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The Canadian federal interest withholding tax regime

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Authors: Gregory Wylie, David Davachi

Most payments of interest made by Canadian borrowers to arm's length non-Canadian lenders do not attract Canadian federal withholding tax. Payments of interest, however, made by a Canadian borrower to a non-arm's length non-Canadian lender do attract Canadian federal withholding tax, charged at the rate of 25% of the gross amount of interest paid, subject to any reduction in such rate under a tax treaty or convention between Canada and the jurisdiction in which the recipient of the interest resides. The carve-out for interest paid to arm's length lenders arises under the *Income Tax Act* (Canada) (the Tax Act) which means its application does not depend upon the existence of an income tax treaty or convention. Furthermore, it applies regardless of the jurisdiction of residence of the lender, or of the nature of the lender (e.g., corporation, limited liability company, trust, or partnership).

Arm's length status

A third-party commercial lender and a borrower would ordinarily be expected to deal at arm's length. For purposes of the Tax Act, a corporation that is "related" to a person is deemed to not deal at arm's length with that person. A corporate borrower and lender would generally only be related in situations of common legal control, either where (a) one person controls the other or (b) each is a corporation under common direct or indirect control by the same person or group of persons. Legal control of a corporation is generally derived through the majority ownership of the corporation's voting equity to give the right to appoint a majority of the corporation's board of directors. Certain rights in respect of shares, such as options, must be taken into account when making this determination. A specific rule of the Tax Act ensures that, where a lender acquires control of the voting equity of a corporate borrower in furtherance of a security arrangement to protect a loan made to the borrower without more, the lender is deemed to not have control of the borrower.

In the case of unrelated persons, it is a question of fact whether they deal with each other at non-arm's length. Although the concept of arm's length in fact is not set out in the Tax Act, the Canadian courts have elaborated on its meaning. It can be considered a relationship where the circumstances do not reflect an ordinary commercial transaction between parties acting in their own separate interests. Generally, in the context of a particular transaction, two unrelated parties can be considered non-arm's length where:

- there is a common mind directing the bargaining for both parties,
- the parties are acting in concert with respect to a common interest, including one party acting as an accommodation to the other to achieve a tax benefit, or
- there is control in fact as between the parties, as for example where one party has excessive advantage or influence over the other.

None of these are expected features of an ordinary commercial lending relationship. Even in

circumstances where a lender enforces security following an event of default, it should not be expected (absent extraordinary circumstances) that the lender would thereby exercise a level of control over the borrower resulting in a non-arm's length relationship.

There is a specific rule in the Tax Act dealing with circumstances in which interest and principal are held by different parties – typically done to allow for separate trading of the interest coupon. The rule applies to deem a non-arm's length relationship to exist between the borrower and an otherwise arm's length non-resident recipient of interest where the principal in respect of the borrowing is held by a person who is non-arm's length with the borrower. Where this rule applies, the interest paid to arm's length non-residents will be subject to Canadian federal withholding tax.

Participating debt interest

Interest withholding tax under the Tax Act also applies to interest that is "participating debt interest", even if paid to an arm's length lender. Participating debt interest is defined to mean interest all or any portion of which is contingent or dependent upon the use of or production from property in Canada, or that is computed by reference to revenue, profit, cash flow, commodity price or any other similar criterion, or by reference to dividends paid or payable to shareholders of any class of shares of the capital stock of a corporation. Such interest does not include ordinary commercial variable rate interest that is computed by reference to a benchmark rate such as CDOR, or which varies directly with a borrower's debt to equity leverage ratio. The participating debt interest rule can be of special concern in the case of a debt obligation that is convertible into shares of the issuer.

Generally, a conversion premium can be treated as deemed interest under the Tax Act, which deemed interest can be considered participating debt interest on the basis that it is an amount contingent on the value of a Canadian business or computed by reference to a "similar criterion" for purposes of the participating debt interest rules. The Canada Revenue Agency has indicated that, in limited circumstances, any conversion premium realized on publicly listed convertible debt will not be treated as participating debt interest. In addition, this issue is avoided in the case of convertible debt that has a term to maturity of at least five years, and the terms of which otherwise comply with certain requirements of the Tax Act.

Treaty relief

Certain relief from Canadian interest withholding tax is available to a non-resident of Canada that is a resident of a country with which Canada has an income tax convention, provided such non-resident is entitled to the benefits of such convention. The 25% statutory withholding tax rate on interest is typically reduced to 10%. The rate reduction would apply to payments to persons related and non-arm's length for purposes of the Tax Act. However, under the *Canada-United States Income Tax Convention* (1980), as amended (the Canada-U.S. Treaty), withholding tax on interest is wholly eliminated on interest arising in Canada and paid to a beneficial owner that is resident of the U.S. and entitled to the benefits of the Canada-U.S. Treaty.

