

April 21, 2008

Mr. Wayne Adams
Director General
Income Tax Rulings Directorate
Canada Revenue Agency
Place de Ville, 16th Floor, Tower A
320 Queen Street,
Ottawa, Ontario K1A 0L5

Dear Mr. Adams:

Concerns regarding Section 18.2

We understand that you are interested in input from the tax community concerning interpretive issues that have been identified in the context of section 18.2, which was included in Bill C-28 and passed into law in 2007 although it will not take effect until 2012. The following are some observations and issues that PricewaterhouseCoopers LLP have identified in our review of the rules, and on which we believe it will be important for the Canada Revenue Agency (CRA) to develop guidelines that will assist taxpayers and their advisors in determining whether, and how, the rules apply to them. We have also set out for your consideration in most of the examples below a suggested approach that we believe is fair and reasonable and accords with our understanding of the intent of the rules. Our primary focus has been on what we would generally categorize as “tracing” issues.

TRACING – Specified Financing Expense – An Overview

The definition of specified financing expense in respect of an inter-affiliate loan (referred to herein as “Restricted SFE”) in subsection 18.2(3) requires a determination of whether particular debt relates to the funding of an inter-affiliate loan (“IAL”).

In the rules, a distinction has been made between borrowed money and an amount payable for property. This is consistent with, and parallels, the distinction in paragraph 20(1)(c) between borrowed money (subparagraph 20(1)(c)(i)) and amounts payable for property (subparagraph 20(1)(c)(ii)).

This document was written by PricewaterhouseCoopers LLP (“PwC”) in connection with the provision of tax services solely for the account of a PwC client. Any use which a person other than the PwC client makes of this document and any reliance on, or decisions made on the basis of, the contents of this document are the responsibility of such person. PwC accepts no responsibility for damages, if any, suffered by a person other than the PwC client as a result of decisions made or actions taken in reliance on the contents of this document.

In the case of borrowed money, the rule provides that it is necessary to determine whether it is “reasonable to considered that the borrowed money is used [in the particular taxation year in which the interest is paid or payable and would otherwise be deductible], directly or indirectly, for the purpose of funding, in whole or in part, the IAL”. (Subparagraph 18.2(3)(a)(i))

In the case of “an amount payable for property” the rule provides that it is necessary to determine whether it is reasonable to consider that the property, or property substituted for it (or, where the property or property substituted for it is a share of a corporation, property of the corporation or of a person related to the corporation, or property substituted for such property) is used, directly or indirectly, for the purpose of funding, in whole or in part, the IAL. (Subparagraph 18.2(3)(b)(ii))

(a) “Borrowed Money” vs. “Amount Payable for Property”

Question:

Can the CRA confirm that the rule in subparagraph (i) applies where there has been an actual borrowing of funds, and that the rule in subparagraph (ii) is restricted to the circumstances where the vendor of the property has received a promissory note or other evidence of indebtedness on the acquisition of the property by the purchaser, or where the purchaser has assumed indebtedness of a third party on the acquisition of the property? This issue is important because, as discussed at greater length below, the rules seem to raise different interpretive issues.

Suggested CRA Approach:

The case law has clearly recognized a distinction between a “borrowing” of funds and other means by which indebtedness arises. See, for example, *T.E. McCool Ltd. v. M.N.R.*, 49 D.T.C. 700, and the more recent case of *Parthenon Investments Limited v. M.N.R.*, 97 D.T.C. 5343 (FCA). The CRA’s interpretive position has also consistently been that there is a distinction. See, for example, CRA Document CRA Document 9910637 – “Making of Loans” – November 5, 1999. Further, the distinction between borrowings and amounts payable is maintained in the Explanatory Notes and in the examples given.

(b) Meaning of “Directly or Indirectly”

Although there are some apparent differences between the wording of subparagraphs (i) and (ii), both use the phrase “directly or indirectly”.

The meaning of the word “directly” seems relatively clear. Can the CRA provide guidance on how it believes “indirectly” should be construed in this context?

Suggested CRA Approach:

The Department of Finance Explanatory Notes suggest that while the basic concept is “tracing”, the term “indirectly” was considered necessary because in a typical double-dip financing structure money will be borrowed in Canada and invested in shares of at least one other corporation before ultimately being used to fund an IAL. The Notes state that in these circumstances the funds were *directly* used to purchase shares of a corporation but their *indirect* use was to fund an IAL.

