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Property Leasing into Canada: How to Open a Closed Market

by Eoin Brady and Richard Marcovitz
PricewaterhouseCoopers LLP

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Consumers and businesses commonly finance equipment purchases using leases. However, non-resident financiers are seldom able to offer lease financing to Canadians because of Canadian withholding tax on rents. This article reviews Canada's taxation of non-resident lessors and suggests approaches to enable non-residents to offer lease financing to Canadians.

Eoin Brady

Richard Marcovitz

eoin.brady@ca.pwc.com

richard.marcovitz@ca.pwc.com

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INTERNATIONAL TAX PLANNING

Co-Editors: Lincoln Schreiner* and Michael Maikawa**

PROPERTY LEASING INTO CANADA: HOW TO OPEN A CLOSED MARKET

*Eoin Brady and Richard Marcovitz****

Consumers and businesses commonly finance equipment purchases using leases. However, non-resident financiers are seldom able to offer lease financing to Canadians because of Canadian withholding tax on rents. This article reviews Canada's taxation of non-resident lessors and suggests approaches to enable non-residents to offer lease financing to Canadians.

KEYWORDS: RENTS ■ NON-RESIDENTS ■ LEASING ■ WITHHOLDING TAXES ■ FOREIGN TAX CREDITS ■ FINANCING

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* Of PricewaterhouseCoopers LLP, Vancouver.

** Of PricewaterhouseCoopers LLP, Toronto.

*** Of PricewaterhouseCoopers LLP, Toronto (e-mail: eoin.brady@ca.pwc.com and richard.marcovitz@ca.pwc.com).

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BACKGROUND

The Department of Finance has been active in opening up new sources of financing for Canadians. Most notably, in the 2007 budget, the federal government announced an agreement in principle to amend the Canada-US treaty¹ to eliminate source-country withholding tax on interest payments, and also proposed to change Canada's domestic tax law to eliminate non-resident withholding tax on interest paid to arm's-length non-residents.² The minister of finance's 2009 budget address, which was delivered during a period of instability in the credit markets, included an announcement that Canada may change the law to broaden the leasing activities that federally regulated financial institutions can undertake.³ Subsequently, the Department of Finance released a brief "consultation" document requesting comments on this issue.⁴ However, in identifying the scope of the consultations, the document made

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- 1 The Convention Between Canada and the United States of America with Respect to Taxes on Income and on Capital, signed at Washington, DC on September 26, 1980, as amended by the protocols signed on June 14, 1983, March 28, 1984, March 17, 1995, July 29, 1997, and September 21, 2007 (herein referred to as "the Canada-US treaty").
 - 2 See Canada, Department of Finance, 2007 Budget, Budget Plan, March 19, 2007, 240. The treaty amendment was subsequently included in the Protocol Amending the Convention Between Canada and the United States of America with Respect to Taxes on Income and on Capital Done at Washington on September 26, 1980, as Amended by the Protocols Done on 14 June 1983, 28 March 1984, 17 March 1995 and 29 July 1997, signed at Chelsea, Quebec on September 21, 2007 (herein referred to as "the fifth protocol"), article 6 (amending article XI of the Canada-US treaty) and articles 27(2) and (3)(d). The fifth protocol entered into force on December 15, 2008. After 2009, arm's-length interest payments between a resident of one country to a non-resident of the other country will no longer be subject to withholding tax. Withholding tax on non-arm's-length interest is being phased out over a three-year period.
The domestic law proposal was subsequently formulated in a series of draft amendments to section 212 of the Income Tax Act, RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act"), enacted by SC 2007, c. 35, sections 59(2) and (3), applicable after 2007. Unless otherwise stated, statutory references in this article are to the Act.
 - 3 Canada, Department of Finance, 2009 Budget, Budget Plan, January 27, 2009, 83.
 - 4 Canada, Department of Finance, *Supporting Stable Financing—Consultations on Leasing* (Ottawa: Department of Finance, 2009) (online: <http://www.fin.gc.ca/activity/consult/leasing-eng.asp>) (herein referred to as "the consultation document"). The document was issued on April 26, 2009; the closing date for submissions was May 8, 2009.

no reference to cross-border leasing or, in particular, the existing impediments to cross-border leasing of tangible personal property to Canadians.⁵

This article reviews the basic income tax concepts⁶ with respect to cross-border leases of tangible personal property and the Canadian rules that apply to non-resident lessors.⁷ We have attempted to illustrate, using examples, the financial impediments to cross-border leases created by part XIII withholding tax under the Income Tax Act.⁸ The article concludes with some suggested approaches to amending the Act to enhance the ability of Canadians to access lease financing from non-resident lessors.

