Taxation of Inbound Investment

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Abstract

The purpose of this paper is to review the factors inherent in the Canadian income tax system that impact directly on inbound investment, including, in particular, the Canadian withholding tax and thin capitalization provisions. This paper discusses the objectives of such provisions, as well as their impact on foreign investment, and compares the Canadian income tax regime with respect to such factors to those of the United Kingdom, the United States, Germany, Australia and the Netherlands.

This paper attempts to assess whether the existing Canadian income tax regime meets its implicit objectives, and whether there are alternative approaches that could provide more equitable results.

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In order to provide a conceptual framework against which the existing Canadian income tax regime can be measured, it is assumed that the underlying objectives of an income tax regime, as it applies to inbound investment, should be as follows:

- The tax regime should be neutral, in that it should not unduly impact the structure or form of investment;
- The tax regime should promote economic development and job creation;
- The tax regime should be structured in a manner that preserves and protects the Canadian tax base;
- The tax regime should ensure that profits from foreign investments bear the same taxation burden as domestic investment, so that foreign investment is not placed at a competitive advantage or disadvantage vis-à-vis domestic investment; and
- The tax regime should be structured with a view towards simplicity, as well as enforceability.

Recommendations

Withholding Taxes

1. It is recommended that intercorporate dividend withholding taxes be reduced or eliminated.

   High tax rates are often cited as an impediment to business investment. This is particularly true for foreign investors. Foreign jurisdictions typically provide for either exemption from domestic tax on distributions from a Canadian subsidiary, or a credit for both the Canadian underlying tax and the withholding tax on such dividends. In the case of a jurisdiction with an exemption system, Canadian taxes in aggregate represent a cost. In credit systems, generally speaking, Canadian taxes in excess of the basic foreign tax rate represent a cost.

   In either case, it is the aggregate of underlying corporate and dividend withholding tax rates that is relevant.

   To the extent that aggregate Canadian tax rates exceed the tax rate in the foreign jurisdiction, it is likely that the Canadian tax rates would be viewed as an impediment to business investment. As such, a lowering of Canadian tax rates may promote investment in Canada. The withholding tax rate reduction should be accomplished through bilateral tax treaty negotiations, so that Canadian-based multinational companies can benefit from negotiated bilateral agreements to reduce withholding taxes on dividends.

2. It is recommended that the existing exemption from withholding taxes on interest payments to arm's-length lenders on long-term debt be expanded to apply to all arm's-length debt.

   In the other countries surveyed, arm's-length interest payments are generally exempt from withholding taxes either under domestic law or by treaty. It is submitted that there is no basis upon which to restrict such an exemption to long-term debt.

   Withholding tax on arm's-length debt generally results in an incremental cost to Canadian business; as such, withholding tax is generally passed on to the debtor through higher

interest rates. An elimination of withholding tax on all arm's-length debt would provide Canadian business with access to global financial markets at competitive interest rates.

Thin Capitalization

1. It is recommended that thin capitalization provisions be amended so that the test of whether a corporation is thinly capitalized is based on the debt-to-equity level of the debtor company as a whole, rather than including only the debt and equity of specified non-resident investors.

   It is submitted that a corporation cannot be considered to be thinly capitalized based solely on a consideration of the mix of debt and equity provided by non-resident shareholders. Thin capitalization provisions should be designed to prevent non-commercial levels of leverage of Canadian subsidiaries of foreign-based enterprises. An arm's-length lender would not base a lending decision solely on the debt-to-equity ratio of a specified non-resident shareholder. Rather, an arm's-length lender would base such a decision on the creditworthiness of the debtor company as a whole. Thin capitalization provisions should operate in a similar manner.

2. It is recommended that a deficit should reduce the measure of equity for purposes of thin capitalization provisions.

   There does not appear to be any basis for excluding a deficit from the determination of equity in determining if a corporation is thinly capitalized. A commercial lender would certainly consider a deficit in making a lending decision.

3. Thin capitalization provisions should include all equity, not just equity provided by non-resident shareholders.

   The existing provisions include only the equity owned by specified non-resident shareholders. As a result, it may not be possible for a non-resident shareholder to loan money directly to a second- or lower-tier Canadian subsidiary. As a result, the non-resident shareholder may be required to loan to the first-tier Canadian corporation, with this entity in turn loaning to the lower-tier subsidiary. However, for commercial reasons, this may not always be possible.

   Such a change could be effected by basing thin capitalization provisions on the total equity of the debtor, rather than just the equity held by non-residents. In order to prevent double counting of equity (i.e. a cascading effect), the equity of a debtor could be reduced by the amount of its investment in other Canadian companies.

4. It is recommended that thin capitalization provisions be based on an average debt level, rather than the highest point in the year.

   It is submitted that using the highest debt level in the year is unnecessarily punitive. A high level of debt may be necessitated by a refinancing or other transaction. However, if the high debt level is only outstanding for a very short period of time, an inappropriate level of interest may be disallowed under the existing provisions.

5. It is recommended that the existing back-to-back loan provisions be tightened.

   Currently, the back-to-back loan provisions apply only in very limited circumstances. It would be reasonable for such provisions to apply to any form of back-to-back financing, as is the case in the proposed legislation in Australia.

6. It is recommended that thin capitalization provisions apply to branches of foreign corporations.

   In Australia, the U.K. and U.S., thin capitalization provisions apply to branches of foreign corporations as well as to domestic corporations. It would appear that there is no rational basis for applying thin capitalization provisions to subsidiaries but not to branches.

Situation Analysis

Reliance on Foreign Investment

For numerous reasons (which are beyond the scope of this paper), Canada has traditionally relied heavily on foreign investment.

As a result, it is important that Canada provide an environment that will foster and encourage ongoing foreign investment. There are numerous factors that an investor may consider in evaluating a potential market, including:

- political stability;
- economic stability;
- availability and capability of labour;
- infrastructure;
- proximity to markets;
- language and cultural considerations;
- level of government and level of government debt; and
- level of taxation.

An evaluation of the relative importance of each of the above factors is beyond the scope of this paper. Furthermore, an investment decision would probably not be influenced by any one of the above factors alone, but rather would be based on an overall evaluation of all factors.

Although it is acknowledged that the level of taxation and the taxation regime, with respect to foreign inbound investment, would not necessarily be a determining factor in an investment decision, it is believed that the level of taxation is a significant factor in such a decision. Accordingly, it is imperative that, if Canada is to continue to rely heavily on foreign investment, the Canadian income tax regime must foster and encourage such investment.

Foreign investment in Canada plays an important role in, and contributes many benefits to, the Canadian economy. Foreign investment results in development of the Canadian economy and the creation of jobs within Canada. In addition, foreign investment supports the Canadian tax base, regardless of the level of tax that is paid on business profits. The tax base is supported by numerous indirect taxes, as well as direct taxation of employees' income.

Taxation Regime

As noted above, there are a number of factors that an investor will consider in evaluating an investment opportunity, including the level of taxation. A business enterprise is subject to numerous direct and indirect taxes, e.g. payroll taxes, health levies, property taxes, capital taxes, sales taxes, direct tax on income and, in addition, in the case of a non-resident investor, withholding tax on distribution of income. It is beyond the scope of this paper to discuss all of these taxes; the focus of this paper is on the Canadian income tax regime as it applies to non-resident investors. However, it is noteworthy that the overall level of taxation (including direct and indirect taxes) may be a significant factor in influencing an investor’s decision.

In many cases, the aggregate level of domestic taxation and foreign taxation on business profits could result in an unacceptable overall tax burden on the profits of an enterprise. In many situations, the domestic country legislation of the foreign investor and income tax treaties may give full or partial relief from economic double taxation on business profits. An important factor in an evaluation of the overall level of taxation on business income is the manner in which such income is taxed on repatriation to the foreign parent. Although a rigorous discussion of the treaty and foreign tax implications is beyond the scope of this paper, some general observations regarding treaty provisions are made.

Competition with Other Markets

Historically, Canada’s economy has depended to a large extent on activity in the natural resources, agricultural and fisheries markets, with a significant contribution by manufacturing industries. In these sectors, investment decisions have often been driven by factors other than those noted above. For example, significant mining activity has been concentrated in Canada due to the abundance of natural resources. Obviously, if a mineral deposit is located in a certain geographic region, the mine must be located there as well. Similarly, manufacturing operations were historically located in proximity to the ultimate consumer market, partly because of tariff barriers, which have since been reduced or eliminated, and partly because adequate and economic transportation resources were not available to facilitate the manufacturing operation being situated in a different geographic region.

Some of the factors that would have led to investment in Canada in the past now have less influence on investment decisions. Political stability and economic development in other regions of the world have made such regions attractive alternatives to Canada. Traditional tariff barriers have been reduced or eliminated. In addition, developing technology and transportation infrastructures have made other locations more economically attractive than in the past.

In many respects, compared to other countries, Canada is at a competitive disadvantage in attracting foreign investment. Canada’s geographic size and relatively small population may make it a less-attractive alternative for a manufacturing facility than other markets (such as the U.S.) which are more densely populated, resulting in enhanced marketability of products. In addition, other factors, including the climate, the availability of skilled labour, and the cost of doing business, may influence investment decisions.