Consistent with the Notes, we submit that the reference to “direct or indirect” funding should be construed to mean that the IAL in question can be demonstrated to have been made with funds that ultimately can be determined to have their source in a borrowing in Canada. In other words, it is still necessary to be able to trace the funds used to make the IAL to a borrowing in Canada that resulted in funds that were invested in one or more other entities in the corporate group and were ultimately used to make the IAL.

We do not believe that the Department of Finance intended that “indirect” in this context meant that the actual use of the borrowed funds could be ignored. Therefore, consistent with the position the CRA has taken in IT-533, it should still be open to taxpayers to plan their affairs so that an IAL is funded, directly or indirectly, using non-borrowed funds. That is, the CRA should be able to confirm that “cash damming” is an acceptable planning technique, just as it has, in the context of paragraph 20(1)(c), expressly accepted that cash damming is acceptable. See in particular paragraph 16 of IT-533.

Based on public statements of the Department of Finance, the delay in the effective date for application of the rules to 2012 was intended to allow taxpayers sufficient time to “adjust to” the new rules. See the May 14, 2007 Department of Finance “Backgrounder”, where the Department of Finance stated that the transitional relief (i.e. the delayed implementation date) would “provide almost five years for Canadian businesses to adjust to the new rules.” It is implicit in this comment that it was recognized that Canadian businesses needed time to identify whether they have borrowings that create Restricted SFE and to take reasonable steps, in advance of the effective date, to ensure that it is possible to comply with the rules. This will not be feasible unless the CRA can confirm that cash damming will be an acceptable approach. We elaborate on this point below.

Support:

The meaning of the phrase “directly or indirectly” was thoroughly canvassed in a paper presented at the 2002 Annual Tax Conference of the Canadian Tax Foundation: Guy Fortin and Mélanie Beaulieu, “The Meaning of Expressions “In the Ordinary Course of Business” and “Directly or Indirectly”,” Report of Proceedings of Fifty-Fourth Tax Conference, 2002 Tax Conference (Toronto: Canadian Tax Foundation, 2003), 36:1-37.

In particular, the authors discuss several technical interpretations that seem to be directly on point. The authors note that the meaning of the expression "paid or payable, directly or indirectly" is relevant for the purposes of paragraph 95(2)(a). In particular, subparagraph 95(2)(a)(ii) (being the re-characterization rule that is also relevant to determining whether a particular loan is an "IAL" for the purposes of section 18.2) refers to income or loss that is derived from amounts that were paid or payable "directly or indirectly" to a particular foreign affiliate of the taxpayer.

In a technical interpretation dated February 1, 1996, the CRA stated that for these purposes, the expression relates to the traceability of the amounts paid:

In our view, where an arm's-length intermediary is involved in a payment flow, an amount would be considered to be paid or payable directly or indirectly by another qualified foreign affiliate to a particular foreign affiliate where the payment can be traced and shown to be a payment made directly or indirectly to a particular foreign affiliate that was deductible by the other foreign affiliate in computing its earnings or loss from an active business.¹

Reference is made to another technical interpretation dated May 21, 1996:

In particular, it is our opinion that in order to meet the words in subparagraph 95(2)(a)(ii) of the Act, "derived from amounts that were paid or payable, directly or indirectly," the amounts in question would have to be able to be directly traced.²

Since a loan between foreign affiliates of a Canadian taxpayer is generally only an IAL for the purposes of the rules where the interest on the loan is "re-characterized income", i.e. income that would be FAPI but for subparagraph 95(2)(a)(ii), it only makes sense that the words "directly or indirectly" would have consistent meanings for the purposes of that rule and section 18.2.

(c) Interest on Amounts Payable for Property

We understand that proposed subparagraph 18.2(3)(a)(ii) was intended to be broad in its scope but it appears to be capable of giving rise to inappropriate results, particularly because of the parenthetical words referring to property of an acquired corporation or of any related corporation.

¹ CRA document no. 9517445, February 1, 1996.

² CRA document no. 9526865, May 21, 1996. The authors also point to detailed commentary to the same effect in CRA document no. 2002-0122335, May 8, 2002.

Where the actual acquired property is shares of a corporation, the words in parentheses include in the concept of “property” acquired with the “amount payable” any property of that corporation or of a person related to the corporation, or any property substituted for such property.

We believe that the intended operation of the rule is as set out in Example 3 of the Explanatory Notes to the Draft Legislation which provides:

Example 3

Canco purchases all the shares of Cansub from a third-party in exchange for an interest-bearing note. Immediately following the purchase, Canco [we presume that this is intended to refer to a sale by Cansub] sells all the assets of Cansub for cash and uses the proceeds to fund an inter-affiliate loan.