The exemption applies in all cases including where the payer and beneficial owner are related, or otherwise do not deal with each other at arm's length for purposes of the Tax Act. The Canada-U.S. Treaty exemption does not apply to certain participating debt interest. In that case the rate of withholding tax would be reduced to 15%.

Thin capitalization debt

A separate Canadian federal withholding tax can apply to a payment of interest that is affected by the thin capitalization rules of the Tax Act. In general terms, the thin capital rules apply to the debt owing by a Canadian corporation to a "specified non-resident" to the extent that corporation's "outstanding debts to specified non-residents" exceed by more than one and a half times its equity – (e.g., retained earnings, paid-up capital and contributed surplus) – in respect of such non-residents (i.e., a debt-to-equity ratio more than 1.5:1). Interest paid on such excess debt is not deductible by the Canadian corporate debtor in computing income. If paid to a non-resident, such denied interest is deemed to be paid as a dividend for purposes of the Tax Act, resulting in the application of Canadian dividend withholding tax to the payment (dividends do not enjoy the same exemptions from Canadian withholding tax as interest). The withholding tax rate on dividends is 25%, subject to available tax treaty relief (e.g., typically 15% under the Canada-U.S. Treaty).

The threshold issue for the application of the thin capital rules to a Canadian corporate debtor is whether its non-resident creditor has, or is affiliated with another non-resident person who has, a material equity interest in the debtor as determined under the thin capital rules (such equity holder being a (specified shareholder). Generally, a specified shareholder is a person who, either alone or together with persons with whom such person is not dealing at arm's length, owns 25% or more of the full voting shares, or 25% or more of the fair market value of all outstanding shares, of the debtor. For purposes of making this determination, if a person has certain rights to acquire or control the debtor's shares, such as options to purchase shares, then such rights must be treated as having been fully exercised.

The thin capital rules of the Tax Act provide corresponding treatment where the Canadian debtor is not a corporation but a trust or partnership or is a non-resident corporation or trust carrying on business in Canada.

Interest paid or credited

Canadian withholding tax only applies to an amount that is "paid or credited" (or deemed to be paid or credited) to a non-resident. In the case of a payment to an arm's length person, this means that the tax can only apply on an actual or deemed payment (whether in cash or in kind), and not to amounts that are merely accrued. In the case of so-called "PIK" (i.e., payment in kind) interest that may be contemplated in a credit agreement, it is a question of fact and law whether the PIK feature creates a payment that can be subject to withholding tax, or merely reflect evidence of an accrued unpaid amount that cannot be subject to withholding tax. Special rules of the Tax Act can require an amount of accrued interest payable to a non-arm's length non-resident creditor over two taxation year ends to be treated as having been paid for withholding tax purposes.

Back-to-back loan rules

The Tax Act contains so called "back-to-back loan" rules intended to apply where a non-resident affiliate of a Canadian borrower causes a loan to be made to the Canadian borrower by a third-party lender to avoid the adverse Canadian withholding tax implications that would otherwise arise if the non-resident affiliate itself made the loan directly to the Canadian borrower (i.e., to avoid tax on a payment made to a related person). The rules are very complex and beyond the scope of this discussion.

In very general terms they can apply where a Canadian debtor has an obligation to pay interest in respect of a debt or obligation owing to a lender (the Intermediary Loan), and as a

part of the arrangements giving rise to or permitting the existence of the Intermediary Loan, a non-resident person or partnership that does not deal at arm's length with the debtor provides certain types of credit support (offside support) to the third-party. What constitutes offside support, and the necessary causal connection between the provision of the offside support and the loan made to the Canadian borrower, are broadly defined in the rules. However, a mere security interest in a property should not be caught by the rules.

If the back-to-back loan rules apply then, for purposes of the withholding tax rules of the Tax Act, there is deemed a loan made by the non-resident affiliate to the Canadian borrower. When interest is paid on the loan received from the third-party lender, there is deemed to be a simultaneous payment of interest on the deemed loan from the non-resident affiliate. That deemed interest payment can be subject to Canadian withholding tax. This is not a tax imposed on the third-party lender. It is strictly a tax imposed on the Canadian borrower. Similar rules can apply for purposes of the thin capital provisions of the Tax Act and which impact only the Canadian resident debtor (i.e., any incremental tax imposed accordingly is not a tax of the third-party lender).