Canada competes with many other markets in attracting foreign investment. For investment from the U.S. (a source of a substantial portion of foreign investment), Canada may compete against other U.S. locations, which, from a taxation perspective, may offer less costly tax attributes. For European and Asian investment in Canada's North America, Canada competes primarily with the United States. Given some of Canada's inherent competitive disadvantages, (such as climate and geographic location), Canada needs to offer a tax regime and economic environment that will foster foreign investment.

Focus of Paper

As noted above, this paper focusses on providing an overview and discussion of the Canadian income tax regime as it applies to inbound investment. Discussion is based on a comparison of the Canadian income tax regime with that of other major industrialized countries. Observations are made based on the implicit objectives of the taxation system as outlined above, these being simplicity, fairness, promotion of economic development and job creation, preservation of the Canadian tax base, and neutrality.

It is beyond the scope of this paper to discuss all aspects of the Canadian income tax regime as it applies to inbound investment. This paper discusses, in particular, issues with respect to withholding taxes and thin capitalization provisions. As appropriate, observations are made on other issues.

Withholding Taxes

Canada Compared to Other Jurisdictions

Most developed countries that have a form of taxation on income impose withholding taxes on certain payments made to non-residents. The purpose of such withholding taxes is to expand the domestic tax base to include not only residents but also non-residents that derive some form of income from a source within the particular jurisdiction. Although the purpose of withholding taxes is generally uniform, the method of application varies by country.

Although there are numerous types of payments made to non-residents that may be subject to withholding taxes, this paper discusses only three types of such payments: dividends; interest; and rents and royalty payments.

Canada

Dividends

Canada imposes withholding tax on dividend payments made to non-residents at a domestic rate of 25 percent. Dividend payments made by corporations are not deductible in computing income for income tax purposes.

Canadian domestic law provides for partial integration of business and individual tax, in order to mitigate double taxation at both the corporate and shareholder level, through a gross-up and credit mechanism applied in computing the tax liability of individual shareholders. The system only partially integrates individual and corporate tax, as the dividend tax credit is fixed and does not fully eliminate or compensate for the underlying corporate tax. There is no form of integration for non-resident shareholders other than partial relief from withholding tax under the applicable treaty.

Although the domestic withholding tax rate for dividends is 25 percent, this rate may be reduced under the provisions of a bilateral income tax convention, provided that the recipient is a resident of the applicable treaty country. Treaty-reduced withholding tax rates for intercorporate dividend payments are typically 5 to 15 percent, with more recent treaties providing for a 5 percent withholding tax rate on intercorporate dividends. The withholding tax is applied on the gross amount of the payment and is a final tax.

Interest

In general, and subject to various exceptions, interest paid by corporations is deductible in computing income for tax purposes provided that the underlying indebtedness was incurred for the purpose of earning income.

Canada imposes withholding tax on certain interest payments made to non-residents at a domestic rate of 25 percent. Withholding tax is applied on the gross amount of the payment and is considered to be a final tax. Although the domestic rate is 25 percent, this rate may be reduced under the provisions of a bilateral income tax convention, provided that recipients are residents of the applicable treaty country. Typically, the treaty-reduced rate is 10 to 15 percent, with more recent treaties providing for a 10 percent rate.

Under domestic law, certain interest payments made to non-residents may be exempt from Canadian withholding tax. The most notable exemption is for interest paid to an arm's length lender, where the terms of the original loan provide that not more than 25 percent of the principal is repayable within five years except in certain limited circumstances.

Under domestic law, certain payments (such as guarantee fees) paid to non-residents may be characterized as interest and thus subjected to withholding tax.

Royalties

In general, rents and royalties paid by corporations are deductible in computing income for tax purposes provided that the expenditure is incurred for the purpose of earning income.

Canada imposes withholding tax on rent and royalty payments made to non-residents at a domestic rate of 25 percent. Withholding tax is generally applied on the gross amount of the payment and is considered to be a final tax. Although the domestic rate is 25 percent, this rate may be reduced under the provisions of a bilateral income tax convention, provided that the recipient is a resident of the applicable treaty country. Typically, the treaty-reduced rate is 10 percent, with certain types of royalty payments being subject to a 0 percent rate.

An exception to the general rule, where tax is withheld on gross payments, is provided for rent on real property and timber royalties, where a non-resident may elect to be subject to normal Canadian income tax on net income (as computed under the provisions of the *Income Tax Act*) at basic Canadian tax rates, rather than on the gross payment.

United States

Dividends

The United States generally operates a classical system of taxation, whereby business profits are taxed at the corporate and shareholder level, without relief from double taxation. A limited exception applies to certain domestically owned corporations that may elect to have business profits taxed, on a current basis, at the shareholder level, thus eliminating the corporate level of taxation. Dividend payments are not deductible in computing income for tax purposes.

Distributions from U.S. companies are treated, regardless of legal form, as a dividend to the extent that the company has either current or accumulated earnings and profits. Accordingly, it is not possible to effect a return of capital if there are earnings and profits.

The U.S. imposes withholding taxes on dividends paid to non-residents. The domestic withholding tax rate is 30 percent, but is generally reduced by treaty. Treaty rates are typically 5 percent for intercorporate dividends.

Interest

Interest payments are, generally speaking, deductible in computing income for U.S. income tax purposes. However, an important aspect of U.S. tax law is the characterization of advances and related payments. As U.S. jurisprudence adopts a substance-over-form approach, an advance that is structured as a debt may be recharacterized as equity. The characterization of an advance as debt or equity is based on a consideration of a number of factors; such factors are not codified, but rather, arise from a long history of jurisprudence. Interest payments on advances that have been recharacterized as equity are treated as distributions, and thus are not deductible for income tax purposes (and, in the case of recipients that are subject to either U.S. tax on net income or U.S. withholding tax, such payments are characterized as dividend income rather than interest income).

Interest payments made to non-residents are, subject to various exceptions, generally subject to withholding tax at a domestic rate of 30 percent. However, interest payments to non-residents who own less than 10 percent of the payor company are generally exempt from withholding tax. The domestic withholding tax rate is normally reduced by treaty, frequently to 0 percent.

Royalties

Royalty payments are, generally speaking, deductible in computing income for U.S. income tax purposes.

Royalty payments made to non-residents are generally subject to withholding tax at a domestic rate of 30 percent. The domestic withholding tax rate is normally reduced by treaty, typically to 10 percent or less.

United Kingdom

Dividends

The U.K.'s imputation tax system provides for partial integration of individual and corporate taxation. Dividend payments are not deductible in computing income for tax purposes.

Income earned by U.K. corporations is subject to mainstream corporate income tax at a rate of 33 percent. Under the imputation system, a corporation is required to pay advance corporation tax (ACT) in respect of any dividend distributions paid. Currently, ACT is equal to 20/80 (i.e. 25 percent) of the actual dividend payment. ACT can be used to offset the corporation’s regular corporation tax (i.e. ACT is a credit against the corporation tax liability). Surplus ACT can be carried back six years and carried forward indefinitely.

Individuals in the U.K. are required to include in income the entire amount of the dividend plus ACT. Individuals are entitled to a credit against income tax for ACT paid by the corporation.

The U.K.’s imputation system is designed to provide integration of corporate and shareholder tax, but also to ensure that dividends have been paid out of profits that have borne U.K. corporate tax. In fact, the system only provides for partial integration of individual and corporate taxation since the credit available for individual shareholders that receive dividends is typically less than the full corporate tax.

The ACT system has traditionally created a bias against U.K. companies making investments in foreign countries. Regardless of the level of tax paid by a subsidiary in a foreign jurisdiction, the ACT system would require additional U.K. corporate tax to be paid on such earnings on distribution by the U.K. company. If the foreign tax rate exceeds the basic U.K. corporate income tax rate, dividends from a foreign subsidiary should not attract any mainstream corporate tax (the dividends are taxable to the U.K. parent, but as the U.K. utilizes a credit system, a full credit of foreign taxes against the U.K. mainstream tax would be allowed). However, when such earnings are distributed by the U.K. parent as a dividend, ACT would be payable, and since there is no mainstream corporate tax liability, the ACT would be a pure cost.

In general, dividends paid by U.K. resident corporations to non-resident shareholders are not subject to withholding tax. However, ACT is payable when U.K. corporations distribute dividends to non-residents of the U.K. Depending upon the relevant tax treaty, non-resident shareholders may be entitled to a partial ACT credit – typically, non-residents are entitled to a credit of one half of the ACT. Where non-resident shareholders are entitled to an ACT credit, the U.K. normally imposes withholding tax on the amount of the dividend plus the ACT credit at the treaty-reduced withholding tax rate.

For non-resident investors, the ability to obtain an ACT refund generally results in a reduction of the overall corporate tax paid. For example, if pre-tax earnings in the U.K. are £100 and the basic corporate tax rate is 33 percent, the aggregate tax burden for Canadian resident investors would be as follows:

Pre-tax earnings	£100
Corporate tax	33
After-tax available for dividend	**£ 67**
The £33 corporate tax is payable as:	
ACT £67 x 20/80	£ 17
Mainstream corporate tax	16
	£ 33

An ACT refund of one half of ACT paid would (pursuant to the treaty) be available. The ACT refund would therefore be £9.

