

BUDGET 2016: NEW RULES TARGETING "BACK-TO-BACK" ARRANGEMENTS

Posted on March 31, 2016

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Budget 2016 proposes a series of new rules targeting the perceived use of "back-to-back" structures to (i) reduce Canadian withholding tax, or (ii) avoid the application of anti-avoidance rules currently contained in the *Income Tax Act* (the "**Tax Act**"). Although the new Budget proposals are presented as a conceptual extension of existing provisions in the Tax Act, in some cases, the proposals bear little resemblance to the existing rules.

"Back-To-Back" Royalty Rules

The first set of proposed new "back-to-back" rules targets the use of intermediaries resident in jurisdictions with which Canada has entered into a tax treaty in a manner that allows persons resident in non-treaty jurisdictions to access treaty-reduced rates of withholding tax in respect of the receipt of rents, royalties or similar payments (collectively, "**royalties**"). The proposed new rules will apply where:

- a. a Canadian-resident person (the "**Canadian Payor**") makes a royalty payment in respect of a lease, license or similar agreement to a person resident in a tax treaty jurisdiction (an "**intermediary**");
- b. the intermediary (or a person or partnership that does not deal at arm's length with the intermediary) has an obligation to pay an amount to another non-resident person (the "**ultimate recipient**") in respect of a lease, license or similar agreement, or of an assignment or an instalment sale; and
- c. one of the following conditions is met:
 - i. the amount the intermediary is obligated to pay is established, in whole or in part, by reference to (1) the royalty payment made by, or the royalty payment obligation of, the Canadian Payor, or (2) the fair market value of property; any revenue, profits, income or cash flow from property; or any other similar criteria in respect of property, where a right to use the property is granted to the Canadian Payor; or
 - ii. it can reasonably be concluded, based on all the facts and circumstances, that the agreement with the Canadian Payor was entered into or permitted to remain in effect because of the arrangement between the intermediary and the ultimate recipient (i.e., the two "legs" of the transaction are connected).

The proposed rule will, however, only apply where the Canadian withholding tax payable in respect of payments to the intermediary is less than the withholding tax that would have been payable if the payment by the Canadian Payor were made directly to the ultimate recipient.

Where the new "back-to-back" rule applies, the Canadian Payor will be deemed to have made a royalty payment directly to the ultimate recipient, and the amount of withholding tax payable in respect of the deemed royalty payment will equal the amount of withholding tax avoided by use of the back-to-back arrangement.

The new "back-to-back" rule will apply to royalty payments made after 2016.

This proposal raises a number of concerns. First, unlike the existing "back-to-back" rules in the Tax Act, it is not clear that these rules are intended to be limited to transactions where there is a close relationship between the Canadian Payor and the ultimate recipient. Second, in the absence of draft legislation, it is not clear what factors would be used to assess whether there is a connection between the two "legs" of the back-to-back arrangement.

Character Substitution Rules

The second set of new "back-to-back" rules proposed in Budget 2016 are intended to prevent perceived tax avoidance through the use of structures intended to circumvent the existing "back-to-back" anti-avoidance rules in Part XIII of the Tax Act relating to interest (or the proposed rules relating to royalties) by establishing payments between the intermediary and the ultimate recipient that are economically similar to interest (or royalty) payments, but that do not formally constitute interest (or royalties).

These new rules would apply to deem a "back-to-back" arrangement to be captured by the existing (or proposed) anti-avoidance rules where:

- a. interest is paid by a Canadian Payor to an intermediary and there is an agreement that provides payments in respect of royalties between the intermediary and the ultimate recipient;
- b. royalties are paid by a Canadian Payor to an intermediary and there is a loan between the intermediary and the ultimate recipient; or
- c. interest or royalties are paid by a Canadian Payor to an intermediary and a non-resident person (e.g., the ultimate recipient) holds shares of the intermediary that include certain obligations to pay dividends or that satisfy certain other conditions (e.g., they are redeemable or cancellable).

The proposed character substitution rules will apply where a "sufficient connection" is established between (i) the arrangement under which an interest or royalty payment is made by a Canadian Payor, and (ii) the intermediary's obligation to the ultimate recipient in each of the three situations described above. Where such

an arrangement is found to exist, the Canadian Payor will be deemed to have made an additional payment to the ultimate recipient having the same character as the payment made to the intermediary, which deemed payment will be subject to Canadian withholding tax. (It is not clear from the Budget documents whether the amount of withholding tax payable in respect of the deemed payment will be reduced by the amount of withholding tax payable in respect of the actual payment made to the intermediary).