LEASING AS A SOURCE OF FINANCING

As noted in the consultation document, leasing has been an important financing option for Canadian consumers and businesses.⁹ Under a leasing arrangement, the lessee acquires the use of the leased asset for the term of the lease, while the lessor retains the ownership of the asset. Thus, a key attribute of a lease, as distinguished from a purchase financed by a loan, is that ownership of the asset remains with the lessor. A financing arrangement that results in a legal transfer of property at the commencement of the agreement is not a lease but a sale; subsequent payments made by

5 As stated in the document, *ibid.*, the issue to be addressed in the consultations was “whether federally regulated financial institutions could and would provide a stable source of lease financing for consumers and businesses.” The questions posed for comment suggest that any policy changes would focus on amendments to the regulatory rules to permit these financial institutions to undertake lease financing of automobiles and personal household property.

6 We do not discuss the goods and services tax (GST) or the harmonized sales tax (HST) (which will obviously be of greater concern in Ontario and other provinces that are planning to harmonize their sales tax with the federal tax). Since, for the most part, non-residents operating outside Canada incur very little GST, the benefits of cross-border leasing arrangements may not be significant if the relevant issue is the ability of the lessor to claim input tax credits. For resident lessees, the amount of GST payable should be the same regardless of the residence of the lessor. There may, however, be some additional complexities to consider, including the application of the drop shipment rules, self-assessment rules, and special relieving rules that may allow the resident lessee to recover GST that is payable on the importation of goods into Canada.

7 For previous consideration of domestic and cross-border issues pertaining to leasing in Canada, see Victor Peters, “Foreign Financing for Canadian Companies,” in *Report of Proceedings of the Thirty-Fifth Tax Conference*, 1983 Conference Report (Toronto: Canadian Tax Foundation, 1984), 265-81, at 270-72; Richard S. Carson, “Canadian Tax Aspects of International Equipment Leasing,” *International Tax Planning* feature (1984) vol. 32, no. 6 *Canadian Tax Journal* 1136-46; Thomas S. Gillespie, “Lease Financing,” in *Income Tax and Goods and Services Tax Considerations in Corporate Financing*, 1992 Corporate Management Tax Conference (Toronto: Canadian Tax Foundation, 1993), 7:1-43; and Roger D. Ashton, “Leasing: Recent Developments,” in *Current Issues in Corporate Finance*, 1997 Corporate Management Tax Conference (Toronto: Canadian Tax Foundation, 1998), 11:1-46, at 11:31. A consistent theme in these articles is the negative effect of Canadian income tax rules on cross-border, as well as domestic, leasing.

8 *Supra* note 2.

9 *Supra* note 4.

the acquiror are payments of principal and interest under a debt contract.¹⁰ We discuss the distinction between a lease and a sale in more detail below.

Whether a financing arrangement involves a lease or a sale is important from a tax perspective. However, many of the financial consequences of a lease or sale in respect of tangible personal property are similar or identical. In particular, the amount of rent that a lessee pays a lessor under a lease is equivalent to the amount that a borrower pays a lender under a loan if the lease and the loan have the same basic characteristics—that is,

- the price of the equipment equals the principal amount of the loan;
- the value of the asset at the end of the lease is the same as the remaining unpaid principal under the loan;
- the rental payments are made at the same time as the blended payments of principal and interest under the loan; and
- the interest rate used to compute the rental payments is the same as the rate of interest under the loan.

Although rental payments are computed using an interest rate, no component of a scheduled rental payment is interest for Canadian tax purposes.¹¹ Instead, the Act treats rental payments as an undifferentiated single amount. In contrast, blended payments of principal and interest that retire an interest-bearing debt are segregated as between principal and interest for tax purposes.

One substantive financial difference between leases of tangible property and loans relates to the value of the property at the end of the lease. This value is normally estimated by the parties at the outset of a lease and is commonly referred to as the “residual value.” For the purpose of computing rental payments, the residual value is similar to the unpaid principal after the last periodic payment under a loan has been made. However, once a borrower has repaid the full principal amount, a lender is not subject to financial risk after the final principal payment is made under a loan, whereas a lessor retains the financial risk associated with converting the residual value of the asset at the end of the lease into cash. The term “capital lease” (and variants thereof) describes a lease in which the lessor transfers substantially all of the benefits and risks of ownership to the lessee.¹² The term “operating lease”

10 *Helby v. Matthews*, [1895] AC 471 (HL).