Dividend	£ 67
ACT refund	9
Grossed-up dividend	76
Withholding tax at 10%	7
Net to Canadian shareholders	**£ 69**

As a result, the total cash distribution received by Canadian shareholders is £69 resulting in an effective U.K. tax burden of 31 percent (compared to the basic corporate rate of 33 percent).

Interest

In general terms, interest expense paid by U.K. resident corporations is deductible for income tax purposes. However, historically, where such interest was paid to non-resident connected individuals, U.K. domestic tax law recharacterized such payment as a non-deductible distribution.

Although characterized as such under corporate law, U.K. treaties normally provided that such interest was deductible provided it met arm's-length standards.

The U.K. imposes withholding tax at a domestic rate of 25 percent on interest paid to non-residents. The domestic rate is generally reduced by treaty, typically to 0 percent.

Royalties

Royalty payments made by U.K. resident corporations are generally deductible in computing income for tax purposes.

Royalties paid to non-residents are subject to U.K. withholding tax under domestic law at a rate of 25 percent. The domestic rate is generally reduced by treaty, typically to 0 percent.

Germany

Dividends

In principle, the German income tax system provides for total imputation and full integration of corporate and individual income tax. Income earned and retained by corporations is subject to income tax at a rate of 45 percent. Upon distribution to shareholders (resident or non-resident), the corporation receives a credit equal to 15 percent, resulting in an effective corporate income tax rate of 30 percent. Dividend payments are not deductible in computing income for tax purposes. Dividends received by individual shareholders are grossed-up to include the underlying corporate income tax; however, individuals are entitled to a tax credit of 30 percent of the grossed-up dividend, resulting in a credit at the individual level for the corporate income tax.

Germany imposes withholding tax on dividends paid to non-residents. The domestic withholding tax rate on dividends is 25 percent and is a final tax. The domestic rate is generally reduced by treaty to 5 percent to 15 percent (0 percent for European Union member countries) for intercorporate dividends.

Interest

Interest payments made by German corporations are, in general, deductible in computing income for tax purposes.

Germany imposes withholding tax on interest payments made to non-residents. The domestic withholding tax rate is 30 percent, however, this rate is generally reduced by treaty. Treaty-reduced rates vary; however, the treaty rate with most significant trading partners is 0 percent.

Interest on certain convertible bonds and profit-sharing bonds is treated as a dividend payment for withholding tax purposes.

Royalties

Royalty payments made by German corporations are, in general, deductible in computing income for tax purposes.

Germany imposes withholding tax on royalty and similar payments made to non-residents at a domestic rate of 25 percent. Treaty rates vary, with the most significant treaties providing for a rate of 0 to 10 percent.

The Netherlands

Dividends

The Netherlands operates a pure classical tax system, with income taxed at the corporate level and dividends taxed at the individual level with no relief or credit for the underlying corporate tax. Dividend payments and other similar distributions are not deductible in computing income for corporate income tax purposes.

The Netherlands imposes withholding tax on dividend payments to non-residents. The dividend withholding tax rate under domestic law is 25 percent of the gross amount of the dividend. This rate is generally reduced to 5 percent (0 percent for EU member countries) by treaty for intercorporate dividends.

Interest and Royalties

Interest and royalty payments are generally deductible for income tax purposes. Interest and royalty payments made to non-residents are generally not subject to withholding tax, however, for withholding tax purposes interest on profit-sharing bonds is treated as a dividend.

Australia

Dividends

Under Australia's tax system, individuals are entitled to a tax credit for the full underlying corporate tax in respect of dividends received, resulting in full integration of corporate and individual income tax. Dividend payments are not deductible in computing income for tax purposes.

Dividends paid to non-residents are free of withholding tax, provided that the dividends are “franked.” Generally, dividends are franked if the amount of the dividend payment by the Australian company does not exceed the undistributed after-tax earnings of the Australian company (i.e. provided the earnings distributed have been subject to Australian income tax). Unfranked dividends are subject to a 30 percent withholding tax under domestic law; however, this rate is usually reduced by treaty.

Interest

Interest payments are generally deductible in computing income for tax purposes.

Australia imposes withholding tax on interest payments made to non-residents at a domestic rate of 10 percent. This rate is reduced to 0 percent under some treaties. An exemption from withholding tax is available for overseas borrowings by way of a public or widespread issue of debentures and commercial paper, provided that an exemption certificate is issued by the Commissioner.

Royalties

Royalty payments are generally deductible in computing income for tax purposes. Royalties paid to non-residents are subject to a 30 percent withholding tax under domestic law, however, this rate is typically reduced to 10 percent by treaty.

Summary of Country Comparison

The following table summarizes the country-by-country comparison of dividend withholding taxes.

TABLE 1

Withholding Tax – Dividends

Country	Rate (Treaty Rates)	System
Australia	0%[1]	Credit system
Germany	25%; (0 to 15%)	Imputation/Credit system
The Netherlands	25%; (0 to 5%)	Classical
U.K.	0%; ACT W/H	Imputation/Credit system
U.S.	30%; (5%)	Classical

1 Dividends paid out of profits on which company tax has been paid are referred to as franked dividends. In the case of non-resident shareholders, franked dividends are not subject to any withholding tax. Unfranked dividends are subject to a 30% domestic withholding tax.

Withholding Tax Issues

Withholding taxes generally represent an additional cost of doing business for non-resident investors. In certain situations, withholding taxes may also represent an additional cost to the resident entity.

Withholding on Gross Payment

In Canada, withholding taxes are normally imposed on the gross payment to non-residents and are considered to be a final tax. Non-resident recipients are usually not entitled to any deductions in computing the liability to tax. There are, however, two exceptions to this general rule. The first

exception is for rents in respect of real property (and certain payments in respect of resources) paid to non-residents. Non-residents may elect to be taxed on net income (computed under Part I of the Act), as if they were residents, in respect of such rents. The second exception is for payments that are attributable to a permanent establishment located in Canada, and that are included in computing income for tax purposes.

In many circumstances, non-residents may incur significant expenses in order to earn the income that is subject to withholding tax. In such situations, a tax on gross income (even at treaty-reduced rates) may result in a tax burden on the net income at unacceptably high levels. Frequently, non-residents will not be in a position to credit the entire withholding tax in the country of residence. In such circumstances, non-residents might either refrain from making an investment in Canada or, alternatively, pass on the incremental cost to the Canadian resident. In many situations, the incremental cost is passed on to the Canadian resident payor by requiring the payment to be grossed-up by the amount of the withholding tax.

In order to promote investment in Canada, consideration might be given to either a reduction in withholding taxes, expanding exemptions from withholding taxes, or expanding circumstances in which non-residents may elect to be taxed on a net basis at the prevailing Canadian tax rates.

It is likely that permitting non-residents to be taxed on a net basis would require complex legislation and could be difficult to enforce as it might be difficult to verify (or determine) whether expenses are properly attributable to a particular source of income. In order to enhance access to global financial and technology markets, it would, therefore, be preferable to expand exemptions to withholding taxes and move towards a greater reduction in treaty-reduced withholding tax rates. While this may result in some revenue loss, since Canada is a net importer of capital, it should promote investment and job creation.

Reduction of withholding tax rates (or expanding exemptions) would also result in Canada's withholding tax regime being more competitive with the other jurisdictions noted. In particular, it is noted that most of the other jurisdictions provide (either in domestic law or in significant treaties) for exemption from withholding tax on interest paid to arm's-length non-residents, whereas in Canada only long-term debt qualifies for such an exemption.

Entitlement to Treaty Benefits

As noted above, most domestic withholding tax rates are reduced by Canada’s treaties. In some situations, however, it is not clear whether recipients should be entitled to the benefit of the treaty reduction. This is particularly true in the case of flow-through entities.

In most tax treaties, the benefits of the treaty provisions are only available to residents of the other contracting state that are liable to tax in that state. Uncertainty arises when payments are made to entities that are treated as flow-through entities in the other country. Examples of such entities include partnerships and, in the U.S., limited liability corporations (LLCs) and corporations that have elected under Subpart S of the Internal Revenue Code (S-Corps).

As a general rule, it would seem that there cannot be any policy reason for denying treaty benefits when the owners/members of such entities are resident in, and liable for tax in, the other contracting states.

It is understood that Revenue Canada is of the view (although this was not always clear) that S-Corps should be entitled to the same treaty benefits as would be available had an election not been made to be treated as an S-Corp. It is also understood that payments made to a partnership are eligible for treaty-reduced withholding rates, provided that the members of the partnership are resident in the other contracting state. However, the benefits might not be equivalent to the benefits that would be available if the members owned the property giving rise to the payment directly. For example, if two U.S. resident corporations were 50 percent members in a partnership that owned 100 percent of the shares of a Canadian corporation, each member would be viewed as owning a 50 percent undivided interest in each share of the Canadian company. As such, dividend payments would qualify for a 15 percent treaty-reduced rate, but not the 5 percent intercorporate rate, since neither member would own 10 percent or more of the shares.

