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Le 27 septembre 2016

Monsieur Ted Cook  
Directeur, Direction de la politique de l'impôt  
Ministère des Finances Canada  
90, rue Elgin  
Ottawa (Ontario) K1A 0G5

**Objet : Règles relatives aux mécanismes d'adossement dans l'avant-projet de loi du 29 juillet 2016**

Monsieur,

Vous trouverez ci-joint un mémoire portant sur l'élargissement des règles relatives aux mécanismes d'adossement dans l'avant-projet de loi du 29 juillet 2016. Ce mémoire sert de complément à notre mémoire daté du 25 juillet 2016 et aux discussions que nous avons eues sur l'avant-projet de loi.

Un certain nombre de membres du Comité mixte et d'autres spécialistes de la fiscalité ont pris part aux discussions ayant abouti à ce mémoire et ont contribué à sa rédaction, notamment :

R. Ian Crosbie  
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Nous espérons que vous trouverez nos commentaires utiles et souhaitons continuer de collaborer avec vous pour répondre aux préoccupations des fiscalistes quant à l'avant-projet de loi. Nous serions donc heureux de vous rencontrer, au moment que vous jugerez opportun, pour discuter de notre mémoire et de toute autre question que vous pourriez avoir.

Nous vous prions d'agréer, Monsieur, nos salutations distinguées.

Kim G. C. Moody  
Président, Comité sur la fiscalité  
Comptables professionnels agréés du Canada

K.A. Siobhan Monaghan  
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C.c. : Brian Ernewein, directeur général, Division de la législation de l'impôt, Direction de la politique de l'impôt, ministère des Finances Canada  
Peter Repetto, chef, Investissements internationaux à l'extérieur du pays, Division de la législation de l'impôt, Direction de la politique de l'impôt, ministère des Finances Canada  
Gabe Hayos, vice-président, Fiscalité, CPA Canada

## **CBA – CPA Canada Joint Committee on Taxation Submission – Back-to-Back Proposals**

Budget 2016 proposed four changes to the “back-to-back” rules in Part XIII of the *Income Tax Act* (Canada) (the “**Act**”).

Specifically, Budget 2016 contained proposals to:

1. Extend the back-to-back rules to royalties and similar payments;
2. Enact new “character substitution” rules;
3. Enact a new back-to-back rule focused on upstream loans to shareholders and persons connected to shareholders; and
4. Enact “multiple intermediary” rules.

Following our face-to-face meeting in June, we provided you with a written submission dated July 25, 2016. In that submission, we described numerous fact patterns that might be caught by these new rules were they drafted too broadly. We provided several recommendations, the purpose of which was to minimize the instances in which inappropriate adverse consequences would result from the application of these rules.

The Department of Finance released detailed legislative proposals to implement the back-to-back proposals (among other measures) on July 29, 2016, just a few days after our submission. The release invited comments on the legislative proposals by September 27, 2016.

In view of the timing of the release, it is apparent that our submissions were not fully considered prior to the release of the legislative proposals. Based on our review of the legislative proposals, and further consideration, for the reasons articulated in our July 25, 2016, we now reiterate our concerns and recommendations, including the following recommendations:

1. The back-to-back rules should not be extended to royalties paid or credited to a person dealing at arm’s length with the payor.
2. The extension of the back-to-back rules should be limited to payments that are “rents, royalties and similar payments”, and should not extend to other payments that may be taxable under paragraph 212(1)(d).
3. The extension of the back-to-back rule to royalties should be limited to fact patterns where a withholding tax avoidance purpose is present.
4. The “character substitution” back-to-back rules should be limited to fact patterns where a withholding tax avoidance purpose is present.
5. The “character substitution” back-to-back rules should not apply to amounts paid or credited to a person dealing at arm’s length with the payor.

6. The back-to-back shareholder loan rules should apply only to debt incurred after 2016.
7. The application of the back-to-back shareholder loan rules to notional cash pooling arrangements should be deferred until consultations with affected taxpayers are undertaken, with a view to determining whether a suitable carve-out for non-tax motivated notional cash pooling arrangements can be developed.
8. The back-to-back shareholder loan rules should apply only where one of the purposes of the transaction is to circumvent subsection 15(2).

The legislative proposals contain an extremely detailed set of definitions and mechanical rules. In our view, this approach to legislative drafting is particularly likely to give rise to inappropriate or unintended results where the scope of such rules is extremely broad and a threshold tax avoidance purpose requirement is not a condition of the application of the rules.

