exceeds two times Equity, the thin capitalization rules will apply even if the interest rate charged is reasonable in the circumstances or represents arm's length rate.[16]

II. SPECIFIED NON-RESIDENT SHAREHOLDER

The term "specified non-resident shareholder" is defined in subsection 18(5) to mean a "specified shareholder" of Canco who is a non-resident person or a non-resident-owned investment corporation. A "specified shareholder" in turn, is defined as a person who, *either alone or together with* other non-arm's length persons, *owns* shares of Canco that represent either 25% or more of the votes of Canco or 25% or more of the value of Canco. The phrase "either alone or together with", when read in conjunction with the word "own" referred to later

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14 "CICA 3860 [now CICA 3861] Shares Reclassified as Debt", Technical Interpretation in CCH Tax Window Files, document number 9619120, dated June 4, 1996 and "Tax Implications of New CICA Handbook Section 3860 [now CICA 3861]," Technical Interpretation of the Financial Institutions Section of the Rulings Directorate, in CCH Tax Window Files, document number 9615465, dated July 17, 1996. See also *Interpretation Bulletin* IT-532, "Part I.3 – Tax on Large Corporations", October 13, 2000, paragraph 11.

15 Patricia L. O'Malley and Wayne L. Tunney, "New Accounting Standards and Tax Planning Transactions: Trouble Ahead for Your Balance Sheet?" *Report of Proceedings of the Forty-Eighth Tax Conference*, 1996 Conference Report, 20:1-36, at 20:18-22.

16 In *Specialty Manufacturing Ltd.* v. *The Queen*, 99 DTC 5222 (FCA), the taxpayer argued that, in the context of the *Canada-U.S. Tax Treaty* (the "**Treaty**"), the charging of an arm's-length interest rate ousts the thin capitalization rules. In that case, the taxpayer was indebted to two U.S. corporations to which it was related. The amount of debt in question exceeded the (old) 3:1 debt to equity ratio and the CRA disallowed a portion of the interest deduction claimed by the taxpayer, based on the thin capitalization rules. The parties agreed that the rate of interest charged on the loans was an arm's-length rate. The taxpayer argued that Article IX of the Treaty (which permits Canada to adjust amounts in respect of arrangements between a Canadian resident and a related U.S. resident if such arrangements differ from those that would have been made between unrelated persons) implicitly precluded the CRA from adjusting deductions where the arrangements between the parties were arm's length. Accordingly, if the interest rate charged was an arm's-length rate, the thin capitalization rules did not apply. The Tax Court of Canada, however, rejected the taxpayer's argument in this regard and concluded that the Treaty did not override the thin capitalization rules. The taxpayer appealed to the Federal Court of Appeal which dismissed the taxpayer's appeal based on the Court's view that the arrangements between the taxpayer and the non-resident were non-arm's length given the 100,000:1 debt-to-equity ratio of the taxpayer. The Federal Court of Appeal therefore never had to decide whether the Treaty overrode the thin capitalization rules.

in the "specified shareholder" definition, implies that the person must own at least one share of Canco before the Canco shareholdings of any non-arm's length person are taken into account. For example, if a non-resident owns shares representing 1% of Canco's voting shares and a non-arm's length person owns 24% of such shares, both the non-resident and the non-arm's length person will be specified shareholders of Canco. However, if the non-resident owns no shares of Canco and the non-arm's length person owns 25% of Canco's voting shares, only the non-arm's length person will be a specified shareholder of Canco.[17]

For purposes of this specified shareholder definition, a person who has any right to Canco shares, to acquire Canco shares, or to control the voting rights of such shares is deemed to own such shares.[18] As well, where a particular person has the right to cause Canco to redeem, acquire or cancel any of its shares (other than shares held by the particular person or a person that is not arm's length to the particular person), Canco is deemed to have redeemed, acquired or cancelled the shares for the purposes of determining whether the particular person is a specified shareholder. These deeming rules, however, do not apply if the foregoing rights are not exercisable at the particular time because such exercise is contingent on the death, bankruptcy or permanent disability of an individual.

In essence, these deeming rules are anti-avoidance rules designed to ensure that a person will not be able to avoid being a specified shareholder by not actually acquiring Canco shares but nonetheless having the ability to control such shares, or by diluting its shareholder interest below the 25% threshold in circumstances where it is within its control to reverse that dilution factor. A person who would otherwise be a specified shareholder of Canco, however, will be deemed

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[17] The CRA agrees with this interpretation (see the first Technical Interpretation referred to *supra* footnote 9). The phrase "either alone or together with" should be contrasted with other phrases in the Act that apply to aggregating shareholdings of non-arm's-length parties. These other phrases make it very clear that one can look to the shareholdings of the person in question, the shareholdings of the non-arm's-length person, or the shareholdings of both such persons. See, for example, subsection 186(2) or paragraph (f) of the definition of "taxable Canadian property" found in subsection 248(1).