It is understood that Revenue Canada is currently of the view that LLCs are not entitled to any treaty benefits. Setting aside the question of whether this position is technically correct, there would appear to be no policy reason for denying treaty benefits.

It is submitted that all flow-through entities should be entitled to full treaty benefits if the members/owners of such entities are resident in the other state. There is no policy reason for denying such benefits, and it needlessly restricts the form of investment into Canada.

Characterization of Payments

One area in which Canadian provisions differ significantly from those of other jurisdictions is the characterization of payments. As noted above, several jurisdictions take the view that, for some purposes, profit participating debt is treated as equity. It is understood that in Germany and The Netherlands, this characterization is only made for withholding tax purposes, whereas in the U.S. the characterization is also made for purposes of computing income of the payor. It is not clear why such a characterization is necessary. There are many situations in which debt may have the characteristics of equity and vice versa. This is particularly true in the case of retractable preferred shares, which in many respects are closer in nature to debt than equity. It is, however, submitted that a recharacterization of such instruments in an international context would be inappropriate unless a corresponding recharacterization were made in a domestic context.

Another area in which there are differences in characterization of payments is the treatment of distributions. As noted above, the U.S. treats all distributions as dividends to the extent of earnings and profits. In contrast, Canada permits a return of paid-up capital on a tax-free basis regardless of whether the corporation has accumulated income. In this context, the Canadian system is much less complex than the U.S. system. In addition, the Canadian approach is more likely to stimulate investment.

Thin Capitalization

The term "thin capitalization" is commonly used to refer to a situation where a corporation, usually a subsidiary of a foreign parent, is financed with very little equity. Governments perceive thin capitalization as eroding their tax base and, in most cases, have passed extensive legislation to place constraints on the method of financing that a corporation can undertake.

This fear stems from the general supposition that a corporation financed with debt pays lower taxes than a corporation financed with equity. In all the countries considered in this paper, interest payments are a deductible expense that reduce taxable income. Therefore, by permitting a corporation to obtain its financing through debt, the government is permitting the corporation to reduce its taxable income.

Financing a company through debt would not be a concern if the ultimate financing was provided by a taxable person resident in the same jurisdiction as the borrower. While the borrower is allowed a deduction for interest expense, the ultimate lender is taxed on interest income. Therefore, if the interest is ultimately subject to income tax in the same jurisdiction as the borrower, the government would generally be indifferent as to the level of interest expense sustained by the borrower. While in this situation the borrower's taxable income is reduced, the government still manages to collect tax by taxing the lender. This balance, however, breaks down when the lender is in a foreign jurisdiction (or is a tax-exempt entity).

Although interest paid to a non-resident recipient is generally subject to withholding tax, the rate of withholding tax tends to be less than the rate of income tax otherwise payable by the borrower. This is especially true where the withholding tax rate is reduced by a tax treaty. Therefore, by permitting a resident corporation to obtain financing through debt held by a non-resident, the government grants an income deduction while failing to create an offsetting income inclusion. This has the overall effect of reducing the tax base and has been controlled through the use of thin capitalization rules.

In addition, for existing Canadian subsidiaries of foreign enterprises, the Canadian tax base is protected, to a degree, by the imposition of withholding taxes on dividends. Relatively high withholding tax rates on dividend distributions may make it more difficult (i.e. costly) for foreign-owned Canadian subsidiaries to substitute debt for equity. There is, therefore, a linkage between withholding taxes applicable on profit distributions and the need for protection of the Canadian tax base with thin capitalization rules.

The following analysis will examine thin capitalization rules as they exist in Canada, the U.S., the U.K., Australia and Germany (The Netherlands has no thin capitalization provisions). Following an overview of the various rules, a discussion of the various objectives behind thin capitalization rules is provided, together with a discussion of various issues with respect to thin capitalization legislation.

Legislation on Thin Capitalization

Thin capitalization is controlled in a wide variety of ways. Approaches range from complex and inflexible legislation to nebulous rules governed by very general principles, typically developed through jurisprudence. For the purposes of this paper, the former are termed the "objective approach" and the latter are termed the "subjective approach." The above-listed countries will be analysed under their appropriate classification.

Objective Approach Countries

Canada

Canada controls thin capitalization through an inflexible legislative provision that prevents a resident corporation from deducting interest on a portion of its loans from non-resident shareholders having a substantial ownership in the resident corporation. Specifically, a corporation is not permitted to deduct a percentage of interest on outstanding debts to specified non-residents where the outstanding debts of the specified non-residents exceed three times the permitted equity. The denied interest expense will generally equal the interest paid on the debt that exceeds the permitted 3:1 ratio.

The key variables in the above ratio – debt and equity – are defined in the legislation. Equity is defined as the total of (i) the retained earnings (but not a deficit) of the corporation at the commencement of the year, except to the extent that those earnings include retained earnings of any other corporation; (ii) the corporation's contributed surplus at the commencement of the year, to the extent that it was contributed by a specified non-resident shareholder of the corporation; and (iii) the greater of the corporation's paid-up capital at the commencement of the year and the corporation's paid-up capital at the end of the year, excluding the paid-up capital in respect of shares of any class of the capital stock of the corporation owned by a person other than a specified non-resident shareholder of the corporation.

Debt, for the purpose of the calculation, is considered to be interest-bearing debt owed to specified non-residents and can include the unpaid interest accumulating on the original loan. In computing the disallowed interest deduction, the legislation uses the greatest aggregate amount of debt owing to specified non-residents outstanding at any time during the year. A specified non-resident shareholder is defined as a person who, either alone or together with persons with whom that person is not dealing at arm's length, owns or has a right to own either shares possessing 25 percent or more of the voting rights of the corporation or shares possessing 25 percent or more of the fair market value of the corporation.

In addition to defining debt, equity and specified non-resident shareholders, thin capitalization legislation generally addresses two financing arrangements that may be used to circumvent basic provisions. The first of these arrangements is the back-to-back loan. This involves the interposition of a third-party financial intermediary as a means of avoiding thin capitalization legislation. In this situation, where a loan would run afoul of the legislation, the original lender would circumvent the rules by loaning the funds to a third-party intermediary who would then loan the funds to the targeted borrower. Canadian legislation addresses such a situation and deems the back-to-back loan to be a debt owing to the original lender. However, the

back-to-back loan provisions apply only where the non-resident specified shareholder loans funds to the financial intermediary on condition that the intermediary make a loan to the Canadian resident. Therefore, the provisions may not apply in all circumstances.

The second financing arrangement that is often addressed in thin capitalization legislation is where a loan provided by an unrelated party is guaranteed by a specified non-resident shareholder. The legislation in some countries provides that interest on non-resident shareholder-guaranteed debt falls within thin capitalization rules and the expense is restricted. Canada has no such provision.

Australia

During Australia's recent election campaign, the outgoing Labour government issued a press release outlining various changes that it wished to implement in the country's thin capitalization rules. The incoming Liberal-National government has indicated that it will implement these changes.

At present, thin capitalization rules ensure that where an Australian subsidiary's debt to its foreign controller exceeds the foreign controller's equity in that subsidiary by a ratio of more than 3:1, a tax deduction for the interest on that debt is disallowed to the extent of the excess. In recognition of their special funding needs, a ratio of 6:1 is allowed for investments in banks and non-bank financial intermediaries.

Foreign debt included in the ratio is broadly defined to mean any amount owing to the foreign controller or its non-resident associates upon which interest is or may become payable. For the purposes of determining the limitation on a tax deduction for the interest, the relevant foreign debt figure is the largest sum owed to a parent during the year. An election can be made, however, to use a weighted average calculation for those days of the year during which the required ratio is exceeded.

Once the foreign debt is determined, it is compared to the foreign equity contributed. In the case of an Australian subsidiary, items included in the calculation of foreign equity include the foreign controller's interests in the paid-up value of shares, the share premium account and the company's retained earnings and asset revaluation reserves. Items reducing the foreign equity figure include loans (except short-term trade credit) owed to the Australian company by the foreign controller or its associates.

The quantum of the components comprising the foreign equity are ascertained at different times during the year. Paid-up share capital and interests in a share premium reserve are determined at the end of the year of income. Retained earnings (or losses) and reserves are calculated at the beginning of the year and are reduced by so much of those earnings and reserves as are applied in paying up shares during a year of income. Intercompany loans owed to the Australian entity by the foreign company or its associates are measured at year-end.

In its press release, the government proposed to reduce the ratio to 2:1. Citing lower ratios in other countries, specifically a ratio of 1.5:1 in the U.S. and 2:1 in Spain, and lower ratios by general commercial standards (the average ratio for private corporate trading enterprises in

Australia peaked at 1.4:1 in 1990 and now stands at 0.8:1), the outgoing government felt that a ratio of 3:1 was too generous. Other than the change in figures, it does not appear that this ratio will change in other respects. That is, it appears the ratio will still be based on related-party debt to equity, making the legislation very similar to provisions in Canada.