### ***Examples of technical glitches***

Although the tax community has had limited time to review these proposals, already a number of anomalies and technical problems have been identified, including the following:

#### **Duplicative Application of Subsection 15(2)**

According to the explanatory notes, proposed paragraph 15(2.16)(b) is intended to ensure that the rules do not apply in respect of an amount that is otherwise subject to subsection 15(2). However, the legislation does not apply that way in some situations. Paragraph 15(2.16)(b) states that the rules would apply only if subsection 15(2) would not, in the absence of subsections 15(2.16) and (2.17), apply to the “shareholder debt” referred to in paragraph 15(2.16)(a). One problem is illustrated by the following example: Canco makes a loan to USParentco, USParentco on-lends the funds to a USSisterco. Under paragraph 15(2.16)(a), USSisterco is the “intended borrower”, USParentco is the “immediate funder” and the “shareholder debt” is the loan made by USParentco to USSisterco. Since this “shareholder debt” is between two non-resident corporations, subsection 15(2) would not otherwise apply because of subsection 15(2.2). The result is that the rules could apply to deem Canco to have made a loan to USSisterco, notwithstanding that the loan from Canco to USParentco would already be subject to subsection 15(2). This would result in double tax.

This particular glitch can be fixed by excluding a debt or other obligation to pay an amount from subparagraph 15(2.16)(c)(i) to the extent that it is already subject to subsection 15(2) or would be subject to subsection 15(2) but for a PLOI election under subsection 15(2.11). The revised wording could be as follows:

- (i) has an amount outstanding as or on account of a debt or other obligation to pay an amount (other than a debt or other obligation to pay an amount to which subsection 15(2) applies or would apply if it were not a pertinent

loan or indebtedness described in subsection 15(2.11)) to a person or partnership that meets either of the following conditions:

We further believe it would be prudent to also add an overriding condition that the back-to-back shareholder loan rule should apply only where one of the main purposes of the transaction in question is to circumvent the application of subsection 15(2). Such an approach would address the very likely instances of future situations arising where similar technical glitches are encountered. In the absence of a purpose test, the rule is overly mechanical in its application.

#### Character Substitution Rules – Common Shares

Under proposed paragraph 212(3.6)(a), the character substitution rules in proposed subsection 212(3.7) would apply in respect of shares of the capital stock of a particular relevant funder if, among other conditions, “the particular relevant funder has an obligation to pay or credit a dividend on the shares, either immediately or in the future and either absolutely or contingently, to a person or partnership”. This is an extremely broad formulation, but also in our view technically deficient because a relevant funder will always have an obligation to pay a dividend once that dividend is declared. In corporate law, once declared, a dividend generally becomes a debt obligation of the issuer. Thus, this language does not distinguish shares that may be intended to be captured from those that may not be intended to be captured.

This issue could perhaps be addressed by replacing the reference to “an obligation to pay or credit a dividend” with a reference to “an obligation to declare a dividend”.

Similar concerns arise under proposed paragraph 212(3.92)(a), although the language of that provision is slightly different from that in proposed paragraph 212(3.6)(a). That is, whereas proposed paragraph 212(3.6)(a) refers to the particular relevant funder having “an obligation to pay or credit a dividend on the shares, either immediately or in the future and either absolutely or contingently, to a person or partnership”, proposed paragraph 212(3.92)(a) refers to a situation where “at any time at or after the time when a particular lease, license or similar agreement referred to in paragraph (3.9)(a) was entered into — the particular relevant licensor has an obligation to pay or credit an amount as, on account or in lieu of payment of, or in satisfaction of, a dividend on the shares, either immediately or in the future and either absolutely or contingently, to a person or partnership”. It is not obvious whether these wording differences are intended to produce any different effect, which in itself may result in unintended implications. It would be preferable for the language of the two provisions to be reconciled if the same effect is intended, or to be more clearly distinguished if a different effect is intended.

Based on our conversations with you, we also understand that this rule is not intended to be limited to situations where the share terms or associated agreements require the dividends to be paid. In our view, such a broad application of the rule would create enormous uncertainty and would not provide the Canadian payor with any meaningful way to determine whether subsequent events might cause the character substitution rules to

be invoked. Indeed, the Canadian payor would be required to determine its withholding obligations from various factual circumstances which, in some cases, may arise only many years after the initial payment (for example, if the funds are initially retained by the recipient and used to pay a dividend a number of years later).

#### Interaction with Section 216 Elections

Another example of a technical glitch arises in relation to circumstances in which a Canadian resident is paying rent to a non-resident taxpayer and the non-resident taxpayer has made a section 216 election to be taxed under Part I of the Act rather than Part XIII of the Act. In such circumstances, in the event that the non-resident taxpayer is making payments to another non-resident, the Canadian resident may be deemed to be making payments to that other non-resident, but the latter will not have and will not be in a position to make a section 216 election. Although we do not believe the rules in general should be interpreted broadly enough to link a real estate rental payment to the payment of interest on a mortgage used to finance the acquisition of the property, the uncertainty in the causal connection rule has caused some practitioners to question this position. In the section 216 context, the property owner will be required to include the rental payment in income for Part I purposes (as if the non-resident were a resident of Canada) so it obviously makes no sense to apply the back-to-back rules in this context. One simple way to address this anomaly would be to exempt rental payments that are subject to section 216 treatment from the ambit of these rules.

