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In this article, the author discusses Canada's latest attempt to fight treaty shopping through an expanded back-to-back regime, focusing on the regime's complex and sometimes mysterious character substitution rules.

Canada's government has been concerned with treaty shopping since long before the advent of the OECD's base erosion and profit-shifting initiative. This is surprising considering Canada's broad treaty network.[1] After several unsuccessful court challenges to perceived treaty-shopping situations,[2] the Canadian federal government announced a consultation on treaty shopping in its 2013 budget. The following year, as part of Budget 2014, the government released for comments a blueprint for a broad domestic anti-treaty-shopping provision combining limitation on benefits and principal purpose features.[3] Then, somewhat surprisingly, later in 2014 the government shelved this proposal while awaiting further developments from the OECD BEPS process.[4]

In the 2016 budget, the government confirmed its commitment to addressing treaty abuse in accordance with the minimum standards established by the OECD. That budget stated that going forward, Canada would consider either of the minimum standard approaches suggested by BEPS action 6 (on treaty abuse), depending on the circumstances and the country's discussions with its tax treaty partners. Canada could amend its tax treaties to include a treaty antiabuse rule through bilateral negotiations, the multilateral instrument (MLI), or a combination of the two. In the 2017 budget, the government noted that it participated in the development of the MLI in order to streamline the implementation of tax-treaty-related BEPS recommendations, including those addressing treaty abuse. The government stated that it is pursuing signature of the MLI and undertaking the necessary domestic processes to do so. Most recently, on June 7, Canada officially signed the MLI.[5]

Despite the strong implication that Canada is pursuing a treaty-based approach to treaty shopping, the Department of Finance has quietly been crafting a mechanical anti-conduit regime that would eliminate treaty-shopping benefits in a broad variety of situations without regard to the

[1] Canada has 93 comprehensive tax treaties in force and 22 tax information exchange agreements in force.

[2] *See Canada v. MIL (Investments) S.A.*, 2007 FCA 236; *The Queen v. Prevost Car Inc.*, 2009 FCA 57 2009; and *Velcro Canada Inc. v. The Queen*, 2012 TCC 57.

[3] For prior coverage, see Michael N. Kandev, "Canada Intent on Stoppin' the Shoppin' and More," *Tax Notes Int'l*, Mar. 31, 2014, p. 1201.

[4] Special Release IT 14-7.

[5] In the backgrounder to the MLI issued on the same date, Canada's Department of Finance stated: "Other than minimum standard provisions and binding mandatory arbitration, Canada will register a reservation on all other provisions in the Multilateral Convention at this time. Canada will continue to assess whether to adopt these provisions at the time the Multilateral Convention is ratified."

taxpayer's principal purpose or whether the transactions are abusive. Budget 2014 introduced rules to limit the use of back-to-back loan arrangements in the context of Canada's thin capitalization rules and withholding tax regime.[6] Most recently, Budget 2016 expanded the back-to-back loan rules in the context of Canada's withholding tax regime. These changes were enacted on December 15, 2016, effective for amounts paid or credited after 2016.[7] The expansion of the back-to-back rules is an important part of Canada's larger efforts to create a strong anti-conduit system and prevent treaty shopping.

Background

The Back-to-Back Loan Rules Generally

The withholding tax rule aimed at curtailing back-to-back loan arrangements is in sections 212(3.1) and (3.2) of the Income Tax Act.[8] If the conditions in section 212(3.1) are satisfied, the operative rule in section 212(3.2) essentially disregards the intermediary and deems interest to be paid to the ultimate funder. Generally, there are three conditions that trigger the back-to-back rule:

- The Canadian taxpayer must pay or credit interest[9] on a particular debt or other obligation to pay an amount to an intermediary person or partnership (taxpayer debt).
- At any time during the period in which the interest accrued, the intermediary must have either an outstanding debt to a nonresident or a "specified right"[10] to a particular property that was granted directly or indirectly by the nonresident. The taxpayer debt and either the intermediary debt or specified right must be connected based on listed factors.[11]
- The withholding tax that would be payable on the interest payment, if it was paid or credited to the ultimate funder rather than the intermediary, would be greater than the withholding tax payable before application of the back-to-back rule.