The press release also indicated proposals to tighten existing thin capitalization anti-avoidance provisions such as rules governing back-to-back loans. Currently, where an intermediary is interposed between a foreign controller and the foreign controller's Australian investment, thin capitalization rules contain anti-avoidance provisions which treat loans made through the intermediary as if they had been made directly from the foreign controller to the Australian entity. To apply the anti-avoidance provisions, however, the government must establish a chain of debt on both sides of the intermediary. Accordingly, the anti-avoidance provisions will not apply if the transaction between the foreign controller and the intermediary does not give rise to a debt obligation (e.g. if it is an equity investment). The government considered this a significant limitation on the effectiveness of the provisions and proposed that the anti-avoidance provisions be amended to ensure that they apply irrespective of whether or not the transaction between the foreign controller and the intermediary gives rise to a debt obligation, provided the foreign controller funds the intermediary.

Finally, the government indicated its disapproval of the current ability of an Australian subsidiary to avoid thin capitalization rules by borrowing overseas from an unrelated third party and having the parent company act as a guarantor of the debt. Therefore, the government proposed that the definition of debt owing to a foreign controller be broadened to include debt supported by third-party guaranteed debts. This measure, however, would not be applied to financial institutions because of their need to rely on such borrowings in their normal business transactions.

Whereas current Australian thin capitalization provisions appear to be very similar to those in Canada, the changes announced in the press release will implement additional restrictions beyond those that exist in Canada. In addition, Australian thin capitalization provisions also apply to non-corporate businesses, including trusts, partnerships and branches of non-resident corporations. The general rules applicable to Australian resident corporations are applied to other entities with such modifications as circumstances require.

Germany

As in Canada and Australia, Germany possesses legislation that limits interest deductibility where thin capitalization is thought to exist. Although details of the legislation differ, the general principles are remarkably similar. German legislation uses a debt-to-equity ratio to determine the amount of interest to be denied; it applies its rules to shareholders having a substantial interest in the borrowing entity; and it captures back-to-back loans, parent-guaranteed loans, and loans established through intermediaries in its application of thin capitalization rules.

In general, German legislation permits a safe-harbour debt-to-equity ratio of 3:1, however, a higher ratio is permitted if it can be demonstrated that the resident entity could have borrowed from a resident arm's-length lender on the same terms. This ratio exists for loans where the interest payable is a fixed percentage of the amount advanced. If, however, under the loan the

interest is not expressed as a fixed percentage of the outstanding amount but, rather, is based on a variable such as profit-sharing, then the debt-to-equity ratio will decrease to 0.5:1. Where the German borrowing corporation is a holding company with shares in at least two affiliated companies and a fixed interest agreement was concluded between the holding company and the foreign shareholder, the debt-to-equity ratio is 9:1. Other ratios exist where interest is based on both profits and a fixed interest rate.

Equity in the ratio is the part of the equity which is allocable to the shareholder. Allocable equity is that part of the equity capital of a corporation at the close of the last fiscal year which corresponds to the share held by the shareholder in the issued capital. The corporation's equity is calculated according to the provisions of the Commercial Code. It includes the issued capital, capital reserves, profit reserves, a profit carry-forward and half of certain special items with equity elements. However, unpaid share subscriptions, a loss carry-forward and an annual loss must be deducted; the annual loss is ignored if the original equity capital is restored through profit reserves or equity contributions before expiry of the third fiscal year following the fiscal year of the loss. In addition, if a corporation not qualifying as a holding company holds an interest in another corporation, the book value of such interest must be deducted from the equity capital.

Debt is very broadly defined as a loan from a shareholder. The law only distinguishes between loans on which the interest is dependent on profits.

In Germany, a shareholder is considered to have a substantial interest in the borrowing entity if the shareholder owns 25 percent or more of the shares in a German corporation. A substantial interest may be held directly or indirectly. In general, those affected by thin capitalization rules are non-resident shareholders and resident entities exempt from corporate tax.

In order to prevent a circumvention of thin capitalization rules, Germany has enacted provisions that deal with back-to-back loans, parent-guaranteed loans, and loans through an intermediary. In doing so, Germany has perhaps the most comprehensive and detailed thin capitalization legislation of all the major industrialized countries.

Subjective Approach Countries

United States

It is difficult to categorize the U.S. under the objective/subjective label. In truth, a fair classification would include it under both categories. First, it could be considered a subjective approach country based on its traditional restrictions on thinly capitalized corporations through the recharacterization of a loan transaction as an equity investment. Second, it could be considered an objective approach country based on its detailed legislation governing "earnings stripping."

Whereas formerly the Internal Revenue Service (IRS) would only recharacterize a loan transaction as an equity investment, the passage in 1989 of specific earnings stripping legislation has resulted in a change in the IRS approach to thin capitalization. The new legislation, however, has not replaced the old subjective legislation. It has merely given the IRS a two-pronged approach to control thin capitalization.

Under the subjective legislation, the IRS has the power to reclassify all thin capitalization, i.e. the legislation applies to residents and non-residents equally. In general, the IRS would form its analysis on a case-by-case basis, comparing the level of capitalization of the company in question to arm's-length situations. In determining whether financing was in the form of equity or debt, the IRS considered such factors as the debt-to-equity ratio, the repayment provisions, the ability to pay the interest out of current income, the relationship between the parties and various other factors. In sum, under the subjective test, it would seem that the IRS has had a great deal of flexibility with which to attack thin capitalization. However, it is understood that these powers were not effective in controlling thin capitalization and hence the objective earnings stripping provisions were added.

With the passage in 1989 of the earnings stripping provisions, the IRS was supplied with additional legislative authority. Simply stated, a corporation with a debt-to-equity ratio exceeding 1.5:1 must defer its excess interest expense deduction if the interest is paid to a related person and is exempt from income tax or subject to a reduced rate under a tax treaty. The amount of deferred interest is the excess of the corporation's net interest expense over 50 percent of the corporation's adjusted taxable income. If the 50 percent adjusted taxable income limit is not fully used in any year, the unused portion may be used during a three-year carry-forward period. Any deferred interest deduction may be carried forward indefinitely.

The legislation defines the debt-to-equity ratio as the ratio of (i) total indebtedness to (ii) the sum of money and adjusted basis of other assets reduced (but not below zero) by such total indebtedness. The proposed regulations do not provide for testing on any date other than the close of the taxable year. Also, the proposed regulations exclude certain short-term payables and commercial financing from the indebtedness figure and, correspondingly, in the asset-based denominator of the ratio.

In 1993 Congress broadened the earnings stripping rules to apply to debt guaranteed by a related foreign person. For the purpose of the earnings stripping rules, guarantees are broadly defined to include any arrangement whereby a person directly or indirectly guarantees the payment of another person's debt obligation. According to the legislative history of this provision, a guarantee also includes a commitment to make a capital contribution to or otherwise maintain the financial viability of the debtor, or even to provide a "comfort letter," regardless of whether it is legally binding. However, an exception is provided for guarantees if the borrower owns a controlling interest in the guarantor.

The other way in which thin capitalization rules may be side-stepped – back-to-back loans – is also addressed in the U.S. legislation, but not in the earnings stripping section. Back-to-back loans are dealt with under legislation relating to conduit financing arrangements. Under new regulations adopted in 1995, the IRS is permitted, but not required, to disregard the participation

of one or more intermediaries in a financing arrangement when the entities are acting as conduit entities. When the IRS disregards the intermediate entities, the financing arrangement will be recharacterized as a direct transaction between the remaining participants and any conduit entity will be treated as an agent of the financing entity. By combining this rule and the earnings stripping legislation, the IRS is capable of attacking any thin capitalization that is conducted through back-to-back loans.

Although it was stated above that the U.S. has a two-pronged approach to attacking thin capitalization, this does not adequately describe the complete legislation. The complexity of the U.S. legislation is unparalleled in other countries. Among other earnings stripping concerns, legislation exists to deal with excess interest arising under high-yield discount obligations and corporate acquisition indebtedness. A detailed discussion of all these provisions is beyond the scope of this paper.

United Kingdom

New thin capitalization rules were introduced by the *Finance Act 1995*. These rules, however, merely appear to have codified Inland Revenue's prior subjective approach to thin capitalization. The new rules can best be analysed after a review of the old rules. In fact, Inland Revenue has said that for the majority of foreign-owned companies, there is no practical change.

Historically, thin capitalization was governed by a complex interaction of domestic law and tax treaties. Under domestic law, interest paid in respect of a security, including a loan or debt, to a non-resident company was considered a distribution, and not interest, where the non-resident company held more than 75 percent of the U.K. company's capital stock or where both the lender and the borrower were more than 75 percent owned by the same non-resident company. In effect, this rule meant that all interest payments to a 75 percent controlling non-resident were considered dividends.

At first glance this rule appears especially harsh. However, it was tempered and brought into line with general thin capitalization provisions through the application of the interest article in tax treaties. Many treaties overrode the U.K. legislation and allowed interest payments to be deducted. Although tax treaties provided for interest deductibility in general, in many tax treaties interest paid to a lender with whom the borrower had a special relationship could be recharacterized as a distribution if the interest payments were in excess of those that would have occurred had no relationship existed.

The problem with the above approach was that not all tax treaties contained a provision that resulted in the appropriate taxation. For example, the U.K.-Germany and U.K.-Japan treaties only allowed Inland Revenue to consider whether the rate of interest was excessive. Therefore, if a company was thinly capitalized, but at a fair market rate, such treaties prevented Inland Revenue from treating any of the interest payments as distributions.