11 See Tim Edgar, “The Concept of Interest Under the Income Tax Act” (1996) vol. 44, no. 2 *Canadian Tax Journal* 277-347, at 284, where the requirements of interest are summarized as follows: “(1) an amount must be compensation for the use of money; 2) the amount must be referable to a principal sum; and 3) the amount must be calculated by reference to the time during which the principal is outstanding—that is, it must accrue on a daily basis or be apportionable in time on such a basis.” Rents, however computed, are compensation for the use of property, not money, and thus would not meet the first, and likely the second, of the three conditions.

12 See Canadian Institute of Chartered Accountants, *CICA Handbook* (Toronto: CICA) (looseleaf), section 3065.5.

describes a lease in which the lessor maintains some risks and rewards associated with the asset. While the use of these terms is often inconsistent and imprecise, in accounting parlance they have a fixed meaning. The current approach under Canadian generally accepted accounting principles (GAAP) is to treat a lease agreement as either an operating lease or, if one of three tests is met, a capital lease. In the latter case, for accounting purposes, the lessee is treated as the owner of the property and as a debtor of the lessor.¹³

Despite the economic similarities between tangible property leases and loans, the tax, legal, and accounting treatments of the two types of transaction are significantly different. The accounting profession has begun to question whether these differences are warranted. The International Accounting Standards Board (IASB) has recently issued a discussion paper on leasing, proposing that, for all types of leases, the lessee will record “an asset representing its right to use the leased item for the lease term (the right of use asset) [and] a liability for its obligation to pay rentals.”¹⁴ Certain provisions of Canada’s Income Tax Act create symmetry between lenders and lessors: for example, the “specified leasing property” rules¹⁵ and a related elective provision under section 16.1 limit the capital cost allowance (CCA) available to a lessor to the amount of principal repaid on a hypothetical loan, and therefore treat the lessee as the owner of the asset for income tax purposes. As discussed below, a simple method for Canada to open up the cross-border leasing market is to change the non-resident withholding tax rules to apply a treatment to leases that is similar to the treatment applied to loans.

COMMON CROSS-BORDER ARRANGEMENTS FOR LEASING INTO CANADA

To understand why changes to cross-border leasing rules may provide a practical benefit to Canadians, it is useful to consider the contexts in which leases that have some cross-border element are used to provide financing in Canada.

The first common circumstance involves a multinational corporate group that manufactures equipment. To encourage distribution of its product, the manufacturer offers, or arranges for, lease financing for consumers and businesses. The party that actually executes the lease with the consumer may be a captive finance company or a dealer in the group’s products. If the lease with the consumer is executed by a dealer, the leased equipment is then sold to the group’s finance company or to a

13 See section 3465 of the *CICA Handbook*, supra note 12. Section 3465 uses the terms “capital lease,” “sales-type,” and “direct financing lease” to describe leases in which the lessor accepts minimal economic risk.

14 See the International Accounting Standards Board, *Leases—Preliminary Views*, Discussion Paper no. DP/2009/1 (London: IASB Foundation, 2009), paragraph 3.26. See also paragraphs 3.16 to 3.21. It is expected that if these proposals are adopted, they will ultimately be incorporated into Canadian GAAP.

15 See regulation 1100(1.11), Income Tax Regulations, CRC, c. 945, as amended.

third party to whom the manufacturing group directs the dealer. Leases of this type frequently involve standard-term contracts and may be accounted for as operating leases. To avoid part XIII withholding tax, lessors who hold the assets during the lease must be residents of Canada or must carry on business through a permanent establishment in Canada. This may oblige the manufacturing group to form and operate a Canadian corporation or branch that registers for and pays Canadian taxes. This requirement has the associated obligation of preparing Canadian dollar books and records. Because leases with Canadian consumers will inevitably be denominated in Canadian dollars, the functional currency election in section 261 may not provide relief from this obligation.¹⁶ In our experience, non-resident financiers incur significant costs to maintain the Canadian dollar records necessary to conduct leasing operations in Canada.