[18] An inequity can arise under these rules, where, for example, there are five equal shareholders of Canco, one of whom is a non-resident, and each of whom has an option to acquire a further number of shares of Canco equal to its current holdings. Although the non-resident only has a 20% equity interest in Canco, this option rule requires one to assume that only the non-resident has exercised its option but that the other Canadian shareholders have not. On this basis, the non-resident would be deemed to have twice as many shares as each of the other four Canadian resident shareholders, or 33% of the shares of Canco. Accordingly, the non-resident would be a specified non-resident shareholder of Canco.

not to be a specified shareholder if there is an agreement in place under which, on the satisfaction of a condition or the occurrence of an event that is reasonably expected will be satisfied or will occur, the person will cease to be a specified shareholder and the purpose for which the person became a specified shareholder was to safeguard its rights in respect of any debt owing to such person or to persons with whom such person was dealing non-arm's length.[19]

III. OUTSTANDING DEBTS TO SPECIFIED NON-RESIDENTS

The phrase "outstanding debts to specified non-residents" is also defined in subsection 18(5) and means the total of all amounts payable by Canco to a person who was, *at any time in the year*, a specified non-resident shareholder of Canco, or a non-resident person or a non-resident owned investment corporation that was not dealing at arm's length with a specified shareholder of the corporation.[20, 21] For these purposes, the only debts to be taken into account are debts in respect of which interest paid or payable by Canco is, or would be, but for the thin capitalization rules, deductible in computing Canco's income for the year. There are a number of interesting points to note about this definition:

- The debts in question, although they must be owing to a non-resident, need not be owing to a non-resident *shareholder*. It is sufficient, for example, if the non-resident lender is not a shareholder but is dealing non-arm's length with a Canadian resident that is a specified shareholder of Canco. This means that, while interest-bearing debt owing to a non-resident non-shareholder may constitute Non-Resident Debt, any surplus contributed by such non-resident person to Canco will not be included in calculating Canco's Equity because the non-resident person is not a specified non-resident shareholder of Canco.

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[19] Subsection 18(5.1).

[20] After June 27, 1999, debt owing to a foreign bank is excluded from the definition of "outstanding debts to specified non-residents" if the bank uses or holds that debt in a Canadian banking business. (The interest on any such debt would be included in the foreign bank's income for Canadian tax purposes and, therefore, would be "caught" by the Canadian tax net. Accordingly, the purpose behind the thin capitalization rules (*i.e.*, to prevent earnings of a Canadian corporation from escaping Canadian tax by reason of excessive interest payments made to a non-resident) would not be invoked in the circumstances and therefore need not apply in such circumstances.)

[21] Certain debts owing to non-resident insurance corporations are also excluded from the definition of "outstanding debts to specified non-residents".

- The definition applies to the gross interest-bearing payables owing by Canco. There is no set-off for receivables that may be owed to Canco by specified non-residents. Thus, even where such receivables are equal to or greater than any payables owing by Canco to specified non-residents, the gross amount of such payables will be taken into account for the purposes of the thin capitalization rules.[22]

- Although non-interest-bearing debt is not factored into the thin capitalization equation, if such debt becomes interest-bearing at any time in the year, such debt must be included in computing Canco's outstanding debts to specified non-residents. This could happen, for example, in the case of overdue trade accounts.[23]

- Where debt is denominated in a foreign currency, it is the CRA's position that the amount of such debt, at any particular time, will be determined by converting such debt into Canadian dollars at the then prevailing rate of exchange. This position could result in an unexpected application of subsection 18(4)[24].

- A loan made by a non-resident person to a non-Canadian partnership of which Canco is a member, will be considered to have been made to the partnership and not to its partners[25] provided that each partner is jointly and severally liable for all debts of the partnership. Where, however, a partner's risk is limited with respect to a loan purportedly made to the

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[22] See Lindsay, *supra* footnote 8.

[23] In *Uddeholm Limited* v. *Her Majesty the Queen* [1987] 2 CTC 236 (FCTD), overdue trade receivables that became interest-bearing caused the taxpayer to run afoul of the thin capitalization rules. However, in *Her Majesty the Queen* v. *Thyssen Canada Ltd.* [1987] 1 CPC 112 (FCA), the Court held that late payment charges on intercompany trade accounts were not considered to be interest and, accordingly, subsection 18(4) did not apply to such charges. See also Loveland, *supra* footnote 8. See also "Thin Capitalization", Special Project, in CCH Tax Window Files, document number 2002-0135330, dated May 13, 2002.

