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2012 Federal Budget: Changes to the thin-capitalization rules

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Canadian tax law, like virtually all developed taxation systems, contains a series of rules that are designed to limit the deduction of interest expense on debt obligations owing from a Canadian entity to non-residents of Canada within corporate groups.[1] These rules are referred to as the thin-capitalization or thin-cap rules. The thin-cap rules can deny a Canadian interest expense deduction on debts and are designed to prevent non-residents from debt financing that is perceived as creating excessive deductions for Canadian tax purposes. Non-resident investors in Canadian business and international corporate groups with material Canadian business or subsidiaries should be mindful of the tax traps inherent in the thin-cap rules.

On March 29, 2012, Canadian Federal Finance Minister Jim Flaherty delivered the government's 2012 federal budget (the "**Budget**"). As is typical in Canada, the Budget contained interesting tax policy changes. In particular, the Budget contained material changes to the thin-cap rules. The following briefly highlights the three most important proposed changes to the thin-cap rules that apply to in-bound Canadian investments. There are other related changes to the thin-cap rules and we encourage you to discuss any such changes with us.

1. Reduction of the debt-to-equity ratio from 2:1 to 1.5:1

The purpose behind the debt to equity ratio is to limit the interest expense deduction available to Canadian resident corporations where such interest is paid or payable on outstanding debts to specified non-residents[2] and the amount of such debt exceeds the permitted debt-to-equity ratio (the "**D/E Ratio**"). This is the central concept of the thin-cap rules: debt in excess of a defined ratio to equity will be denied deductibility. Sometime ago, the Department of Finance established an Advisory Panel on Canada's System of International Taxation (the "Panel"). The purpose of the Panel was to provide a high level critique of that aspect of Canada's tax system. One of the recommendations of the Panel was that Canada reduce the 2:1 D/E Ratio employed in our thin-cap rules because it is high compared to actual corporate balance sheets in the Canadian and world economy. The panel suggested as well that, in its current form, the D/E Ratio allows inappropriately high levels of foreign related-party debt. Taking the advice of the panel, the Department of Finance, as part of the Budget, proposes that the D/E Ratio be reduced to 1.5:1 for all corporate taxation years commencing after 2012. This change in the permitted D/E Ratio is the most significant of the amendments to Canada's thin-cap rules in the Budget. Non-residents that have planned on the basis of a 2:1 D/E Ratio would be wise to consider injecting more equity or structuring alternatives.

[1] The rules may also capture debt obligations that fall outside of a true "corporate group" relationship.

[2] A non-resident person who, either alone or together with other non-arm's length persons, owns shares of the Canadian resident corporation that represent 25% or more of the votes or 25% or more of the value of the Canadian resident corporation.

2. Inclusion of partnership debt in the D/E Ratio

Canada's thin-cap rules do not currently extend to partnerships. The Budget proposes to include in the calculation of the D/E Ratio of a Canadian resident corporation the debt of a partnership in which the corporation is a member. The debt of the partnership owed to a specified non-resident of the corporation will be allocated to the corporation based on its proportionate interest in the partnership[3]. The measures are expected to apply in respect of partnership debts that are outstanding during corporate taxation years commencing on or after March 29, 2012.

Where the allocation of the partnership debt to the member corporation results in the member corporation's debts exceeding the D/E Ratio (the "**Excess Debt**"), the partnership's interest deduction will not be denied. Rather, an amount equal to the interest on the Excess Debt will be required to be included in the computation of the member corporation's income. The included income will be treated as business or property income and its source will be determined in relation to the source against which the interest is deductible at the partnership level.

This change to the thin-cap rules, while significant, merely serves to codify the Canada Revenue Agency's position that it would apply the general anti-avoidance rule to structures that avoided the D/E Ratio by having money lent to a partnership instead of directly to the member corporation.

3. Interest Disallowed by the D/E Ratio Treated as Dividends for Withholding Tax Purposes

Withholding tax rules under Part XIII of the *Income Tax Act* currently treat interest for which a deduction has been denied under the thin-cap rules as interest income. The Budget proposes to re-characterize the treatment of disallowed interest for withholding tax purposes (including any amount that is required to be included in computing the income of a corporation in respect of an amount deductible by a partnership of which the corporation is a member) as dividend income. The effect of this amendment will likely be to increase the amount of withholding tax collected as a result of the thin-cap rules.

The withholding tax on deemed dividends will be due when applicable withholding taxes on interest payments are otherwise due. There are special rules for the allocation of these deemed dividends where there are multiple non-resident creditors of the Canadian entity.
This is also a significant change in the law. It serves to assimilate the Excess Debt into equity where previously the only implication of Excess Debt was denied interest expense.

This measure will come into effect for Canadian resident corporations with taxation years ending on or after March 29, 2012.

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[3] For example, if the Canadian resident corporation is a 50% partner and its only shareholder lends $100 to the partnership, the Canadian corporation will include $50 in its computation of debt for purposes of the D/E Ratio