Another common type of cross-border leasing arrangement is a lease with a financing company that has no interest in the distribution of a particular product. The transaction may involve equipment that is already owned by the user and is sold to the financier, which leases it back to the original owner. Alternatively, the financier may be prepared to fund a large purchase by agreeing to take ownership of an asset to be used by a third party. These leases may involve customized agreements. For accounting purposes, they are commonly treated as direct financing or capital leases, because the financier does not accept risk associated with the residual value of the asset at the end of the term. The financier's willingness to enter into a lease instead of simply lending money may be a result of possible tax advantages such as tax depreciation associated with ownership of the asset. These leases are most common with respect to high-cost transportation equipment, but may also involve other types of property. Non-resident lessors occasionally participate in this Canadian market if, and only if, an exemption from Canadian withholding tax is available.

TAXATION OF NON-RESIDENT LESSORS

Non-resident lessors can be taxed on rents from residents of Canada under part I or part XIII.¹⁷ To prevent double taxation, paragraph 214(13)(c) provides for regulations to modify the application of part XIII withholding tax to non-residents that carry on business in Canada. The current and draft versions of regulation 805 exempt from part XIII tax amounts paid to a non-resident that are attributable to a permanent establishment in Canada as defined in regulation 400(2). For the most part, the definition of "permanent establishment" in the regulations is likely to apply to the same arrangements as the definition in the permanent establishment article (article 5) of Canada's tax treaties. Thus, residents of treaty countries can be

¹⁶ See the definition of "functional currency" in subsection 261(1).

¹⁷ Non-residents subject to part I tax may also be subject to tax under other parts of the Act, such as part XIII.1 and part XIV. In this article, a reference to taxation under part I is intended to distinguish between taxpayers taxed on a gross basis under part XIII and taxpayers subject to various other parts of the Act that may apply to non-residents who are taxed on net profits.

taxed on Canadian-source rents under part I or part XIII, but not both.¹⁸ Draft regulation 802 exempts authorized foreign banks and registered non-resident insurers from part XIII tax on amounts included in part I income from carrying on business in Canada. The version of regulation 802 that will be replaced has been applied to all non-residents.¹⁹ In accordance with the draft version of regulation 802, lessors that are neither authorized foreign banks nor registered non-resident insurers, and are not resident in a treaty country, could theoretically lease tangible personal property into Canada and be subject to Canadian income tax under both part I and part XIII if they are carrying on business in Canada but not through a permanent establishment under regulation 400(2).

Whether part XIII or part I tax applies to a non-resident lessor is significant because part XIII tax on gross rents is likely to exceed part I tax on a lessor's net income. Thus, a non-resident lessor that leases property subject to Canadian withholding tax may wish to have its Canadian-source income taxed under part I through a Canadian permanent establishment. However, tangible personal property seldom constitutes a permanent establishment for the lessor under either the treaty definition or the definition in the regulations. Instead, a lessor of tangible personal property generally maintains a permanent establishment in the place where it conducts its business, (that is, financing or operations).²⁰ As a result, to avoid taxation under part XIII, a non-resident may have to set up a Canadian subsidiary or open up a branch that conducts a sufficient level of activity to constitute a permanent establishment.

TAXATION UNDER PART I

Non-resident lessors that maintain a permanent establishment in Canada are taxed under part I. Accordingly, they must apply the general rules in the Act regarding the computation of income from a business and some of the rules with respect to computing taxable income. The Act contains several rules that create symmetry between the taxation of branches and the taxation of resident corporations. In practice, however, the tax results between the two may differ. For example, branches are not subject

18 It is theoretically possible that a resident of a treaty country that is exempt from part XIII tax because of regulation 805 could also be exempt from part I tax. This could be the case if regulation 805 applied because the non-resident maintained a permanent establishment in Canada as defined in regulation 400(2) but had no permanent establishment as defined under the applicable treaty. At one time, regulation 805 provided a universal exemption from part XIII tax for non-resident taxpayers who carried on business in Canada. See David G. Broadhurst, "Issues in Withholding," in *Income Tax Enforcement, Compliance, and Administration*, 1988 Corporate Management Tax Conference (Toronto: Canadian Tax Foundation, 1988), 11:1-18, at 11:16, for a discussion of the application of former versions of regulations 802 and 805. See also *United Geophysical Co. of Can. v. MNR*, [1961] CTC 134 (Ex. Ct.); and *GLS Leasco Inc. et al. v. MNR*, [1986] 2 CTC 2034 (TCC).