The withholding tax back-to-back rule is subject to two carveouts. First, section 212(3.1)(b) excludes an intermediary that is either a person resident in Canada who does not deal at arm's length with the taxpayer or is a partnership — each member of which is a person meeting the same qualification. Second, section 212(3.1)(e) is a 25 percent de minimis rule that excludes situations in which the intermediary debt or the value of the specified right is less than 25 percent of the taxpayer debt plus other debts owed by the taxpayer to any person or partnership not dealing at arm's length with the taxpayer. The latter rule is intended to save some bona fide cash pooling and securitization arrangements.

Budget 2016 Amendments

Budget 2016 amended the back-to-back withholding tax rules in three significant ways.

First, it clarified the application of the rules to multiple-intermediary arrangements and other complex situations.

Second, it extended the back-to-back rules to items covered by the defined term "rent, royalty

[6] The 2014 back-to-back rules have been covered extensively in these pages before. *See* Steve Suarez, "Canada's Problematic Proposed New Loan Rules," *Tax Notes Int'l*, May 5, 2014, p. 441; Suarez, "An Analysis of Canada's Latest International Tax Proposals," *Tax Notes Int'l*, Sept. 29, 2014, p. 1131; and Kandev, "Canadian Interest Anti-Conduit Rule Soon to Be Law," *Tax Notes Int'l*, Dec. 15, 2014, p. 1027.

[7] Budget Implementation Act, 2016, No. 2, S.C. 2016, c. 12.

[8] Unless otherwise specified, section references in this article are to the Income Tax Act, R.S.C. 1985, c. 1 (5th Supp.) as amended.

[9] Determined without reference to the thin capitalization back-to-back rule in section 18(6.1) and the deemed dividend rule for nondeductible interest in subsection 214(16).

[10] A specified right to property is defined in section 18(5) as a right to mortgage, hypothecate, assign, pledge, or in any way encumber the property to secure payment of an obligation (other than a debt or obligation described in paragraph (6)(a) or paragraph (6)(d)(ii)) or the right to use, invest, sell, or otherwise dispose of, or in any way alienate, the property unless the taxpayer establishes that all of the proceeds (net of any costs) received, or that would be received, from exercising the right must first be applied to reduce an amount described in (6)(d)(i) or (ii).

[11] The connecting factors that qualify are: (i) recourse for the intermediary debt must be limited to the taxpayer debt; or (ii) it can reasonably be concluded that all or part of the taxpayer debt became owing, or was permitted to remain owing, because all or part of the intermediary debt was entered into or was permitted to remain outstanding, or the intermediary anticipated that all or a portion of the debt or other obligation would become owing or remain outstanding. Similar connecting factors apply for a specified right.

or similar payment."[12] Subsections 212(3.9) to (3.94) provide a new regime for these payments that is similar to the existing back-to-back loan regime but is subject to some notable differences. The new regime applies automatically to non-arm's-length payments, while arm's-length arrangements are subject to a "one of the main purposes" tax avoidance test. These rules would attack structures like that which was successful in the *Velcro* case.[13]

Third, Budget 2016 added the character substitution rules. The supplementary budget materials explain:

> Budget 2016 proposes to extend the back-to-back rules in Part XIII to prevent their avoidance through the substitution of economically similar arrangements between the intermediary and another non-resident person. Specifically, a back-to-back arrangement may exist in situations in which:
>
> - interest is paid by a Canadian-resident person to an intermediary and there is an agreement that provides payments in respect of royalties between the intermediary and a non-resident person;
> - royalties are paid by a Canadian-resident person to an intermediary and there is a loan between the intermediary and a non-resident person; or
> - interest or royalties are paid by a Canadian-resident person to an intermediary and a non-resident person 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).
>
> Under these proposed character substitution rules, a back-to-back arrangement will exist where a sufficient connection is established between the arrangement under which an interest or royalty payment is made from Canada and the intermediary's obligations in each of the three situations described above. The presence of such a connection will be determined by applying tests similar to those used for back-to-back loans and back-to-back royalty arrangements, but adapted to reflect the particular circumstances of these arrangements. Where a back-to-back arrangement exists under these proposed rules, an additional payment of the same character as that paid by the Canadian resident to the intermediary will be deemed to have been made directly by the Canadian resident payor to the other non-resident person. This measure will apply to interest and royalty payments made after 2016.

These rules are the most controversial aspect of the 2016 amendments to the back-to-back loan regime.