[24] Robert D'Aurelio, "International Issues: A CCRA Perspective," in *Report of Proceedings of Forty-Second Tax Conference*, 1990 Conference Report (Toronto: Canadian Tax Foundation, 1991), 44:19, at 44:18.

[25] "The CCRA Round Table," in *Report of Proceedings of Forty-Fourth Tax Conference*, 1992 Conference Report (Toronto: Canadian Tax Foundation, 1993), 54:1-37, question 12. Where however, it may reasonably be considered that the partnership was formed primarily to avoid the application of the thin capitalization rules, the general anti-avoidance rule will be considered. See also *supra* footnote 7.

partnership, such loan will be treated as having been made to the partner.[26]

- Accrued interest that is in respect of an unpaid interest payment, is included in the calculation of Canco's Non-Resident Debt[27] but only if interest is charged on the accrued interest.[28]

- Non-Resident Debt does not normally include a debt where the interest payable for the year by Canco has been formally waived by the creditor (in a written, bilateral waiver binding on the parties) before the end of the taxation year. This is so because no interest is construed to be payable by Canco in these circumstances and, accordingly, no interest is deductible by Canco in these circumstances.[29]

IV. BACK-TO-BACK LOANS

Subsection 18(6) provides that where any loan (the "**First Loan**") is made to a person by either a specified non-resident shareholder of Canco, or by a non-resident person or a non-resident owned investment corporation that was not arm's length to a specified shareholder of Canco, on condition that a loan (the "**Second Loan**") be made by *any* person to any corporation resident in Canada, then, for the purposes of the thin capitalization rules, the lesser of the amount of the First Loan and the amount of the Second Loan is deemed to be debt incurred by the

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[26] *Wildenburg Holdings Limited* v. *MNR*, 98 DTC 6462 (Ontario Court of Justice) (confirmed on appeal, 01 DTC 5145). (*Wildenburg* was a decision of the Ontario courts because the underlying assessment was based on the thin capitalization provisions of the Ontario *Corporations Tax Act* (which mirror those in the Act). The CRA, however, has confirmed that it will follow the *Wildenburg* decision. (See "Thin Capitalization" in CCH Tax Window Files, document number 9822340, dated November 25, 1998, and *Technical News No. 16*, March 8, 1999.))

Compare *Wildenburg* with *Metro-Can Construction Ltd.* v. *HMQ*, 00 DTC 6495 (FCA) (leave to appeal to the SCC denied) wherein the Court held that, in the context of the debt forgiveness rules, the loan in question had been made to the partnership, and not its partners. See also "Thin Capitalization", Canadian Tax Foundation Roundtable Questions and Responses in CCH Tax Window Files, document number 9822340, dated November 25, 1998.

[27] R.M. Beith and C. Gouin-Toussaint, *infra* footnote 29, question 3. See also "Compound Interest and Thin Capitalization", Technical Interpretation of the International and Trusts Division, in CCH Tax Window Files, document number 2002-0136625, dated November 14, 2002.

[28] This position is set out in a Technical Interpretation dated July 25, 1994 and issued by the Reorganizations and Foreign Division of the Rulings Directorate. The basis for this decision is that non-interest-bearing debt does not form part of Non-Resident Debt.

[29] A.P.F.F. Annual Conference, question 37, in CCH Tax Window Files, document number 3m09520, dated October 8, 1993.

Canadian borrower corporation to the person who made the First Loan. In essence, subsection 18(6) is an anti-avoidance rule designed to deal with the situation in which a non-resident, instead of making a loan directly to Canco, lends the funds to another person on condition that the other person make the Canco loan.

It should be noted that for the foregoing rule to apply, it is not necessary that the borrower under the First Loan be the lender under the Second Loan. Nor is it necessary for the borrower under the Second Loan to be the Canadian corporation in respect of which the lender under the First Loan is a specified non-resident shareholder. For example, if a U.S. parent ("**Parentco**") makes a loan to a U.S. company ("**Lender A**") on condition that the Canadian subsidiary of Lender A make a loan to the Canadian subsidiary of the U.S. parent ("**Cansubco**"), subsection 18(6) will deem Cansubco to have borrowed the money from Parentco. Similarly, if Parentco makes a loan to Lender A on condition that Lender A make a loan to a wholly-owned Canadian subsidiary of Cansubco ("**Subco**"), subsection 18(6) will deem Subco to have borrowed the money from Parentco.