Although the inter-affiliate loan is funded by the proceeds of disposition from the sale of assets, the shares of the company that owned the assets were acquired by means of the interest-bearing note and so it is reasonable to consider that property of the company was substituted for property that was used to fund the inter-affiliate loan.

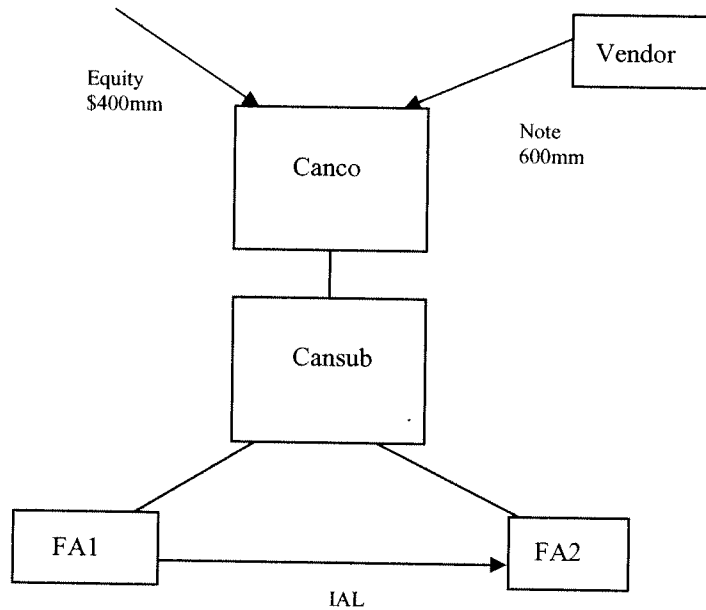
Based on the example, we assume that it was concluded that the amount payable for the shares had a sufficient nexus, both temporally and otherwise, to the property used to make the loan (which might be considered to be property that was “indirectly” acquired for the amount payable) that it was considered appropriate to treat the financing expense as having been incurred to indirectly finance the IAL.

Does the CRA have a view as to the scope of the rule in the following situations? In other words, in these situations does Canco have Restricted SFE?

Assume that in all of the examples below Canco acquires Cansub in Year 1 for \$1 billion which it finances with \$400 million of non-borrowed funds and a note for \$600 million issued to the vendor.

Example 1 – Pre-existing IAL

When acquired, Cansub has a share investment in a foreign affiliate (FA1), which had previously made an IAL to a foreign operating subsidiary of Cansub (FA2).



Question:

The rule applies to disallow interest expense to Canco if any property of Cansub “is used” to fund an IAL. It seems a reasonable interpretation of the provision to construe it as forward-looking only. That is, a pre-existing IAL should not result in the application of the rule. Can the CRA confirm this?

Suggested CRA Approach:

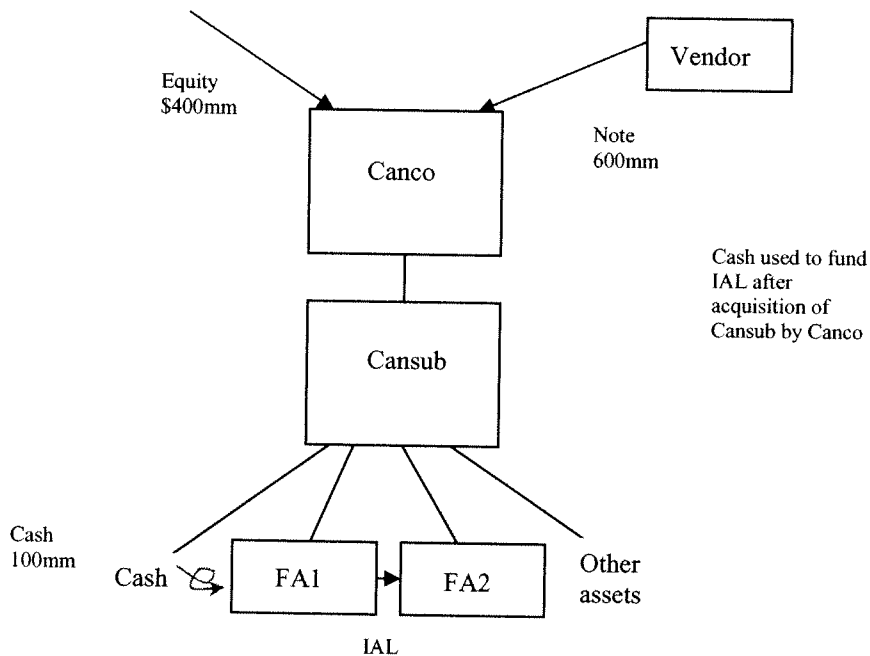
The Explanatory Notes contain an example (Example 4) in which there is an actual borrowing (by Canco) to acquire the shares of another corporation (Cansub) in which there is a pre-existing IAL. The Notes confirm that normally, the borrowed funds will not be considered to have funded the IAL. The Notes suggest that there may be circumstances, such as where the seller of the shares has, as part of the series of transactions in which the Cansub is acquired and in contemplation of the sale, provided funds to Cansub which were used for the purpose of funding an IAL, where it might be concluded otherwise.

