TAX EXECUTIVES INSTITUTE, INC.

September 26, 2014

Please Respond To:
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Tax Policy Branch
Department of Finance
90 Elgin Street
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Re: *Back-to-Back Loan Arrangements*

To Whom It May Concern:

On August 29, 2014, the Government released draft legislative proposals and explanatory notes in respect of numerous measures announced in the 2014 Budget Message. On behalf of Tax Executives Institute (TEI), I am writing to express our comments and concerns about the revised proposals relating to back-to-back loan arrangements through intermediaries (hereinafter "the Proposals").

Background on Tax Executives Institute

TEI is the preeminent international association of business tax executives. The Institute's more than 7,000 professionals manage the tax affairs of nearly 3,000 of the leading global companies. Canadians constitute approximately 15 percent of TEI's membership, with our Canadian members belonging to chapters in Calgary, Montreal, Toronto, and Vancouver. TEI members must contend daily with the planning and compliance aspects of Canada's business tax laws, including its treaties. Many of our non-Canadian members work for companies with substantial activities and investments in Canada. The comments set forth in this letter reflect the views of TEI as a whole, but more particularly those of our Canadian constituency.

TEI concerns itself with important issues of tax policy and administration and is dedicated to working with government agencies to reduce the costs and burdens of tax compliance and administration to our common benefit. In furtherance of this goal, TEI supports efforts to improve the tax laws and their administration at all levels of government. We believe that the diversity, professional training, and global viewpoint of our members enable us to bring a balanced and practical perspective to the issues raised by the Proposals.

Legislative Consultation Background

In our April 10, 2014, comments on the 2014 Budget Message, we observed that these Proposals represent the third successive Budget in which the Government has broadened the scope, and tightened the requirements, of Canada's thin capitalization regime and the related withholding tax requirements (hereinafter the "Thin Cap regime"). TEI supports the Government's aim of ensuring that the Thin Cap regime is neither frustrated nor improperly avoided, but we continue to believe that the Proposals are overbroad, will adversely affect numerous ordinary commercial financing arrangements, and undermine the competitiveness of Canadian businesses. As a result, TEI reiterates its recommendation that the Proposals be abandoned; instead, the Government should rely upon anti-avoidance measures already in the Act to address its concerns.

In the event that the Government decides against abandoning the Proposals, we offer the following recommendations to narrow their scope and prevent their application in inappropriate facts and circumstances. We believe that our recommendations are consistent with the aims of the legislation and — much like the August revisions to the February 2014 version of the Proposals — will provide greater clarity for taxpayers and Canada Revenue Agency (CRA) alike and afford taxpayers both appropriate relief and more certainty for their financing arrangements.

Recommendations

A. *Clarification of "specified right"*

The explanatory notes to the 2014 Budget Message stated that a "guarantee," in and of itself, would not be considered a pledge of property triggering the Proposals. The corresponding legislative language released with the Budget, however, was unclear about the provision's scope. With the introduction of the defined term "specified right" in subsection 18(5) in the August 29 draft legislation, we believe the Government has ameliorated concerns about "guarantees." Hence, TEI welcomes the change.

In a similar fashion, though, the explanatory notes to the August 29 Proposals state, in part, "[a]n intermediary will not be considered to have a specified right in respect of a property solely by virtue of having been *granted a security interest* in the property." (Emphasis supplied.) TEI believes the expression of the legislation's intent to preclude the mere grant of a security interest from triggering the rules is similarly helpful, but we believe that additional statutory language should be incorporated in the proposed definition of "specified right" to eliminate uncertainty about an important commercial issue and ensure that the mere granting of security interests in property will not trigger the Proposals. This can be accomplished, for example, by adding to the end of the proposed definition of "specified right" the following phrase: "and excludes a security interest."

B. *Addition of purpose test to new triggering rule*

In the 2014 Budget Message, the Government explained that it was targeting debts owing by a taxpayer to an intermediary where the intermediary receives a limited recourse loan or a conditional loan from a particular person having specified relationships with the taxpayer. The Proposals expand the triggering rules by adding proposed clauses 18(6)(c)(i)(D) and (ii)(B). Under the new clauses, the application of the rules will be triggered where "it can reasonably be concluded" that, if the intermediary's debt did not exist or if the specified right had not been granted, either all or a portion of the taxpayer's debt would not be outstanding or the terms or conditions of the taxpayer's debt would be different.

TEI submits that the phrase "it can reasonably be concluded" is overbroad and the added test is highly subjective. We recommend revising the test to include a "principal purpose" test similar to the one found in paragraph 95(6)(b). There are many commercial, non-tax reasons why the amount or terms of a loan might be different if the intermediary debt or specified right did not exist. Adding a "principal purpose" requirement to the test in proposed clauses 18(6)(c)(i)(D) and (ii)(B) will ensure that the proposed triggering rules do not catch transactions that should not be subject to the Thin Cap regime.