An exception to the back-to-back loan rule is provided for in paragraph 3 of *Interpretation Bulletin* IT-59R3.[30] In that paragraph, the CRA states that subsection 18(6) will generally only be applied in those situations in which the application of the thin capitalization rules is otherwise frustrated or circumvented. Therefore, for example, where a non-resident corporation lends money to its Canadian subsidiary, which it then reloans to another Canadian subsidiary, subsection 18(6) will not apply to the second loan provided that the thin capitalization rules apply to the initial loan.

In a Technical Interpretation dated October 2, 1996,[31] the CRA further expanded upon its position as set out in paragraph 3 of IT-59R3. In that technical interpretation, the CRA stated that it would not apply subsection 18(6) to a Second Loan in circumstances in which such loan is

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30 *Supra* footnote 11. See also R.M. Beith and C. Gouin-Toussaint, "The CCRA Round Table: Canada-U.S. and International Issues," in *Tax Planning for Canada-US and International Transactions*, 1993 Corporate Management Tax Conference (Toronto: Canadian Tax Foundation, 1994), 22:1-15, question 9.

31 "Thin Capitalization - Back-to-Back Loans", Technical Interpretation of the Reorganizations and International Division of the Rulings Directorate, in CCH Tax Window Files, document number 9617815, dated October 2, 1996.

made by a Canadian resident corporation ("**Canco 1**") to a second Canadian resident corporation ("**Canco 2**") provided that:

- the person who made the First Loan is a specified non-resident shareholder of Canco 1 and qualifies as a specified shareholder of Canco 1 (otherwise than by virtue of a right referred to in paragraph (c) or (d) of the definition of specified shareholder in subsection 18(5));
- the First Loan and the Second Loan bear that same rate of interest; and
- Canco 1 and Canco 2 are related.

In two more recent Technical Interpretations,[32] however, the CRA, drew back from its position as set out in the October 2, 1996 Technical Interpretation. In these latter interpretations, the CRA stated that although it would stand by paragraph 3 of IT-59R3, its interpretation of that paragraph was more restrictive than as set out in its earlier technical interpretation. Specifically, the CRA is of the view that paragraph 3 of IT-59R3 contemplates a situation in which a non-resident person that has *de jure* control over a Canadian resident corporation ("**Canco 1**"), makes a loan to Canco 1 and Canco 1, in turn, makes an equivalent loan to another Canadian resident corporation ("**Canco 2**") over which the non-resident person also has *de jure* control. In these circumstances, the CRA will not seek to apply subsection 18(6) provided that interest on the Second Loan exceeds interest on the First Loan.

This more recent position of the CRA therefore differs in two ways from its earlier position as set out in the October 2, 1996 Technical Interpretation. First, the earlier interpretation merely required that Canco 1 and Canco 2 be related. Although Canco 1 and Canco 2 will be related if they are both controlled by the non-resident person, they can also be related even if such common control does not exist. Thus, the requirement for common *de jure* control is more restrictive than the earlier requirement that the two Canadian corporations merely be related. Second, the CRA's new position requires that interest on the Second Loan exceed the

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32 See "Thin Capitalization - Back-to-Back Loans", Technical Interpretation of the Reorganization and International Division, Rulings Directorate, in CCH Tax Window Files, document number 9630406, dated March 27, 1998 and "Thin Capitalization - Back-to-Back Loans", Technical Interpretation of the Reorganization and International Division of the Rulings Directorate, in CCH Tax Window Files, document number 97-1335, dated March 24, 1998. See also *Income Tax Technical News No. 15*, December 18, 1998.

interest payable on the First Loan whereas the earlier position merely required that the interest rate on both loans be the same. The reason for this change in position is that interest on the First Loan would technically not be deductible if interest on the Second Loan were the same because, in such circumstances, it could not be said that Canco 1 is using the proceeds of the First Loan to earn income.

Subsection 18(6) will also not apply to transactions that have the same effect as a back-to-back loan but which are structured in a different way. For example, if Canco borrowed money from a non-resident person that is neither a specified non-resident shareholder of Canco, nor related to a specified shareholder of Canco, such loan will not be included for purposes of the thin capitalization rules even if it is guaranteed by a non-resident person that is a specified non-resident shareholder of Canco or is non-arm's length to a specified shareholder of Canco.[33, 34]

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[33] In a Technical Interpretation dated June 23, 1989 (Reference No. 7-3792), the CRA stated that subsection 18(6) will not apply to such guaranteed transactions provided that:

(a) the security for the guarantee does not consist of a debt obligation of the lender or a person dealing non-arm's length with the lender;

(b) the non-resident guarantor retains beneficial ownership of such security; and

(c) the lender does not have any control over, or the right to use, the security for any purpose until the time that Canco defaults on the loan and the non-resident lender defaults on its obligations under the guarantee.