These comments suggest that normally, the rules are to be construed as forward looking. That is, in interpreting subparagraph (ii), in the usual case the rule should only be considered to apply if property owned by Target at the time it was acquired, or property substituted for such

property, is used for the purpose of funding an IAL that is made after the time of the acquisition.

Example 2 – Target Cash used to fund IAL

When acquired, Cansub has \$100 million of cash, which it uses after the acquisition to invest in the shares of a foreign affiliate (FA1), which in turn makes an IAL to a foreign operating subsidiary of Cansub (FA2).



Question:

The rule applies to disallow interest expense to Canco in connection with an amount payable if the property acquired with the amount payable is shares of a corporation, and property of that corporation, or property substituted for property of that corporation, is used to fund an IAL. In this example, \$100 of Cansub’s cash is used to fund an IAL through funding FA1, which makes an IAL to FA2. However, Canco financed its purchase of Cansub only in part with the indebtedness incurred to acquire the shares (i.e. the amount payable). Does the CRA consider that if *any* property of Cansub (regardless of whether the amount is nominal in relation to the amount of the acquisition debt or the acquisition price as a whole) is used to fund an IAL, all of the interest on the acquisition debt is Restricted SFE?

It is noted that if, after the acquisition of Cansub by Canco, Cansub merges with Canco, the acquisition debt would presumably then be considered to relate to property substituted for the shares and, from that point, it would be necessary to determine whether, and to what extent, the acquisition debt should be allocated to the shares of FA1 through which the IAL was funded. Can the CRA comment on how the CRA would consider that the amount of Restricted SFE would be determined in this case? That is, would the CRA consider that (A) interest on \$100 million of the \$600 million amount payable would be Restricted SFE; (b) none of the interest on the \$600 million amount payable would be Restricted SFE; or (c) interest on \$60 million of the \$600 million amount payable would be restricted SFE (based on the proportion of the purchase price for the shares that was financed by the acquisition debt).

Suggested CRA Approach:

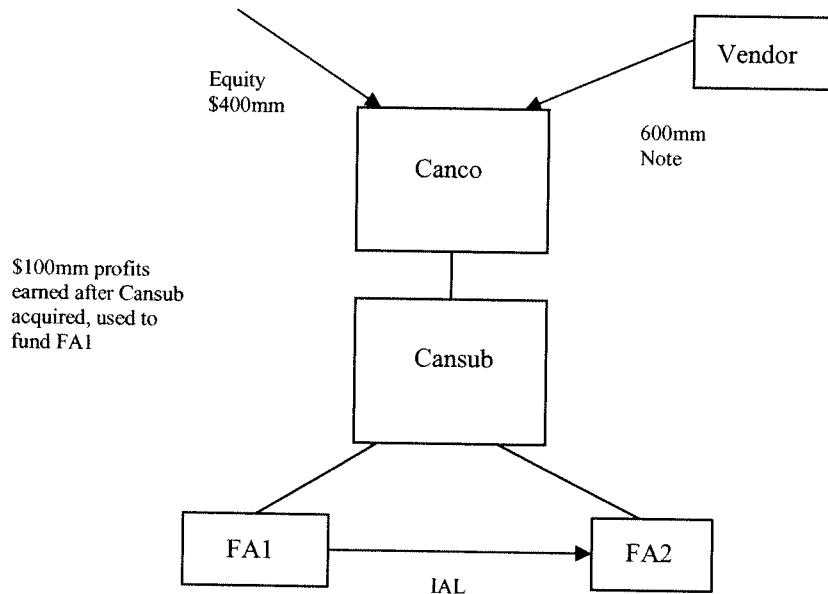
The general concept in subparagraph (ii) appears to be one of substituted property based on the assumption that in acquiring the shares of Cansub, Canco has indirectly acquired the assets of Cansub.