Examining the Character Substitution Rules

New subsections 212(3.6) and (3.7) contain the character substitution rules, which extend the back-to-back loan regime in Part XIII (Canada's withholding tax provisions). In keeping with a familiar drafting pattern, subsection 212(3.6) contains the conditions for application, and subsection 212(3.7) sets out the effects of the rules, which purport to cover two situations: the conversion of interest into dividends and the transmogrification of interest into rents or royalties. While subsection 212(3.6) describes the offending back-end shareholding or royalty arrangement, subsection 212(3.7) deems the same to be a "relevant funding arrangement," forcing it back into the main operative provisions of subsections 212(3.1) and (3.2). A substantially similar set of provisions — the back-to-back rent and royalties regime — in subsections 212(3.92) and (3.93) addresses two situations: the conversion of rents and royalties into dividends and the morphing of rents or royalties into interest. The remainder of these comments will focus principally on the former.

Equity-Funded Arrangements

The first set of situations described respectively at 212(3.6) and (3.92) — equity-financed relevant funding arrangements and

[12] The expression "rent, royalty or similar payment" is defined in subsection 212(3.94) to essentially refer to the variety of payments covered by paragraph 212(1)(d).

[13] *Supra* note 2. *Velcro* involved a related-party back-to-back royalty arrangement in which a Canadian sublicensee paid royalties to a Dutch corporation that paid royalties to a head licensor in the Netherlands Antilles.

lease, license, or similar arrangements — has given taxpayers the greatest cause for concern.

As noted, subsection 212(3.6) describes the two alternative back-end arrangements to which subsection 212(3.7) applies.

> The first, described in paragraph (a), is: shares (other than specified shares) of the capital stock of a particular relevant funder, in respect of a particular relevant funding arrangement, if — at any time at or after the time when the particular debt or other obligation referred to in paragraph (3.1)(a) was entered into — the particular relevant funder has an obligation to pay or credit an amount as, on account or in lieu of payment of, or in satisfaction of, a dividend on the shares, either immediately or in the future and either absolutely or contingently, to a person or partnership, and any of the following conditions is met:
>
> (i) the amount of the dividend is determined, in whole or in part, by reference to an amount of interest paid or credited, or an obligation to pay or credit interest, under a relevant funding arrangement, or
>
> (ii) it can reasonably be concluded that the particular relevant funding arrangement was entered into or was permitted to remain in effect, because
>
> (A) the shares were issued or were permitted to remain issued and outstanding, or
>
> (B) it was anticipated that the shares would be issued or would be permitted to remain issued and outstanding.

Contrary to the initial announcement in Budget 2016, specified shares are altogether excluded from the ambit of the character substitution rule. The term "specified shares" is defined at new subsection 212(3.8) to essentially refer to shares that are redeemable or retractable. These shares are deemed to be debt under subsection 212(3.81), and therefore the main provisions at subsection 212(3.1) and (3.2) apply to them directly, without the need to meet the requirements of the character substitution rules.

For example, if a Bermuda corporation funds a Luxembourg subsidiary by way of mandatorily redeemable preferred shares and the Luxembourg intermediary lends to a Canadian subsidiary at interest, that interest would be subject to full Canadian withholding tax of 25 percent, without any reduction under the Canada-Luxembourg tax treaty, because subsection 212(3.2) deems the Canadian borrower to pay the interest to the ultimate funder, the Bermuda corporation.

Therefore, it appears that the character substitution rules are targeting shares, other than redeemable or retractable shares, such as common shares.[14] Importantly though, the key precondition for the application of paragraph 212(3.6)(a) is that the particular relevant funder have an "obligation to pay or credit . . . a dividend on the shares, either immediately or in the future and either absolutely or contingently" to a person or partnership. Under Canadian corporate statutes, as in most foreign corporate regimes,[15] the obligation to pay a dividend arises only if and when the dividend is formally declared by way of corporate resolution.[16] There is no automatic right to a dividend distribution. This holds true even if the share terms provide for a cumulative dividend entitlement or if the corporation has adopted a dividend policy.[17] In other words,

[14] *See* International Fiscal Association, Finance Roundtable (Apr. 6, 2017), Q.12. At IFA, Department of Finance officials stated that the back-to-back rule in paragraph 212(3.6)(a) was intended to apply to common-share dividends. The example considered involved a Canco that pays interest on an interest-bearing loan from its parent, Forco 2, which declares and pays dividends on its common shares held by Forco 1. The question: Did the department intend that section 212(3.6)(a) would not apply since there was no obligation in the common-share terms to declare any dividends? Finance indicated that the intent was to capture not only preferred dividends, but also common-share dividends because a dividend declaration on common shares generates an obligation to pay the dividend. However, whether the rule applied would depend on whether the linkage test was met, which would require consideration of relevant factors such as the timing and quantum of the dividend payments.