In other words, the guarantee cannot be considered to be a loan by the non-resident or the specified non-resident shareholder of its assets to the lender.

If the specified non-resident shareholder were to acquire a term deposit of the lender, such term deposit would constitute a loan made by the specified non-resident shareholder to the lender and, as such, may well fall within the provisions of subsection 18(6). Similarly, if the specified non-resident shareholder made additional deposits with a lender bank as security for the guarantee, such deposits would be considered to be loans made to the lender and, therefore, the rules in subsection 18(4) would apply. Where, however, the security comprises of pre-existing deposits of the non-resident, the application of subsection 18(6) would depend on all the relevant circumstances. For example, if the deposits were made by the non-resident in the ordinary course of its business and were not dependent upon the loan being made by the lender, a subsection 18(6) might not apply. On the other hand, if the terms of the guarantee require the non-resident to maintain the deposits which it otherwise could have withdrawn, the terms and conditions of the deposits may have changed to such a degree that they may constitute the making of new loans by the non-resident to the lender, in which case subsection 18(6) would apply. Alternatively, if the deposit was a term deposit which was subsequently renewed pursuant to the terms of a guarantee, subsection 18(6) will generally apply at the time of the renewal.

Note that the Report of the Technical Committee on Business Taxation, *supra* footnote 7, recommended that all indebtedness (including amounts on deposit) be made subject to these back-to-back rules.

[34] The federal budget of February 28, 2000 proposed to extend the thin capitalization rules to these guarantee situations. The adverse reaction to this proposal, however, was very intense and, as a result, the Department of

V. PLANNING POINTS

The following planning points should be considered to reduce the impact of the thin capitalization rules:[35]

- Dividend payments by Canco should be delayed until after its year-end so that its retained earnings at the start of the following year are as high as possible.

- Subsidiaries of Canco should pay tax-free intercorporate dividends to Canco before its year-end so as to increase Canco's earnings at the beginning of the immediately following year.

- If it appears that Canco will be offside the thin capitalization rules, steps should be taken as soon as possible to increase its paid-up capital by capitalizing its surplus and adding it to the paid-up capital of shares owned by specified non-resident shareholders. (No deemed dividend (and, accordingly, no withholding tax) will arise on this capitalization if the contribution to surplus was originally made in the circumstances described in paragraph 84(1)(c.3).) Note, however, that the effectiveness of this capitalization will depend on the impact of the averaging rules applicable to paid-up capital, which will vary depending on the timing and amount of the capitalization and the amount of excess Non-Resident Debt.[36]

- If it is anticipated that the 2:1 debt-to-equity ratio will be exceeded in a particular year, the specified non-resident shareholder can subscribe for additional shares of Canco and thereby increase the paid-up capital of its shares in Canco. This addition to paid-up capital will not only be of assistance in the year in which such shares are subscribed for, but will also increase Canco's Equity for purposes of computing the debt-to-equity ratio in the following year. However, as in the case of the surplus capitalization, the effectiveness of this type of

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Finance issued a News Release on May 9, 2000 stating that this proposal would be deferred pending further consultation with the public. The News Release also stated that any proposal emanating from this consultation process would be brought forward on a prospective basis only. To date, nothing further has been heard from the Department of Finance with respect to this issue.

35 See Lindsay, *supra* footnote 8, at 53 and 54.

36 See *supra* footnote 6.

planning will be impacted by the averaging rules applicable to paid-up capital.

- Where specified non-resident shareholders of Canco or non-residents dealing non-arm's length with specified shareholders of Canco owe money to Canco, consideration should be given to setting off all or a portion of such payables against Canco's Non-Resident Debt, in order to reduce the gross amount of Canco's interest-bearing payables. Such set-off, however will likely result in an acceleration of withholding tax payable.

VI. CONCLUSION

The thin capitalization rules must be kept in mind in any cross-border financing situation that involves significant non-resident shareholders or non-resident persons who deal non-arm's length with significant shareholders. Moreover, it should be remembered that these rules can apply, not only at the time of initial capitalization, but also on an ongoing basis. Accordingly, careful attention should continuously be paid to the matters that might cause Canco to fall offside these rules.

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