It would seem, based on the wording, that the interest on the acquisition debt is Restricted SFE if *any* property of Cansub, no matter how nominal, is used to fund an IAL. The rule in subsection 18.2(2) would then operate. Under that rule, Canco's interest on the acquisition debt would be allowed to the extent that it exceeds the "double-dip income". If the interest rate on the IAL is (hypothetically) the same as the interest rate on the acquisition debt, the effect would be that Canco could continue to deduct the interest on \$500 million of the acquisition financing, but interest on \$100 million of the acquisition debt would be non-deductible.

However, after Cansub and Canco were merged, all of the merged entity's financing, including its non-borrowed funds and the acquisition debt, would have financed the acquisition of *all* of the assets substituted for the shares of Cansub. Presumably, from this point, *at most*, \$100 million of the acquisition debt could be considered to relate to property that funded the IAL. However, in the case of a merger, it is not possible to trace specifically trace acquisition debt to particular assets of the target that are substituted for the originally acquired shares. As we submit below, in these circumstances, we believe that the jurisprudence supports the conclusion that it should be possible to "positively trace" so that borrowed sources of financing are allocated first to assets other than the funding of an IAL.

Example 3 – IAL funded with Post-Acquisition Profits

Over a course of 3 years, Cansub earns profits from its operations and at the end of Year 3, Cansub has \$100 million of retained earnings. In year 4, Cansub funds an affiliate with \$100 million and the affiliate makes an IAL of \$100 million.



Question:

In this situation, it would appear that for Years 1 through 3, none of Canco’s interest expense is Restricted SFE. However, in year 4, even if it could be demonstrated that the IAL could be traced to cash on hand from the operations of Cansub, it appears that property of Cansub was used to fund the IAL. Would the CRA’s view be that in year 4 some of the interest expense on the vendor-provided financing becomes Restricted SFE? If so, how would the amount of Restricted SFE be determined?

Suggested CRA Approach:

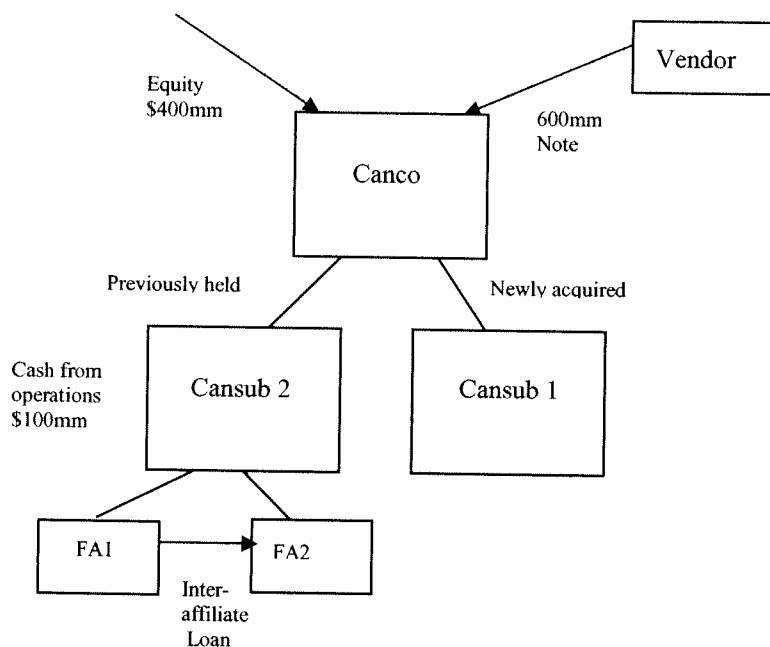
This example is similar to example 2 above, but in this case the IAL is not necessarily funded with property that was held by Cansub at the time it was acquired by Canco, or property substituted for such property. If the CRA were to interpret the reference to “property” of Cansub as restricted to property on hand when the property financed with the acquisition debt (i.e. the shares of Cansub) was acquired by Canco, or property substituted for that property,

then so long as the funding of the IAL could be traced to after-acquired property the appropriate result would seem to follow.

Again, to illustrate why this is an appropriate result, if Canco and Cansub were to merge after the acquisition, the acquisition debt could only be considered to be an amount payable for property of Cansub that existed at the time of the merger. Earnings subsequently generated by the merged entity would not be considered to be substituted assets.

Example 4 – Property of “Related Person”

Canco has another subsidiary, Cansub 2, which it acquired with non-borrowed funds and owned before it acquired Cansub 1. Cansub 2 has cash (from operations) of \$100 million and no borrowings. Cansub 2 funds an affiliate FA1, which makes an IAL to a foreign operating subsidiary of Cansub 2 (FA2).