[15] A random sampling indicates that this is the case in Brazil, Colombia, Germany, Indonesia, Italy, Luxembourg, Malta, Norway, Panama, Russia, Singapore, South Africa, South Korea, and the U.S.

[16] *See* Canada Business Corporations Act, R.S.C., 1985, c. C-44, at para. 24(3)(b) (clearly referring to the right to receive a dividend "declared by the corporation").

[17] In *Prevost Car*, *supra* note 2, a Dutch-incorporated joint venture company had a formal policy of distributing 80 percent of the dividends it received from a Canadian operating subsidiary to its two shareholders. The court accepted that the dividend policy did not create an automatic obligation to pass on the dividends from the taxpayer to the shareholders of the Dutch corporation, thus denying the government's contention that the dividends were not beneficially owned by the Dutch company.

before a dividend declaration, no obligation to pay a dividend exists, whether immediate or future, absolute or contingent.[18] The character substitution rules are not triggered (if they are triggered) unless and until a dividend has actually been declared.

Although in theory the character substitution rules may apply to any share (other than a specified share), in practice they can be avoided by carefully managing the legal nature of distributions from the intermediary. The challenge regarding equity-funded arrangements, from a taxpayer's vantage point, is that it is more difficult to design a tax-effective treaty-shopping structure that does not use debtlike preferred shares.[19] Using the previous example, if the Bermuda parent corporation funded the Luxembourg corporation with only common equity, interest received by it would be taxed at the full Luxembourg rate of 27.08 percent (with credit for Canadian withholding tax),[20] and any after-tax amounts distributed to Bermuda would suffer withholding tax of 15 percent, making the arrangement undesirable. Instead, the Bermuda parent could use a U.K. financing company, which would be subject to a 19 percent corporate tax rate and no dividend withholding tax, yet the tax leakage would remain substantial.

Also, for the character substitution rules to apply, the dividend must be declared at or after the time the particular debt or other obligation referred to in paragraph (3.1)(a) is entered into. It remains uncertain whether a dividend declaration that occurs after the particular debt or other obligation has ceased to exist still triggers paragraph 212(3.6)(a). The text of the rule suggests that it might, but arguably this would not be an appropriate result.

Assuming the relevant obligation to pay a dividend exists, one of two additional conditions must be met for the character substitution regime to apply. One condition is that the amount of the dividend be determined, in whole or in part, by reference to an amount of interest paid or credited, or an obligation to pay or credit interest, under a relevant funding arrangement. This essentially describes a tracking share arrangement, which would typically be rare. The other condition is that it can reasonably be concluded that the particular relevant funding arrangement was entered into or was permitted to remain in effect either because the shares were issued or were permitted to remain issued and outstanding or because it was anticipated that the shares would be issued or would be permitted to remain issued and outstanding. This describes circumstances in which the relevant funding arrangement can be most directly traced to the issuance of shares.

The Alchemy of Character Substitution

The second set of situations described at subsections 212(3.6) and (3.92) — arrangements that substitute interest for royalties and vice versa — is quite surprising.

As noted, subsection 212(3.6) describes the two alternative back-end arrangements to which subsection 212(3.7) applies. One is detailed above. The second, described at paragraph (b), relates to:

> a specified royalty arrangement, if — at any time at or after the time when the particular debt or other obligation referred to in paragraph (3.1)(a) was entered into — a particular relevant funder, in respect of a particular relevant funding arrangement, is a specified licensee that has an obligation to pay or credit an amount under the specified royalty arrangement, either immediately or in the future and either absolutely or contingently, to a person or partnership, and any of the following conditions is met:
>
> (i) the amount is determined, in whole or in part, by reference to an amount of interest paid or credited, or an obligation to pay or credit interest, under a relevant funding arrangement, or
>
> (ii) it can reasonably be concluded that the particular relevant funding arrangement was entered into or was permitted to remain in effect, because

[18]An internal contingency is not a true condition.

[19]To be economically viable, the structure would require an intermediary jurisdiction that meets the following criteria: (i) it has a tax treaty with Canada that reduces withholding on interest; (ii) it does not impose material corporate tax; (iii) it provides a tax credit for Canadian withholding tax; and (iv) it does not impose a dividend withholding tax.

[20]Decreased from the prior 29.22 percent.

(A) the specified royalty arrangement was entered into or was permitted to remain in effect, or

(B) it was anticipated that the specified royalty arrangement would be entered into or remain in effect.