The new character substitution rules will apply to interest and royalty payments made after 2016.

This proposal raises many of the same concerns canvassed above with respect to the proposed "back-to-back" royalty rules. Furthermore, the proposal raises several practical tax policy questions. For example, why should the tax treatment of a royalty payment to a non-resident be affected because the non-resident chooses to finance its operations (for example, the purchase of the intellectual property to which the royalty relates) with a loan from another non-resident person (e.g., the ultimate recipient) or with shares having certain dividend obligations or which are redeemable? On their own, there is nothing about such financing arrangements (which, after all, are commonplace for Canadian companies) which are, per se, offensive. It may well be that the focus of this proposal will be narrowed when draft legislation is released, but, at present, it appears to be overly broad.

"Back-To-Back" Shareholder Loan Arrangements

The third set of new "back-to-back" rules will apply to "back-to-back" loan arrangements intended to avoid the application of Canada's shareholder loan rules, which (when applicable), can result in an income inclusion (in the case of a Canadian-resident shareholder) or a deemed dividend subject to withholding tax (in the case of a non-resident shareholder). The Budget documents suggest that taxpayers have been using intermediaries to avoid the application of these rules.

In simple terms, the new "back-to-back" shareholder loan rules will apply where a shareholder of a Canadian-resident corporation (or a person or partnership that is "connected" with the shareholder or that is a member of a partnership that is a shareholder) owes an amount (the "shareholder debt") to an intermediary who is not connected with the shareholder, and either:

- a. the intermediary owes an amount to the corporation (the "**intermediary debt**") and either recourse is limited in whole or in part to amounts recovered by the intermediary from the shareholder on the shareholder debt, or it can reasonably be concluded that the shareholder debt became owing or was allowed to remain owing because the intermediary debt was or was anticipated to be entered into; or
- b. the intermediary has a "specified right" in respect of a particular property that was granted by the corporation and either the existence of the specified right is required under the terms of the shareholder debt or it can reasonably be concluded that the shareholder debt became owing or was allowed to

remain owing because the specified right was or was anticipated to be granted. (For these purposes, a "specified right" is proposed to be defined in the same way as the term is defined under the existing "back-to-back" loan rules.)

If such an arrangement is found to exist, the shareholder will be deemed to be indebted to the corporation in an amount equal to the lesser of (i) the amount of the shareholder debt, and (ii) the sum of the intermediary debt and the total fair market value of property over which the intermediary has a "specified right".

This proposal will apply to back-to-back shareholder loan arrangements as of March 22, 2016. For existing arrangements, the deemed indebtedness will be deemed to have become owing on March 22, 2016.

Multiple Intermediary Arrangements

Finally, Budget 2016 proposes rules to clarify that the existing back-to-back rules, as well as the new back-to-back rules proposed in the Budget, also apply to arrangements where there are multiple tiers of intermediaries. Under these new proposals, the back-to-back rules will apply to all arrangements that are "sufficiently connected" to the arrangement under which a Canadian-resident makes a cross-border payment of interest or royalties to an intermediary. Where such an arrangement exists, an additional payment (of the same character as that paid by the Canadian-resident to the first intermediary) will be deemed to have been paid directly by the Canadian-resident to the ultimate non-resident recipient in the chain of connected arrangements.

The proposed "back-to-back" shareholder loan rules will also be expanded to address multiple intermediary arrangements.

This proposal will apply to payments of interest or royalties made after 2016 and to shareholder loans as of January 1, 2017.

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The Department of Finance has not yet released draft legislation containing details of the proposed new "back-to-back" rules, but given the proposed effective dates for the new rules, it is expected that such draft legislation should be released in the near future.

by Carl Irvine

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.

The logo for mcmillan, featuring the word "mcmillan" in a lowercase, sans-serif font. The letters "m", "c", "m", "i", "l", "l", and "a" are in a dark red color, while the letters "n" and "n" are in a light blue color. The logo is positioned in the upper left corner of a banner image that shows a low-angle view of a modern glass skyscraper against a clear sky.

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