Question:

Cansub 2 is a “person related to” Cansub 1. On the words, it appears that Canco’s interest expense in respect of the indebtedness that relates to the acquisition of Cansub 1 could be Restricted SFE, even though assets it already owned (indirectly through Cansub 2) were used to fund an IAL and even though the foreign operating subsidiary that obtains the IAL may have been a pre-existing operating subsidiary with no connection to Cansub 1. Does the CRA agree?

Suggested CRA Approach:

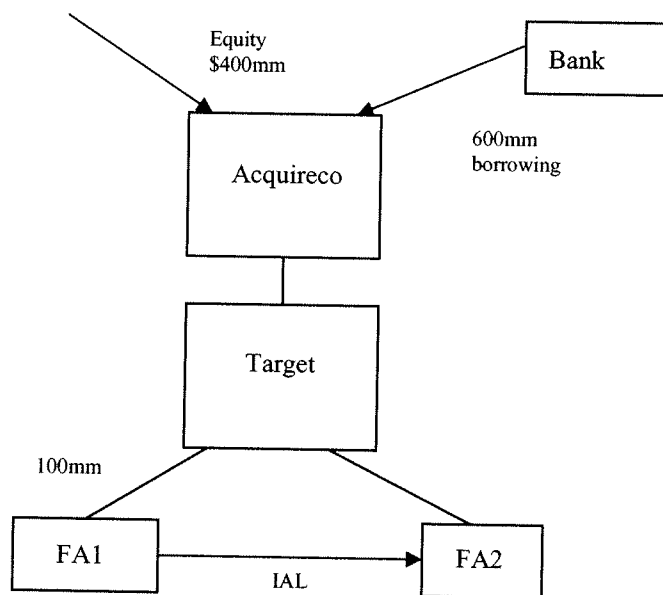
Based on the apparent tax policy behind section 18.2, this situation should clearly not result in any disallowance of interest expense to Cansub. The CRA should interpret the rules in a reasonable manner that requires a clear nexus between the “amount payable” and the property that is used for the purpose of the funding of the IAL.

(d) Acquisitions Funded with Borrowed Funds

The application of the rule where an acquiring corporation (“Acquireco”) has borrowed to fund its acquisition of a target (“Target”) seems somewhat more clear; however, questions arise where Acquireco and Target are subsequently merged.

For example, assume that Acquireco agrees to acquire Target for \$1 billion and finances the acquisition with \$400 million of non-borrowed funds and \$600 million of borrowed funds.

Example 1 – Pre-Existing IAL



At the time that Acquireco acquires Target, Target has a pre-existing share investment of \$100 million in a foreign affiliate (FA1) that made an IAL of \$100 million to FA2.

Target amalgamates with or is wound up into Acquireco. It is accepted (see IT-533) that the interest on the acquisition financing is deductible under paragraph 20(1)(c), on the basis that

the assets of the merged entity are substituted for the Target shares that were the originally acquired property.

Question:

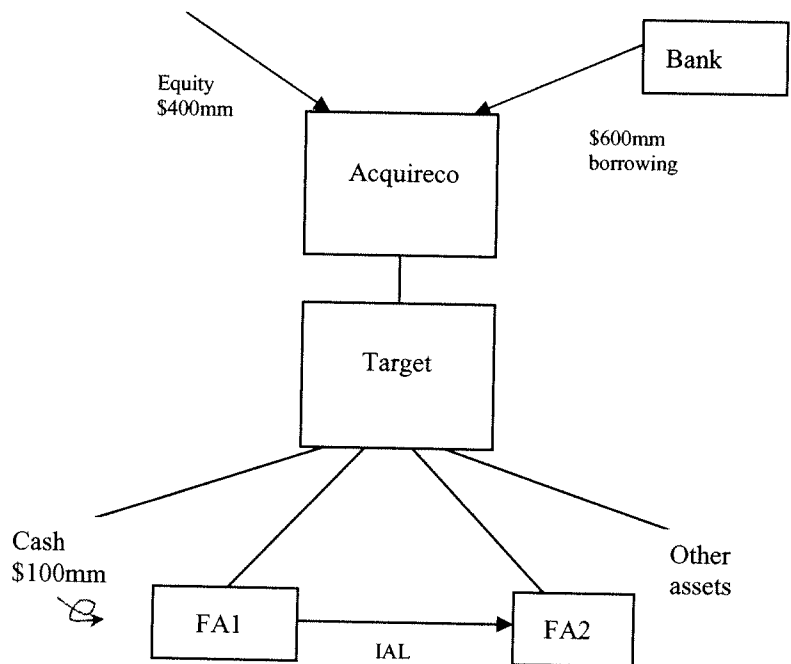
In this situation, it is difficult to see how the acquisition debt could have “funded” the IAL, given that the IAL was already in existence. Does the CRA agree?