The codification of the new U.K. thin capitalization provisions came in two steps. First, in 1992, Inland Revenue codified its interpretation of "special relationship." Second, the legislation was changed by the *Finance Act 1995* to get around treaty anomalies (dealing with discrimination) by

expanding application of the rule to all lenders. However, to prevent the rule from applying to most domestic lenders, the legislation excludes lenders who are liable for U.K. corporation tax. Thus, although the legislation does not make reference to the residence of the lender, in effect the provisions only apply to non-resident lenders.

The new legislation considers a payment to be a distribution, and not interest, where:

(a) the borrower is a 75 percent-owned subsidiary of the lender or both the borrower and lender are 75 percent-owned subsidiaries of a third company; and

(b) all or any part of the distribution would not have been paid to the lender if the lender had been a party with whom there was no relationship, arrangement, or other connection (formal or informal).

Thus, any interest paid between two companies (when there is a 75 percent relationship) is considered to be a distribution to the extent that the payment would not have been made had the parties been acting at arm's length.

In establishing the debt level, Inland Revenue considers the borrower's position in relation to other entities in the same "U.K. grouping." A higher debt-to-equity ratio might be obtained where the borrowing capacity of the U.K. grouping to which the borrower belongs exceeds that of the individual borrower. A U.K. grouping consists of a U.K. holding company and all its effective 51 percent subsidiaries. Therefore, where the borrowing capacity of this group is stronger than that of the individual borrower, Inland Revenue would accept a related-party debt-to-equity ratio equal to the higher ratio of the group. Conversely, if the U.K. group had a weaker borrowing capacity, the acceptable ratio for the individual borrower would be lower than the borrower could obtain independently.

When considering what would be an appropriate interest expense, Inland Revenue has historically looked at debt-to-equity ratios and interest cover ratios. For ordinary industrial or commercial activities, the acceptable debt-to-equity ratio was widely considered to be 1:1. If a higher ratio was sought, Inland Revenue needed to be convinced that the ratio was appropriate. For an interest cover ratio, a ratio of 3:1 was generally deemed acceptable.

Although Inland Revenue has stated that it will look at much more than ratios when determining whether a loan stems from an arm's-length position, it is difficult to imagine that ratios will be completely disregarded. What this approach proves, however, is that the U.K. thin capitalization test will continue to rely on subjective standards. A borrower will be given the opportunity to argue that interest payments made are appropriate and should not be treated as distributions.

The legislation does not specifically deal with back-to-back loan arrangements or guarantees.

Summary of Thin Capitalization Provisions

The following tables summarize thin capitalization provisions in the countries examined.

TABLE 2

Tests for Thin Capitalization

Country	Subjective	Fixed Ratio	Income
Australia		3:1, 6:1	
Germany		3:1, 9:1 (0.5:1)[1]	
U.K.	✓		
U.S.	✓	1.5:1	(2+:1)[2]
Canada		3:1	

1 Higher ratios may be accepted if proven arm's length.
0.5:1 ratio for participating debt.
2 Income ratio based on pre-depreciation income and is, therefore, higher than 2:1.

TABLE 3

Debt Included in Debt-to-Equity Ratio

Country	All Debt	Related Non-Resident Debt	Back-to-Back	Guaranteed
Australia		✓	✓	✓[1]
Germany		✓	✓	✓
U.K.		✓		
U.S.	✓		✓	✓
Canada		✓	✓	

1 proposed

TABLE 4

Equity Included in Debt-to-Equity Ratio

Country	All Equity	Foreign-Related Equity	Cascade Effect Eliminated
Australia		✓	✓
Germany		✓	✓
U.K.		N/A	N/A
U.S.	✓		N/A
Canada		✓	✓

TABLE 5

Effect of Thin Capitalization Rules

Country	Disallowed Interest	Carry-forward	Deemed Dividend
Australia	✓		
Germany	✓		
U.K.	✓		✓
U.S.	✓	✓	✓[1]
Canada	✓		

[1] There is no reclassification of a payment as a dividend under earnings stripping rules.

TABLE 6

Entities to Which the Thin Capitalization Rules Apply

Country	Domestic Corporation	Branches	Partnerships	Trusts
Australia	✓	✓	✓	✓
Germany	✓			
U.K.	✓	✓		
U.S.	✓	✓		
Canada	✓			

Issues with Respect to Thin Capitalization

In analysing any taxing provision, careful regard must be given to the objectives underlying the system. For this paper, the objectives are considered to be (i) neutrality; (ii) the promotion of job creation and economic growth; (iii) the protection of the Canadian tax base; (iv) the simplification of the taxation system; and (v) the enhancement of equitable taxation by ensuring that all businesses share in the cost of providing government services.

As can be seen from the country-by-country overview, thin capitalization legislation consists of many subparts that combine to determine the ultimate debt structure that is acceptable to any given country. This paper now turns to discuss how each of these subparts could be structured in order to meet the above objectives. Care must be taken, however, not to lose sight of the effect thin capitalization legislation has in meeting the objectives set for a taxing provision.

Book Value vs. Tax Values

In most of the countries noted, book values are used to determine whether a corporation is thinly capitalized. An exception to this is the U.S., where equity is determined as the tax value of assets less liabilities. Canada is, to a certain extent, also an exception, as the paid-up capital of shares is used, rather than the book value. Frequently, paid-up capital may be less than the amount paid by a shareholder for shares and less than the book value of the shares. This may produce an inequitable result for a non-resident shareholder.

Frequently, when a non-resident acquires an existing Canadian corporation, a Canadian acquisition company is used, such that the paid-up capital is increased to fair market value. If a non-resident indirectly acquires shares of a Canadian corporation that is a subsidiary of a non-resident corporation that is purchased, the thin capitalization limit continues to be based on historic book value, as paid-up capital cannot be increased to fair market value. In the second scenario, the ultimate non-resident shareholder would not be able to obtain the same degree of leverage in the Canadian subsidiary as would be the case if the Canadian subsidiary had been acquired directly.

Accordingly, the use of paid-up capital in the definition of equity may provide inequitable results.

Definition of Equity

There are several issues with respect to how equity is defined. In all of the countries considered (except the U.S., which uses the tax value of equity) the definition of equity includes at least a portion of share capital, surplus and retained earnings.

Share Capital

The first aspect of the definition of equity is whether all share capital should be included, or only share capital owned by certain non-residents. It is questionable whether a corporation can be considered to be thinly capitalized without a consideration of all debt and all equity. A debt-to-equity ratio, by its very nature, focusses on the borrowing capacity of an entity. It is the total equity of a corporation that determines its borrowing capacity. To consider anything other

than all debt and all equity would add considerations other than borrowing capacity to the equation. These other considerations could be addressed elsewhere in a thin capitalization calculation. Including only share capital owned by specified non-resident shareholders results in certain problems.

For example, under Canadian thin capitalization legislation, a non-resident shareholder may be precluded from loaning funds directly to a second-tier Canadian subsidiary, as the latter does not have any share capital owned by specified non-resident shareholders. There may be valid business reasons for having a structure in which it is desirable to loan directly to such a subsidiary, however, Canadian thin capitalization provisions would require the non-resident to loan to the Canadian parent, which would then be required to loan funds to the second-tier subsidiary. As a result, the existing tax legislation may cause businesses to undertake non-commercially motivated activity, and it is certainly conceivable that commercial considerations could preclude such indirect loans. Furthermore, such back-to-back loans could, technically, be caught by Canadian back-to-back loan provisions, although it would seem that this is clearly not the type of situation that such provisions were intended to apply to.

A second problem with including only shares owned by specified non-residents can be illustrated by example. Consider a situation where three parties (one non-resident and two Canadian) wish to establish a corporation where each own one third. Assume that $12 million of funding is required, but the two Canadian resident investors are capable of providing only $1 million each. The non-resident is capable of providing $10 million of funding, but in order to preserve the equal ownership wishes to have $9 million in the form of debt. Under Canada's existing thin capitalization legislation, the entity would be thinly capitalized although the debt-to-equity ratio in total is only 3:1. It is also notable that, if the two Canadian resident shareholders were non-resident, the entity would not be thinly capitalized.

Changing the definition of equity to include all equity would eliminate both the above inconsistencies. However, such a change would need to be slightly modified in order to ensure that a group of related companies could not be established that, as a whole, would breach thin capitalization rules. For example, if all equity is included in the definition, it would be possible in the multi-tiered example given above to double count the equity invested in the Canadian parent and reinvested in the second-tier subsidiary. That is, if the foreign parent were to loan funds separately to the Canadian parent as well as to the second-tier subsidiary, the foreign parent’s initial equity investment in the Canadian parent would affect the debt-to-equity ratio in both the Canadian parent and in the second-tier subsidiary. By doing so, a foreign parent could lend to the Canadian group, as a whole, funds in excess of the acceptable ratio without breaching the ratio for any individual company. This problem, however, could be solved by modifying the definition of equity to include all equity except intercompany investments from a company affiliated with the specified non-resident shareholder.

The current Canadian approach favours simplicity, forcing taxpayers to structure their investments to avoid the apparent anomalies.