Subject to an additional arm's-length test, paragraph 212(9.2)(b) operates very similarly and purportedly transmogrifies royalties into interest. It is utterly mysterious how a rent or royalty can be determined, in whole or in part, by reference to an amount of interest or how a relevant funding arrangement can be entered into *because* a specified royalty arrangement was entered into. While interest is compensation for the use or retention by one person of a sum of money owed to another,[21] rent is compensation for the use or occupation of property, or for the right to use or occupy property,[22] and a royalty is compensation for the use of property, usually copyrighted material or natural resources, expressed as a percentage of receipts from using the property or as an account per unit produced.[23] It is not clear how a logical or legal connection between interest, on the one hand, and rents or royalties, on the other, can exist as suggested by paragraph 212(3.6)(b).

Similarly, it is difficult to conceive of common situations in which rents or royalties are converted into interest or in which a particular relevant royalty arrangement was entered into *because* a debt or other obligation was entered into. Here, at least, some possibilities can be envisaged. Probably the only likely situation, which may fall under clause 212(3.92)(b)(i)(A), involves participating debt interest that tracks underlying rents or royalties or the value, production, or use of the underlying leased or licensed property. A more remote possibility involves money that has been lent to allow either the acquisition or development of tangible or intangible property that then has been leased or licensed. Arguably, however, the link between the two is too tenuous to meet the nexus requirements of clause 212(3.92)(b)(i)(B) in these situations.

Conclusion

As part of Budget 2016, the government of Canada enacted rules that strengthen and extend the existing back-to-back rules. The apparent objective is to create a robust anti-conduit system, limiting the ability to structure inbound arrangements that produce a treaty-shopping benefit.[24] The principal target of the 2016 back-to-back changes involving character substitution seems to be arrangements using debtlike preferred shares to fund interest-bearing loans. The other aspects of the character substitution amendments raise some conceptual difficulties and appear to be of less practical significance. Still, increasingly careful management of structures is necessary to ensure that the back-to-back regime is kept at bay. ■

[21]The term "interest" is not defined for the purposes of subsection 212(3) or Part XIII ITA in general. The classic Canadian judicial definition of "interest" is found in the leading Supreme Court of Canada case, *Re Validity of Section 6 of the Farm Security Act 1944 (Saskatchewan): Saskatchewan (Attorney General) v. Canada (Attorney General)*, [1947] SCR 394, in which Justice Ivan Rand defined interest broadly to include "the return or consideration or compensation for the use or retention by one person of a sum of money, belonging to, in a colloquial sense, or owed to another."

[22]The term "rent" is also undefined for the purposes of Canada's withholding tax rules. According to the Federal Court of Appeal, "rent is defined as an amount paid as compensation for the use or occupation of property, or for the right to use or occupy property. . . . Thus, a payment made as compensation for the use of property in Canada or for the right to use property in Canada is within the scope of paragraph 212(1)(d) of the *Income Tax Act* (if it is paid to a non-resident)." *Transocean Offshore Ltd. v. R.*, 2005 FCA 104.

[23]The term "royalty" is also undefined for Part XIII ITA. In *Mobil Oil Canada Ltd. v. R.*, 2001 FCA 333, the Federal Court of Appeal adopted the following meaning for the term:

> Mobil relies on the following definition, which appears in Black's Law Dictionary, 5th ed. (St. Paul, Minn: West Publishing Co., 1979) at page 1195:
>
> > Compensation for the use of property, usually copyrighted material or natural resources, expressed as a percentage of receipts from using the property or as an account per unit produced. A payment which is made to an author or composer by an assignee, licensee or copyright holder in respect of each copy of his work which is sold, or to an inventor in respect of each article sold under the patent. Royalty is share of product or profit reserved by owner for permitting another to use the property. In its broadest aspect, it is share of profit reserved by owner for permitting another the use of property. . . .
> >
> > In mining and oil operations, a share of the product or profit paid to the owner of the property.
>
> It is common ground that this definition is appropriate to describe the Canadian usage of the word "royalty" in the commercial context.

[24]The original back-to-back loan rules, introduced in Budget 2014, were initially viewed as mainly attacking transactions designed to benefit from the domestic withholding tax exemption for arm's-length interest. However, it quickly became clear that the government intended the back-to-back rules to be a much broader set of anti-conduit rules attacking treaty shopping more generally. The 2016 amendments highlight the government's policy in this regard.