Suggested CRA Approach:

The IAL was in place when Target was acquired by Acquireco. It would appear based on the example in the Explanatory Notes that in the normal case, it is not intended that the pre-existing IAL would, in and of itself, result in Acquireco having Restricted SFE. Therefore, none of the borrowing should be considered to have “funded” an IAL, whether before or after Acquireco and Target merge.

Example 2 – Target Cash used to Fund IAL

After Acquireco acquires Target, Target makes a \$100 million share investment in FA1, which makes an IAL to FA2 using cash on hand at the time it was acquired.



Question:

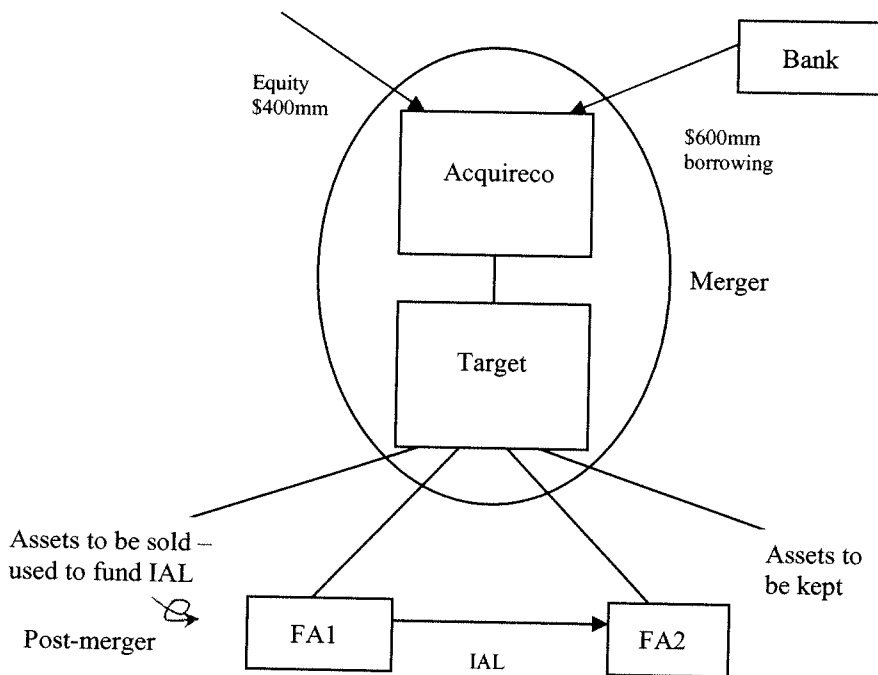
In this situation, assume Target and Acquireco do not merge. Does the CRA agree that Acquireco did not use any borrowed money to directly or indirectly fund the IAL? If not, why not?

Suggested CRA Approach:

The rule in subparagraph 18.2(3)(a)(ii) that is applicable to “amounts payable” for property contemplates that interest on an amount payable may be Restricted SFE where the amount is payable for shares of a corporation and property of that corporation is then used to fund an IAL. Example 3 in the Explanatory Notes is an example of this. The rule in subparagraph 18.2(3)(a)(i) is narrower. The borrowed money did not indirectly fund the IAL even though assets of the Target funded the IAL.

Example 3 – Post-Merger Tracing

After Acquireco acquires Target, Target is liquidated into Acquireco or amalgamates with Acquireco. Certain assets of Acquireco are sold for \$100 million and the proceeds are used to make a \$100 million share investment in FA 1, which makes an IAL to FA2.



Question:

Would the CRA consider that: (a) interest on \$100 million of the \$600 million acquisition debt would be restricted; (b) none of the interest on the \$600 million on the acquisition debt would be restricted; or (c) interest on \$60 million of the \$600 million acquisition debt would be restricted (based on the proportion of the purchase price financed by the acquisition debt)?

Suggested CRA Approach:

In this case, the current use of the borrowed money is to acquire assets which were previously assets of Target and that are substituted for the shares of Target when Acquireco and Target merge. This is the basis (as set out in IT-533) for continued deductibility of interest on the acquisition debt under paragraph 20(1)(c) after the merger.