Absent a "principal purpose" requirement, we believe that this test will unnecessarily broaden the scope of the rule, create substantial uncertainty about the interpretation of the Proposals, and increase the number, scope, and degree of controversies between taxpayers and CRA. Indeed, CRA auditors may "reasonably conclude" that the facts and circumstances should be interpreted differently from an equally reasonable conclusion a taxpayer might reach in respect of the same facts and circumstances. Hence, we recommend revising this prong of the test by adding a "principal purpose" test to better target offside arrangements, narrow the scope of controversies, and minimize the provision's potential application to ordinary commercial arrangements.

C. *Balancing the 25 percent de minimis test*

Example 3 of the explanatory notes to the Proposals illustrates that the Proposals may apply to certain cash-pooling arrangements that Canadian businesses have with third-party banks. On the other hand, Example 2 of the explanatory notes illustrates how the 25 percent *de minimis* rule in proposed paragraph 18(6)(d) provides a safe harbour by adding to the denominator of the formula in that provision certain amounts loaned by the intermediary to persons not dealing at arm's length with the taxpayer (provided those amounts are owing under the same loan agreement as the taxpayer's loan agreement or an agreement connected thereto). TEI believes that this safe harbour is critical to ensuring that the Proposals do not inadvertently apply to ordinary commercial financing arrangements. More important, while we believe the threshold would be better if it were increased from 25 to 50 percent, the proposed paragraph should, at a minimum, be revised in two respects.

First, the proposed phrase ". . . an agreement *that is connected to* the agreement . . ." in proposed subparagraph 18(6)(d)(ii) is vague. (Emphasis supplied.) TEI recommends replacing that phrase with ". . . an agreement *with respect to* the agreement . . . ." We believe this change would be consistent with the aim of the provision and is clearer because of well-established jurisprudence interpreting the phrase "with respect to."

Second, the reference to "the intermediary" in proposed subparagraph 18(6)(d)(ii) should be revised to refer to "the intermediary or a person or partnership that does not deal at arm's length with the intermediary." We note that the triggering points in proposed subparagraphs 18(6)(c)(i) and (ii) are applied to "the intermediary or a person or partnership that does not deal at arm's length with the intermediary." We believe paragraphs 18(6)(c) and (d) should have comparable scope and consistent reach and thus recommend this additional language for subparagraph 18(6)(d)(ii).

D. *Congruency of the Interest Disallowance Rules with Part XIII Withholding Tax*

The intent of proposed subsections 212(3.1) to (3.3) is to ensure that the withholding tax rules in Part XIII of the Act are not circumvented by financing arrangements where a non-resident of Canada provides debt funding to a taxpayer resident in Canada through an intermediary instead of providing the funding directly and in a manner that would have triggered the Thin Cap regime. Moreover, we believe those rules are intended to parallel, and have comparable reach as, the proposed interest expense disallowance rules in subsections 18(6) and (6.1). We note, however, that the equivalent of paragraph 18(6)(b) was omitted from subsection 212(3.1). Specifically, proposed paragraph 18(6)(b) states, as follows:

(b) *the intermediary is neither:*

(i) *A person resident in Canada with whom the taxpayer does not deal at arm's length, nor*

(ii) *A person that is, in respect of the taxpayer, described in subparagraph (a)(i) of the definition "outstanding debts to specified non-resident" in subsection (5)*;

Likewise, the clarification included in proposed subparagraphs 18(6)(c)(i) and (ii) of the August 2014 version of the draft legislation (which includes the phrase: ". . . *in respect of the taxpayer, described in subparagraph (a)(i) of the definition 'outstanding debts to specified non-residents' in subsection (5)* . . . ") omits a similar phrase from the parallel proposed subparagraphs 212(3.1)(b)(i) and (ii).

To clarify the operation of the withholding tax rules and ensure consistency with the rules governing the disallowance of interest expense deductions, we recommend that:

(1) proposed subsection 212(3.1) be revised to include a new paragraph (b) that contains the same limitations set forth in proposed paragraph 18(6)(b); and

(2) proposed, re-numbered subparagraphs 212(3.1)(c)(i) and (ii) include the same clarifications that are set forth in the parallel proposed subparagraphs 18(6)(c)(i) and (ii).

We note that cross references could also be made to the definitions in subsection 18(5) in the same manner as is done elsewhere in proposed subsection 212(3.1) (*see, e.g.*, the language of proposed subparagraph 212(3.1)(b)(ii)).

Conclusion

Absent additional clarifications and revisions, we believe the Proposals remain overbroad and will — to the detriment of Canadian businesses — apply to many ordinary commercial financing transactions. Hence, we urge the Department to incorporate TEI's recommendations.

TEI's comments were prepared under the aegis of its Canadian Income Tax Committee, whose chair is Grant L. Lee of HSBC Bank Canada. Should you have any questions about TEI's comments, please feel free to contact Mr. Lee at 604.641.2502 (or grant_lee@hsbc.ca) or Paul T. Magrath, TEI's Vice President for Canadian Affairs, at 905.804.4930 (or paul.magrath@astrazeneca.com).

Respectfully submitted,

Tax Executives Institute, Inc.

Mark C Silbiger

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International President

cc: Brian Ernewein, General Director, Tax Policy Branch
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