19 *Twentieth Century Fox Film Corp. v. The Queen*, [1985] 2 CTC 328 (FCTD).

20 See Keith R. Evans, "Leased Equipment: When Does a Permanent Establishment Exist?" (2002) vol. 50, no. 2 *Canadian Tax Journal* 489-523, for consideration of this issue.

to the thin capitalization rules, and it is unlikely that a branch could execute an intra-company lease with an entity of which it is a part.²¹ In theory, a non-resident that operated its leasing activities through a branch would incur approximately the same amount of part I tax as a Canadian subsidiary that conducted similar activities. However, in our experience, the only non-residents that lease through Canadian permanent establishments are authorized foreign banks.²²

TAXATION UNDER PART XIII

Non-residents that are not carrying on business in Canada through a permanent establishment are subject to withholding tax on Canadian-source rental income pursuant to paragraph 212(1)(d). The basic charge to tax on rents reads as follows:

212(1) Every non-resident person shall pay an income tax of 25% on every amount that a person resident in Canada pays or credits, or is deemed by Part I to pay or credit, to the non-resident person as, on account or in lieu of payment of, or in satisfaction of, . . .

(d) rent, royalty or similar payment, including, but not so as to restrict the generality of the foregoing, any payment

(i) for the use of or for the right to use in Canada any property, invention, trade-name, patent, trade-mark, design or model, plan, secret formula, process or other thing whatever.

The preamble states that subsection 212(1) applies to amounts that a person resident in Canada “pays or credits, or is deemed by Part I to pay or credit, to the non-resident person as, on account or in lieu of payment of, or in satisfaction of” amounts described in the paragraphs that follow. The references in paragraph (d) to rent and in subparagraph (d)(i) to payment for the use of any property are broad enough to apply to virtually all payments for the use of property under agreements that are leases at law.

The basic charge to tax in the preamble refers to amounts paid by a resident of Canada to a non-resident. However, various rules expand or limit the application of part XIII tax to rental payments, such that part XIII tax on rents is better described as applying where a lessee pays an amount in respect of the use of property in Canada to a non-resident that does not include the amount in part I income from an activity conducted in Canada. For example, subsection 212(13.1), which applies to payments by partnerships,²³ paragraph 212(13.2)(a), which applies to payments made

21 See *Cudd Pressure Control Inc. v. R.*, [1999] 1 CTC 1 (FCA). However, see also *Twentieth Century Fox Film Corp.*, supra note 19, which involved a “back-to-back” royalty arrangement that effectively circumvented part XIII tax. Also see David A. Ward, “Attribution of Income to Permanent Establishments” (2000) vol. 48, no. 3 *Canadian Tax Journal* 559-76.

22 As defined in section 2 of the Bank Act, SC 1991, c. 46.

23 See paragraph 212(13.3)(b) in respect of partnerships of which authorized foreign banks are members.

by non-resident persons, and paragraph 212(13.3)(a), which applies to authorized foreign banks, make part XIII tax applicable to payments made by a non-resident that are deducted in computing income for Canadian tax purposes.²⁴ Subparagraph 212(1)(d)(ix) provides an exemption for payments for the use of corporeal property outside Canada, and subparagraph 212(1)(d)(x) exempts payments to a person with whom the payer is dealing at arm's length that are deducted from income from a business carried on outside Canada. Finally, regulations 805 and 802, which are discussed above, exempt from part XIII tax certain amounts included in the part I income of a non-resident.

In addition to the exceptions to paragraph 212(1)(d) for rents in respect of tangible property used outside Canada, subparagraph 212(1)(d)(vii) exempts certain payments for leases of railway rolling stock entered into before November 19, 1974 and short-term leases thereafter. Subparagraph 212(1)(d)(xi) exempts rental payments made between parties dealing at arm's length for aircraft and related equipment.

CANADA'S TREATIES

Canada's treaties deal with leases of tangible personal property in article 12 (Royalties). In most of Canada's treaties, the definition of royalties in article 12 includes a reference to payments for the use of, or the right to use, tangible personal property.²⁵ Subject to limited exceptions, article 12(2) allows Canada to tax royalties that arise in Canada at a rate not exceeding 10 percent. Provisions such as article VII(6) of the Canada-US treaty clarify that an item covered in article XII cannot be exempted under articles V (Permanent Establishment) and VII (Business Profits).