Therefore, depending on the facts, it is possible that a portion of the acquisition debt should be considered to have funded the IAL. This could be the case where all of the cost of acquiring the shares of Target was financed by borrowings, or where non-borrowed sources of funds cannot reasonably be considered to have funded the IAL. However, consistent with its position in IT-533, the CRA should accept that the current use of the borrowed money is not to fund, directly or indirectly, an IAL, provided that Target has other assets (i.e. assets other than its investment in FA1 in the examples above) having a fair market value, at the time of its acquisition by Acquireco, equal to or greater than the acquisition debt. That is, CRA should accept that the acquisition debt can be “positively traced” first to assets that would not result in any Restricted SFE.

Support:

The ability to positive trace interest expense to a qualifying use where qualifying assets have a fair market value in excess of the taxpayer’s debt and it is not possible to specifically determine that the borrowing was directly used for a non-qualifying purpose is supported by *Ludmer v. The Queen*, 2001 SCC 62. In that case, one of the issues before the Court was the ongoing ability of the corporate taxpayer to deduct interest expense after it disposed of the shares of the investment corporations (which the Court found were income-producing assets) for shares of a subsidiary, an interest-bearing note and a non-interest bearing promissory note. The value of the shares and the interest-bearing note received in this transaction (which the Court accepted were income-producing) exceeded the borrowings that had funded the acquisition of the shares of the investment corporations. The Court found that in the circumstances where new assets (both income producing and non-income producing) had been substituted for the original, income-producing asset, the taxpayer was entitled to “positively trace” the borrowing that had funded the acquisition of the originally held property to *any* of the income-producing assets received in the rollover transaction in substitution for the original

property. The Court held that so long as the value of the qualifying assets exceeded the amount of borrowed money, the taxpayer could choose to trace the borrowing to the qualifying assets (paragraph 78):

...although the appellant Ludco initially received a mix of income-earning and non-income-earning assets as consideration for the shares in the Companies, the value of the income-earning assets (or current eligible use property) exceeded the amount of the borrowed money. In these circumstances, the income producing replacement property can be linked to the entire amount of the loan and it can be said that the interest charges were "wholly applicable" to the source of the income. Consequently the entire amount of the interest payment continued to be deductible after the rollover occurred.

(e) Practical Limitations on Ability to Trace

Of as much importance is the inability of many, if not most, taxpayers to reconstruct the use of existing borrowings, when those borrowings have refinanced other borrowings incurred long before the rules in section 18.2 were conceived of. Many of our clients have stated that it is simply not possible to determine whether existing borrowings were used, directly or indirectly, for the purpose of funding an IAL that may exist in the corporate group. Can the CRA comment on what it expects by way of supporting documentation from taxpayers to establish the current use of a particular borrowing?

Suggested CRA Approach:

Consistent with *Ludco* and the CRA's position in IT-533, in circumstances where it is clear that a particular borrowing resulted in proceeds that can be traced and demonstrated to have been used to fund, directly or indirectly, an IAL (adopting the meaning of "indirectly" already elaborated on), it is reasonable to expect that section 18.2 will apply. For example, in a "tower" financing structure, it would be difficult for a taxpayer to sustain the argument that the borrowing by the partnership did not fund an IAL.

We suggest that if the taxpayer is a corporation with various sources of funding, some borrowed and some not, and the practical reality is that funds from these various sources are commingled, the CRA should accept that the "positive tracing" approach described above provides a reasonable starting point. That is, where it is not possible in practical terms to trace a particular investment in an offshore financing structure to a particular borrowing, because the structure was funded out of the general corporate funds of the Canadian taxpayer, some of which represented proceeds of borrowings, and some of which were provided from other sources, the CRA should accept that provided the taxpayer had sufficient non-borrowed funds at the time the particular investment was made to have funded the off-shore financing structure, the taxpayer's interest expense will not be restricted under the rules.

We also note that if the CRA can clarify that cash-damming is an acceptable approach, many taxpayers will be in a position to take steps, between now and 2012, to arrange their affairs so that the source of funds for any IAL can be determined. However, it is important that the

CRA provide this clarification now so that taxpayers can in fact take reasonable steps to be prepared for the rules taking effect.

* * * * *

We trust that the above is useful to you. We would be happy to discuss the examples set out above, and our suggestions as to an appropriate CRA approach, at your convenience. Please do not hesitate to call either of us.

Nick Pantaleo
Partner, Canadian National Technical
Services



(416) 365-2701

Elizabeth Johnson
Partner, Canadian National Technical
Services



(416) 869-2414