Retained Earnings

An issue with respect to retained earnings is whether all retained earnings should be included, or only a portion of them. In Australia and Germany, only a proportionate amount of retained earnings is included (being equal to the proportion of the non-residents' ownership), whereas in Canada the entire retained earnings balance is included. There does not appear to be any logic to including the entire balance of retained earnings, but not the entire balance of share capital and contributed surplus. However, as noted above, it would seem to be more appropriate to assess whether a company is thinly capitalized based on the total balance sheet, rather than just the equity and debt of specified non-residents.

A second issue with respect to retained earnings is whether retained earnings should be calculated on a cost basis or on an equity or consolidated basis. The Canadian legislation includes retained earnings, except to the extent that those earnings include retained earnings of another corporation, thus requiring use of cost-basis accounting. This can give rise to inappropriate results. For example, a non-resident may be required to loan directly to second- or lower-tier subsidiaries in order to remain onside of thin capitalization provisions.

A consolidated approach to calculating equity is used in the U.K. While such an approach may provide a more equitable result, it would also increase the complexity of the provisions. For example, it would be necessary to have specific legislation to prevent the double counting of equity that could result by loaning to the Canadian parent (using consolidated retained earnings) and also loaning to the subsidiary.

Deficits

Canadian thin capitalization provisions do not require a deficit balance to be deducted from equity, as is the case in other jurisdictions. Deducting deficits in the calculation of equity fails to fully recognize the equity contributed by non-residents in any ratio calculation. However, as deficits would likely erode the ability of a company to borrow from an arm's-length party, it is difficult to justify their exclusion in any thin capitalization calculations. Also, it should not matter whether the deficit arises before or after the loan is made. In either situation, the deficit has a direct effect on a corporation's borrowing capacity and should be considered when determining a fair debt-to-equity ratio.

Adjustments to Equity

Certain other countries have more complex legislation that causes equity to be reduced by various amounts. For example, in Australia, loans to the non-resident shareholder reduce the shareholder's equity. While this may provide a truer measure of the non-resident's equity investment, in Canada there are other provisions (in particular Sections 15 and 17) that would normally prevent such loans and make such an adjustment unnecessary. However, these provisions do not address related-party equity investments. If the purpose of the legislation is to prevent such practices as leveraging a Canadian company in order to invest in a foreign affiliate, then merely reducing the definition of equity by related-party loans would be insufficient and the rules would need to be expanded to include related-party equity.

Definition of Debt

Type of Debt Included

The definition of debt raises similar issues to those raised for the definition of equity. First, should just related-party debt be included or should it be all debt? Second, should debt be that of the consolidated group of companies or should it be only that of the legal entity? Third, once the above two questions are answered, what type of debt should be considered, i.e. should only interest-bearing debt be considered or should non-interest-bearing debt also be included? In addition, should substitutes for debt (such as leasing obligations or derivatives) be included?

As thin capitalization rules are concerned with interest, it appears appropriate that only interest-bearing debt is considered in the equation. In fact, if there is non-interest-bearing debt, it is arguable that such debt should be included in the definition of equity.

As to the first two issues, the discussion on the definition of equity applies equally as well to debt.

Measurement of Debt

In Canada, thin capitalization rules apply based on the greatest amount of interest-bearing debt outstanding at any time in the year. While this is a simple approach, it can obviously produce an inequitable result in situations where a large amount of debt is outstanding for a very short period of time. In Australia, the disallowance of interest is based on the greatest amount of debt outstanding in the year, however, a taxpayer can elect to use the weighted average of debt outstanding in periods where the maximum debt-to-equity ratio is exceeded, thereby providing partial relief. On balance, although averaging requires legislative complexity and would also create complexity for compliance and enforcement, it is likely justified because it achieves a more equitable result.

Back-to-Back Loans

Back-to-back loans are specifically addressed in the legislation of all the objective approach countries discussed in this paper. This is an expected outcome, however, the form of the legislation (and probably the effectiveness of the legislation) varies.

In Canada, back-to-back loan provisions apply only where the non-resident shareholder makes a loan to a person "on condition that" a second loan be made to the Canadian resident. Accordingly, the provision would arguably not apply where the non-resident shareholder merely has funds on deposit with a third party, but has not deposited the funds on condition that a second loan be made (even though the deposit may be pledged as security for the second loan).

In addition, Canadian provisions do not deal with any situations other than back-to-back loans. For example, the provisions would not apply where the specified non-resident shareholder acquires retractable preferred shares of the intermediary. Proposed legislation in Australia would deal with this issue by applying to any back-to-back "financing."

Clearly, back-to-back loans enable corporations to circumvent thin capitalization rules. Therefore, in order to prevent a corporation from avoiding thin capitalization rules by interposing a third-party intermediary in a loan transaction, Canada should consider extending its back-to-back loan provisions to include indirect financing by a specified non-resident shareholder.

As noted earlier, the existing Canadian provisions may also apply to a situation where the intermediary is a Canadian holding company, although it is presumed that this is not an intended result.

Guaranteed Loans

This is one area where, even among the objective approach countries analysed in this paper, agreement cannot be found. For example, Canada does not address the issue, Germany addresses the issue, and the former Australian government indicated in its press release that whereas it formerly felt that the issue should not be addressed, it now takes the position that thin capitalization rules should tackle parent guarantees of debt incurred by resident subsidiaries from third-party lenders.

Parent guarantees are generally perceived as a mechanism that permits thin capitalization rules to be circumvented. They allow a corporation to borrow from a foreign third party on the strength of the parent's credit. This creates an opportunity for tax planning where a foreign parent's equity can be used to support third-party loans to the subsidiary. In reality, however, there are many situations where a domestic subsidiary may have sufficient borrowing capacity, however, a lender will nonetheless request a parent-company guarantee. Normally, a lender will seek the greatest amount of security possible. Therefore, if legislation requires the inclusion of parent-guaranteed debt, it may preclude otherwise commercial lending practices and cause an increase in the cost of capital for Canadian subsidiaries (as a third-party lender would presumably require a higher interest rate if a parent guarantee is not provided).

The balance in considering whether to include third-party debt supported by shareholder guarantees is difficult. Most countries to date have backed away from including debt supported by guarantees in the test because of the concern about disrupting normal commercial financing arrangements. On balance, debt guaranteed by shareholders should likely not be included in thin capitalization ratios except in situations where it is clear that the Canadian subsidiary could not borrow without such support or where the overall debt-to-equity ratio exceeds certain defined limits.

Industry Ratios vs. General Ratios

Establishing debt-to-equity ratio is another area where countries differ in their approach to thin capitalization. Some countries have one fixed ratio, others have two ratios, and yet others have a number of ratios. Where more than one ratio exists, it is likely because the country recognizes that different industries have different debt-to-equity needs and that tax rules should reflect these differing needs. For example, real estate enterprises are typically more highly leveraged, as are financial institutions. A single thin capitalization limit for all industries places non-resident-owned entities at a disadvantage, as they are required to have the resident subsidiary

borrow directly from third parties, thereby losing access to the global credit rating of the parent company.

By imposing general ratios, a country may restrict the establishment of a company in an industry where a higher ratio is required. This would defeat the tax objective of job creation and economic growth. The simplicity that comes with maintaining only one ratio may not offset the drawbacks of inflexibility.

While there are drawbacks to a single ratio, there are also merits. A non-legislative approach (or a subjective approach) would likely result in greater uncertainty for investors, lower enforceability, and increased litigation. Any attempt to legislate multiple ratios would undoubtedly result in problems, as many enterprises are diversified in many industries.

An alternative approach would be to allow the Canadian subsidiary to have the same debt-to-equity ratio as the parent company on a worldwide consolidated basis. While such an approach would seem to be equitable, it would undoubtedly be complex and difficult to enforce.

It should be noted that the Canadian legislation currently provides one exception to the general rule of a 3:1 debt-to-equity limit. This exception applies to companies whose principal business is the development or manufacture of airplanes or airplane components.

Disallowed Interest Carry-Forward

The U.S. is unique in its approach to disallowed interest. The effect of the U.S. earnings stripping legislation is to disallow excess interest over the lifetime of the company. That is, if the company fails to meet the thin capitalization criteria for a short period, it will not be penalized if it ultimately makes up for its breach in subsequent periods. Other countries do not provide this leeway. To be fair, it is only the earnings stripping legislation that allows for a carry-forward. The traditional thin capitalization approach in the U.S. does not allow for carry-forwards when recharacterizing a loan as equity.

By allowing an interest carry-forward, a country implicitly recognizes that a company may fall short of the general standard at some periods, often during the start-up phase, yet still not breach the concept of thin capitalization over its life. This is especially important where a country uses an income statement approach to disallowing the deductibility of excessive interest. It is impossible for a company to predict, with certainty, its income for any coming year. Therefore, by strictly enforcing a rule that disallows interest in excess of an unpredictable foundation, a government would not be acknowledging the cyclical aspect of modern-day business. By allowing for an interest carryover, a government would merely be allowing a corporation the flexibility to meet acceptable related-party debt and interest levels over the life of the business.

