BUDGET 2016: DEBT PARKING RULES EXPANDED TO ADDRESS FOREIGN CURRENCY DENOMINATED DEBTS

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In Budget 2016, the Government proposed new anti-avoidance rules to close a loophole that the Government believes permits taxpayers to "park" debt denominated in a foreign currency with a party with which it does not deal at arm's length, instead of repaying it, in order to avoid realizing accrued foreign exchange gains and losses.

Background

For Canadian tax purposes, all amounts relevant to the computation of taxable income must generally be converted to, and reported in, Canadian dollars. As a consequence, a taxpayer may realize a gain or a loss on the repayment of a debt denominated in a foreign currency when the value of the foreign currency changes relative to the Canadian dollar.

The *Income Tax Act* ("**Tax Act**") deems a gain or loss realized in respect of a foreign currency on a foreign currency denominated debt that is held on capital account to be a capital gain or loss from the disposition of the foreign currency. However, such a gain or loss is generally considered to have been realized only at the time the debt is actually settled, whether by virtue of being repaid or otherwise extinguished.

To avoid realizing a gain due to an appreciation in the value of the Canadian dollar relative to a foreign currency in which a particular debt is denominated, some taxpayers have opted to enter into "debt-parking" transactions. In a conventional "debt-parking" arrangement, instead of simply repaying a debt with an accrued foreign exchange gain, the debtor arranges for a person with which it does not deal at arm's length (e.g., an affiliate) to acquire the debt from the lender for a purchase price equal to the amount owing on the debt. The transfer of the debt by the lender to the non-arm's length person would generally not result in the debt being settled or extinguished. Indeed, although the debt would effectively be repaid from the lender's perspective, from the debtor's perspective, the debt remains outstanding (i.e., it is now owing to the non-arm's length person). As a result, the foreign exchange gain would not be triggered as long as the non-arm's length person allows the debt to remain outstanding. The debt could be left outstanding indefinitely, or could potentially be repaid at a later date if, for example, the debtor has since sustained sufficient capital losses to offset the foreign

exchange gain, or the Canadian dollar has depreciated sufficiently relative to the foreign currency in which the debt is denominated such that the accrued gain has significantly decreased or has disappeared altogether.

Currently, the Tax Act contains rules that deal with "debt-parking" transactions for purposes of the "debt forgiveness" rules. Where these "debt-parking" rules apply, a debt is deemed to have been repaid for an amount equal to its cost to the new, non-arm's length creditor. Any difference between the principal amount of the debt and the amount for which it is deemed to have been repaid is treated as a "forgiven amount", which is then applied to reduce various tax attributes of the debtor, and can ultimately lead to an income inclusion for the debtor where there are insufficient tax attributes to fully absorb the forgiven amount[1].

While the existing debt-parking rules will generally deem a foreign currency debt owed to a third party to have been repaid at the time of its acquisition by a non-arm's length creditor, any foreign exchange gain accrued on the debt would not be taken into account in determining the forgiven amount of the debt, since, based on the interpretation of the existing rules by the Canada Revenue Agency (the "**CRA**"), it is the historical foreign exchange rate at the time the debt was issued that is to be used for purposes of determining the forgiven amount that arises as a consequence of the application of the debt-parking rules[2]. Accordingly, the amount of any accrued foreign exchange gain in respect of a debt deemed settled under the "debt parking" rules would not, under existing rules, result in any incremental reduction in a debtor's tax attributes, nor would any portion of such accrued foreign exchange gain be required to be included in the debtor's income at the time the debt became a parked debt.

Budget 2016: Debt Parking Proposals

Although it is the Government's view that debt-parking transactions undertaken to avoid foreign exchange gains could be challenged under the general anti-avoidance rule ("**GAAR**") in the Tax Act, such challenges under the GAAR can often be time-consuming and costly, and could also yield unfavorable results from the Government's perspective. As a result, Budget 2016 proposes to introduce rules aimed at ensuring that any accrued foreign exchange gain on a foreign currency debt will be realized when the debt becomes a parked obligation. In this regard, a debtor will be deemed to have realized a foreign exchange gain that it would otherwise have realized if it had paid an amount (expressed in the currency in which the debt is denominated) in satisfaction of the principal amount of the debt equal to:

i. where the debt becomes a parked obligation as a result of its acquisition by the current holder, the amount for which the debt was acquired; and
ii. in any other case, the fair market value of the debt.

For these purposes, a foreign currency debt will become a parked obligation at a particular time where:

i. at that time, the current holder of the debt does not deal at arm's length with the debtor, or, where the debtor is a corporation, has a "significant interest"[3] in the debtor, and
ii. at any previous time, a person who held the debt dealt at arm's length with the debtor, and, where the debtor is a corporation, did not have a "significant interest" in the debtor.

The Government has proposed to enact statutory exceptions to the new anti-avoidance rules to ensure that a foreign currency debt will not become a parked obligation in the context of certain *bona fide* commercial transactions. One such exception provides that a foreign currency debt that is acquired by the current holder as part of a transaction or series of transactions that results in the acquisition of a significant interest in, or control of, the debtor by the current holder (or a person related to the current holder) will not become a parked obligation unless one of the main purposes of the transaction or series of transactions was to avoid a foreign exchange gain. Another exception would provide that a change of status between the debtor and the current holder (i.e., from dealing at arm's length to not dealing at non-arm's length, or, if the debtor is a corporation, from the current holder not having a significant interest in the debtor to having one) will not cause the debt to become a parked obligation unless one of the main purposes of the transaction or series of transactions that gave rise to the change of status was to avoid a foreign exchange gain.

The proposed revisions to the debt-parking rules will also provide relief to financially distressed debtors. The relief will be similar to the existing relieving provisions that enable insolvent debtors to claim a deduction that may fully or partially offset the inclusion in income of any residual forgiven amount that may arise under the debt forgiveness rules.

Although Budget 2016 contained a general summary of the proposed rules, it did not include any detailed draft legislative measures. As a result, it remains to be seen how the proposed revisions to the debt-parking rules will be integrated with the existing rules. Specifically, it will be interesting to see whether the exceptions proposed for *bona fide* commercial transactions and a change in status between a debtor and creditor will restrict the broader application of the debt forgiveness rules more generally, or whether they will be limited in their application to simply precluding the immediate recognition of an accrued foreign exchange gain.

The proposed measures will apply to a foreign currency debt that meets the conditions to become a parked obligation on or after March 22, 2016. However, the new proposals will not apply where the satisfaction of the conditions occurs before 2017 and results from a written agreement entered into before March 22, 2016.

by Michel Ranger

[1] After being applied to reduce a debtor's tax attributes to the maximum extent required under the Tax Act, one-half of any residual forgiven amount would then generally be required to be included in the debtor's income.[ps2id id='1' target='/]

[2] See, for example, Canada Revenue Agency Document No. 2009-0347661C6, "Debt parking and foreign currency", December 8, 2009.[ps2id id='2' target='/]

[3] Generally, a person will be considered to have a "significant interest" in a corporation if the person (alone or together with any non-arm's length persons) owns shares of the corporation to which 25% or more of the votes or value of the corporation are attributable. Additional rules, which parallel the interpretative rules that currently form part of the debt forgiveness provisions in the Tax Act, are proposed to be enacted to deal with situations involving trusts and partnerships.[ps2id id='3' target='/]

A Cautionary Note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.

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