#### Specified Shares

Where a relevant funding arrangement (“RFA”) as described under paragraph (c) of that definition exists because of the existence of specified shares, there does not appear to be a relevant funder in respect of that RFA: the definition of relevant funder does not contemplate a paragraph (c) RFA. Paragraph (c) of the RFA definition seeks to identify specified shares that meet the conditions in subparagraph 3.1(c)(i) or (ii), but those provisions contemplate debts and specified rights, but not specified shares.

Accordingly, the interaction of these provisions is uncertain and should be clarified.

### ***Scope Considerations***

We cannot emphasize enough the concerns we have with respect to the extremely broad scope of these proposals. The addition of character substitution rules only serves to intensify these concerns – particularly with reference to a variety of *bona fide* arm’s length commercial transactions. As noted above, the tax community has only had limited time to review these proposals and to consider their implications in practice. Nevertheless, we are already observing real world concerns, including the following:

Back to Back Royalty Arrangement/Character Substitution Rules  
Unintended Implications for Cross-Border Securitization Transactions

Asset securitization is a common form of secured borrowing whereby a party seeking financing (the “**Original Owner**”) secures lower borrowing costs by segregating a portion of its property to service the debt. This is often achieved by the Original Owner selling income-generating assets to a bankruptcy-remote special purpose vehicle (an “**SPV**”) which issues notes, typically with fixed interest rates, (“**Notes**”) secured by the assets to arm’s length investors (“**Noteholders**”). The SPV uses the proceeds of the arm’s length borrowing to pay for the assets. The character substitution rules included in the back-to-back rent/royalty proposals appear to have an unintended implication for certain cross-border lease or royalty securitization transactions.

Such transactions may occur where both foreign and Canadian assets (e.g, equipment subject to leases with arm’s length parties, or intellectual property licensed to arm’s length parties) are sold to a non-Canadian SPV entity (the “**Foreign SPV**”) which acts as the global Note issuer for the corporate group. In some circumstances it is not commercially expedient or efficient to establish a separate Canadian SPV issuer of Notes – particularly where the Canadian assets comprise only a small portion of the total securitized portfolio. In these circumstances, the Foreign SPV will often be entitled to a reduced rate of Part XIII tax on Canadian-sourced cross-border rent, royalties or similarly payments it receives under an applicable treaty.

Proposed subsection 212(3.93) could deem the Notes to be “relevant royalty arrangements” and the Noteholders to be “relevant licensors” even though the Notes have a fixed interest rate. In particular, we are concerned that in many situations the condition in proposed subparagraph 212(3.92)(b)(ii) could be satisfied because it may be reasonable to conclude that the particular lease or license agreement with the Foreign SPV was entered into or permitted to remain in effect either because the Notes were issued or were anticipated to be issued. Because of the breadth of subsection 212(3.92), the same conclusion might be drawn where the Notes are issued by another foreign entity that then funds the Foreign SPV by way of debt or equity.

If proposed subsection 212(3.93) were to apply to the Notes as described above, a Canadian payor of rents, royalties or similar payments to the Foreign SPV would be deemed by proposed subsection 212(3.91) to have paid amounts of the same character to the Noteholders, unless the withholding tax that would be payable on such deemed payments does not exceed the treaty-reduced withholding tax payable on the actual payments to the Foreign SPV (proposed paragraph 212(3.9)(c)). As a practical matter, it will almost certainly be impossible for the Canadian payors to confirm whether this is the case (given their inability to determine the identity of the Noteholders, which may also change from time to time, and may include investment partnerships and other collective investment vehicles) and, accordingly, such payors would be forced to withhold tax based

on the domestic withholding tax rate of 25% or risk facing the assessment of tax and associated penalties and interest for failure to withhold.

The back-to-back/character substitution rules, as illustrated by the example in the explanatory notes, are stated to be intended to target arrangements that attempt to avoid or reduce withholding tax on rents, royalties or similar payments by transacting through one or more intermediaries. The asset securitization transactions described above do not constitute such arrangements. Rather, they are in essence secured borrowing transactions undertaken (albeit indirectly) by the Original Owner. If the Notes were issued by the Original Owner, interest paid to the Noteholders by the Original Owner (whether it is Canadian resident or not) would not be subject to Part XIII tax. Accordingly, in determining whether the proposed rules apply, the comparison in proposed paragraph 212(3.9)(c) should be between: (i) the withholding tax that would be paid on interest on the Notes paid by the Foreign SPV (or that would be paid if the interest was instead paid by the Original Owner) if the Foreign SPV (or the Original Owner) were resident in Canada, and (ii) the Part XIII tax otherwise payable on the rent, royalties or similar payments made by the Canadian lessees/licensees. A narrower “fix” would be to provide that proposed subparagraph 212(3.92)(b)(ii) does not apply where Foreign SPV (the “relevant licensor”) and the Original Owner deal at arm’s length with the Noteholders (the “ultimate funders”).