Concern with interest carry-forwards may not be as much of an issue where the legislation attacks excessive leverage and interest expense through a balance sheet test. Under such a test, for example, the 3:1 ratio, a company is not at the mercy of cyclical fluctuations and can undertake advance planning to meet the ratio. If the purpose of the 3:1 ratio is to set an upper leveraging threshold for any given year beyond which a government will not accept interest deductibility,

then granting an interest carry-forward would allow a company excessive deductibility rights. If, however, the purpose of the 3:1 ratio is to set an acceptable limit over the life of a company, then carry-forwards may be appropriate.

A possible drawback to recognizing interest carry-forwards is that such recognition would add to the complexity of thin capitalization legislation. However, it is possible that the drawbacks of this added complexity may be offset by the economic benefits resulting from a measure of neutrality being incorporated into the legislation. Once an overall taxing measure is set, an argument can be made that economic growth and efficiency is best promoted through a neutral taxing system that allows a company to work through its economic cycles.

Objective Approach vs. Subjective Approach

As was seen in the overview of the various countries' legislations, thin capitalization has been dealt with through both objective legislation and subjective criteria. Using subjective criteria to measure thin capitalization allows for the flexibility required for different companies and different industries. The subjective approach can achieve all that the objective approach achieves and more. The drawback, however, of using a subjective approach is that taxing provisions become uncertain and, as a result, more complex. A subjective approach can lead to extensive tax planning to meet a myriad of criteria and where a corporation disagrees with the taxing authority, litigation may result.

Type of Organization

Another issue that may be examined is whether thin capitalization rules should apply not only to corporations but also to branches, partnerships and trusts. In the U.S., earnings stripping provisions apply to branches as well as corporations and, as noted above, in Australia thin capitalization provisions apply to all forms of business enterprise.

In assessing whether thin capitalization provisions should apply to all enterprises, consideration should be given to whether there is sufficient non-corporate investment to warrant such a change, which would of necessity entail detailed legislation. Such legislation would be extremely complex, and defining such aspects as equity for partnerships and trusts would be extremely difficult.

However, we would recommend that thin capitalization rules apply to branches. There does not appear to be a policy reason why branches should be treated differently from subsidiaries. Consideration could be given to applying the rules to other types of organizations if there is sufficient non-corporate investment or if there is a concern that corporate investment will be converted into non-corporate form to avoid the rules.

Thin Capitalization and Canadian Tax Objectives

No discussion would be complete without analysing the reason for the existence of thin capitalization legislation, keeping in mind tax objectives surrounding the legislation as a whole.

Clearly, thin capitalization legislation as a whole does not simplify the tax system. The best that can be achieved is to keep definitions of equity and debt as simple as possible. A range of ratios for different situations would likely not result in excessive complexity. Currently, the Canadian legislation is the simplest of all the countries discussed in this paper and, perhaps, the least effective in restricting the interest deductibility of thinly capitalized companies.

Thin capitalization rules, however, protect the Canadian tax base. By disallowing a certain amount of interest expense, the legislation prevents excessive foreign debt and promotes local borrowing.

The most compelling reason for rules on thin capitalization, and that advanced by the former Australian government in its press release, is that by allowing the domestic subsidiaries of foreign controlled companies to obtain tax benefits of unduly high debt-to-equity ratios, they are placed at an advantage relative to nationally owned and financed companies. For example, where a foreign multinational is able to shift profits out of Canada and thereby achieve both a lower tax expense in Canada and in the world, the company will be at an unfair competitive advantage over a local company that is subject to higher tax. While this is theoretically possible, it is not entirely clear whether a foreign parent will necessarily have a lower tax burden in all situations, as the interest expense paid by the Canadian company will typically be subject to both Canadian withholding tax and foreign income tax. In many situations, leveraging of a Canadian subsidiary is performed for other purposes including managing of foreign exchange risk and managing the foreign parent's foreign tax credit situation. In these situations, it is certainly not clear that the Canadian subsidiary would have any competitive advantage over a Canadian enterprise.

Treaty Issues; Double Taxation

Disallowance of interest expense under any domestic thin capitalization rules may result in economic double taxation within a multinational corporate group. As more and more countries impose and tighten their domestic thin capitalization rules, the likelihood of economic double taxation increases. The government should adopt, as a treaty policy, measures designed to eliminate economic double taxation that arises as a result of domestic thin capitalization rules – possibly by including interest disallowed under thin capitalization rules as an issue that could be dealt with by the competent authority process provided under most treaties.

Financing Through Tax-Exempt Entities

A problem has arisen in some countries, such as Canada, where thin capitalization rules only apply to loans from non-residents. In these countries it has been suggested that it is possible to obtain a loan from a local tax-exempt entity with the same erosion to the Canadian tax base as would be the case if the loan was obtained from a non-resident. Some countries have addressed this issue by applying thin capitalization rules to all debt where the lender is not subject to local income tax. This type of legislation catches both non-resident entities and local tax-exempt entities.

It should be noted, however, that in Canada the perceived abuse would likely be loans obtained from pension funds, and therefore the interest is not in reality exempt from taxation, but rather, the taxation is merely deferred until such time as the funds are distributed to the beneficiary. Accordingly, any consideration of whether such loans should be subject to thin capitalization limitations should only be undertaken with adequate consideration of the policy rationale allowing tax-assisted retirement savings.

Technical Committee on Business Taxation

The Technical Committee was established by the Minister of Finance, at the time of the March 1996 federal budget, to consider ways of:

- improving the business tax system to promote job creation and economic growth,
- simplifying the taxation of businesses to facilitate compliance and administration, and
- enhancing fairness to ensure that all businesses share the cost of providing government services.

The Technical Committee will report before the end of 1997; consultations with the public will follow the release of the report.

The Technical Committee is composed of a panel with legal, accounting and economic expertise in the tax field. The members are:

Mr. Robert Brown
Price Waterhouse
Toronto, Ontario

Mr. James Cowan
Stewart McKelvey Stirling Scales
Halifax, Nova Scotia

Mr. Wilfrid Lefebvre
Ogilvy Renault
Montreal, Quebec

Professor Nancy Olewiler
Department of Economics
Simon Fraser University
Burnaby, British Columbia

Mr. Stephen Richardson
Tory, Tory, Deslauriers & Binnington
Toronto, Ontario

Professor Bev Dahlby
Department of Economics
University of Alberta
Edmonton, Alberta

Mr. Allan Lanthier
Ernst & Young
Montreal, Quebec

Professor Jack Mintz (Chair)
Faculty of Management,
University of Toronto (on leave)
Clifford Clark Visiting Economist
Department of Finance
Ottawa, Ontario

Mr. Norm Promislow
Buchwald Asper Gallagher Henteleff
Winnipeg, Manitoba

The Technical Committee has commissioned a number of studies from outside experts to provide analysis of many of the issues being considered as part of its mandate. These studies are being released as working papers to make the analysis available for information and comment. The papers have received only limited evaluation; views expressed are those of the authors and do not necessarily reflect the views of the Technical Committee.

A list of completed research studies follows. They may be requested from:

Distribution Centre
Department of Finance
300 Laurier Avenue West
Ottawa, Ontario K1A 0G5
Telephone: (613) 995-2855
Facsimile: (613) 996-0518

They are also available on the Internet at http://www.fin.gc.ca/

Technical Committee on Business Taxation Completed Research Studies

☐ **WORKING PAPER 96-1**
Comparison and Assessment of the Tax Treatment of Foreign-Source Income in Canada, Australia, France, Germany and the United States
Brian Arnold (Goodman Phillips & Vineberg)
Jinyan Li and *David Sandler* (University of Western Ontario)

☐ **WORKING PAPER 96-2**
Why Tax Corporations
Richard Bird (University of Toronto)

☐ **WORKING PAPER 96-3**
Tax Policy and Job Creation: Specific Employment Incentive Programs
Ben Cherniavsky (Technical Committee Research Analyst)

☐ **WORKING PAPER 96-4**
The Effects of Taxation on U.S. Multinationals and Their Canadian Affiliates
Jason Cummins (New York University)

☐ **WORKING PAPER 96-5**
The Integration of Corporate and Personal Taxes in Europe: The Role of Minimum Taxes on Dividend Payments
Michael Devereux (Keele University)

☐ **WORKING PAPER 96-6**
International Implications of U.S. Business Tax Reform
Andrew Lyon (University of Maryland)

☐ **WORKING PAPER 96-7**
The Economic Effects of Dividend Taxation
Ken McKenzie (University of Calgary)
Aileen Thompson (Carleton University)

☐ **WORKING PAPER 96-8**
Capital Tax Issues
Peter McQuillan and *Cal Cochrane* (KPMG Toronto)

☐ **WORKING PAPER 96-9**
Compliance Issues: Small Business and the Corporate Income Tax System
Robert Plamondon (Ottawa)

☐ **WORKING PAPER 96-10**
Study on Transfer Pricing
Robert Turner (Ernst & Young, Toronto)

☐ **WORKING PAPER 96-11**
The Interaction of Federal and Provincial Taxes on Businesses
Marianne Vigneault (Bishop's University)
Robin Boadway (Queen's University)

☑ **WORKING PAPER 96-12**
Taxation of Inbound Investment
Gordon Williamson (Arthur Andersen, Toronto)