Further, what this example illustrates quite graphically is that extending the scope of the back-to-back rules and the character substitution rules to situations involving *bona fide* arm’s length transactions is fraught with difficulty and risk that the tax law will have the effect of undermining the efficient and effective functioning of capital markets and resource allocation and investment decisions. For instance, if the market response to the above example is to exclude Canadian assets from global securitization vehicles, the effect is likely to be to increase the cost of capital and funding (or accessing technology) to Canadian businesses, whether owned by Canadians or non-residents.

Thus, here too, we would emphasize that a prudent approach would be to provide that the new rules apply only where one of the main purposes of the transaction in question is tax avoidance, consistent with the purpose expressed in the explanatory notes. Without such a condition, it is likely that these rules will interfere with a wide spectrum of legitimate arm’s length commercial arrangements, only some of which have yet to be noticed.

### ***Concluding Comments and Recommendations***

Accordingly, we strongly urge the Department of Finance to take a more incremental approach to permit the rules to be developed and tailored appropriately to each main category of circumstances, and to permit further consultations with affected stakeholders.

In general, we see five main categories of circumstances. In all cases, “A” is a Canadian resident and “C” is a non-resident, and A makes payments to another person, “B” (resident or non-resident), that makes payments to C.

- A. In Case A, each of A, B and C are dealing at arm's length. In our view, this case should be out of scope of the current rules and proposals.
- B. In Case B, A is dealing at arm's length with B, but B and C are non-arm's length. In our view, this too should be out of scope of the current rules and proposals. A cannot reasonably be expected to police and take responsibility for any arrangements that B and C may have in place. Unless A is not risk-averse or has significant bargaining power relative to B/C, the result as a practical matter in many cases will be that A will either not enter into the transaction or will incur effectively unrecoverable gross-up costs.
- C. In Case C, A is not dealing at arm's length with B, but B and C are at arm's length. Once again, it is our view that this case should be out of scope of the current rules and proposals. If C is at arm's length with A/B, it would be very unusual for a tax policy concern to arise. If B is resident in Canada, then payments by B to C would already in general be subjected to the appropriate withholding tax. If B is a non-resident, then payments from A to B would already in general be subjected to the appropriate withholding tax.
- D. In Case D, A, B, and C are not dealing at arm's length. In this case, we understand that there can be tax policy concerns. We nevertheless believe that, even in this case, the rules should be constructed in such a way as to not be overly broad or assume the worst. That is, the rules should be focussed on situations of real withholding tax avoidance, and that avoidance should be identified and measured properly. They should not be triggered simply because the non-resident members of the group may engage in foreign income tax planning. Moreover, the rules should not creep by stealth toward becoming a broad unilateral anti-treaty shopping regime. Such a measure has been considered by the Government of Canada and has been withdrawn pending the current international developments in relation to the OECD BEPS initiative (in particular, under Action 6 and Action 15). There are important differences between what may be viewed as an "anti-conduit rule" and a broader treaty-shopping regime. Moreover, with reference to "character conversion" considerations, it is not at all obvious that character should be determined based on that of the payments between A and B rather than those between B and C.
- E. In Case E, A and C are not dealing at arm's length, but B is at arm's length with each of them. In other words, this is the type of case where A and C have interposed an arm's length party between them in general (though not necessarily) in order to achieve a Canadian withholding tax benefit. We understand that this was the main type of case targeted by the introduction of subsection 212(3.1) and related provisions. Thus, while we understand why this type of case would remain within the scope of the current rules, nevertheless we are concerned about situations where the rules may apply even though there is no Canadian withholding tax planning. For example, this type of case would include many perfectly *bona fide* cash pooling arrangements which are not entered into with a tax avoidance purpose.

In brief, we strongly urge the Department of Finance to exclude Cases A, B and C from the current rules and proposals, and to revisit and refine the tests that would be applied in Cases D and E, in



order to better balance the protection of the Canadian tax base objective with the interest of not unduly penalizing taxpayers that are not engaging in Canadian withholding tax avoidance. In particular, reliance on the vague term “because” gives rise to far too much uncertainty with respect to whether an appropriate balancing has been achieved. While we do not exclude the possibility of tax policy concerns arising in relation to Cases A, B and C, we expect they would be extremely rare and addressing them would require more refinement and consultation. As always, we would be pleased to provide any assistance we can toward achieving such a better balance.