The definition of royalties in the OECD model convention does not include income from the rental of tangible personal property.²⁶ Thus, the model convention

24 An authorized foreign bank is deemed to be a resident of Canada in respect of amounts paid by the bank in respect of its Canadian banking business. Subsections 212(13.2) and (13.3) may overlap.

25 Article XII(4) of the Canada-US treaty reads, in part, "The term 'royalties' as used in this Article means payments of any kind received as a consideration for the use of, or the right to use, . . . tangible personal property." The Canada-Norway treaty, however, contains no reference to tangible personal property: see the Convention Between the Government of Canada and the Government of the Kingdom of Norway for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital, signed at Ottawa on July 12, 2002, article 12(4). See also article 12(3) of the Convention Between Canada and the Cooperative Republic of Guyana for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and for the Encouragement of International Trade and Investment, signed at Georgetown on October 15, 1985; and article 12(3) of the Agreement Between Canada and Jamaica for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, signed at Kingston on March 30, 1978.

26 See article 12(2) of the Organisation for Economic Co-operation and Development, *Model Tax Convention on Income and on Capital: Condensed Version* (Paris: OECD) (looseleaf) (herein referred to as "the model convention").

contemplates that rents can be exempted under articles 5 and 7, as is the case for payments made by a resident of Canada to a resident of a country (such as Norway) whose treaty follows the model. Canada has entered a reservation on the OECD royalty article to clarify that generally its treaties will include rental payments in the scope of article 12.²⁷ Thus, residents of most of the countries that have treaties with Canada will be taxed on rents under either part I or part XIII.

The rules in article 12 of Canada's treaties with respect to where rents arise and by whom they can be taxed, and the specific exemptions from withholding tax in Canada's treaties, have a similar effect to the rules in part XIII. That is, the right of the source country to apply withholding taxes is better described as depending on whether the rental payments are paid in respect of a Canadian source or included in part I income, rather than where the parties are resident. For example, article XII(2) of the Canada-US treaty permits Canada, as the country of source, to tax rents that arise in Canada, and article XII(6) deems rents to arise where the property is used. Thus, the treaty effectively allows Canada to tax payments made by non-residents who operate in Canada, as contemplated by domestic provisions such as subsection 212(13.2), but prevents Canada from taxing payments made by residents for the use of property outside Canada, as contemplated by subparagraph 212(1)(d)(ix). Provisions such as article XII(5) of the Canada-US treaty have a similar effect to regulation 805, exempting from part XIII tax any payments made to a non-resident that carries on business through a permanent establishment in Canada. Canada's treaties also include exemptions from part XIII tax for various types of transportation equipment.

CLASSIFICATION OF A LEASE FOR PART XIII AND TREATY PURPOSES

It is commonly understood that the Act is an accessory statute that applies once the legal consequences of a transaction have been determined. In accordance with the Act's accessory nature, whether an arrangement is a lease or a sale is based on the applicable commercial law.²⁸ Tax and commercial courts, and numerous commentators, have considered the common-law meaning of lease, and the distinction between a lease and a sale.²⁹ A lease can be described as a contract that gives a lessee a temporary,

27 See the OECD commentary on article 12, at paragraph 35. In entering a reservation on article 12(1), Canada has expressed its desire to retain a 10 percent rate of tax in its treaties. In paragraph 35, Canada expresses a willingness to exempt, by negotiation, various royalties and payments for the use of intangible property, but not a willingness to exempt tangible personal property.

28 In *R v. Lagueux & Frères Inc. (FC)*, [1974] CTC 687 (FCTD), Décarv J held that the Act is an accessory system that applies only to the effects produced by contracts, and that those effects are determined under the applicable civil or common law.

29 As discussed below, the Canada Revenue Agency (CRA) has also struggled with this issue: see the text at note 34, *infra*, and following. For more extensive discussion, see Stephen W. Bowman, "The Continuing Evolution of Lease vs. Sale," paper presented to the Law Society of Upper

but exclusive, right to use property.³⁰ The borderline cases of classification in respect of contracts regarding tangible personal property generally relate to whether a purported lease that has an automatic transfer of title after a series of mandatory payments or a bargain purchase option is actually a sale.³¹ For whatever reason, there is little discussion of whether contracts that purport to be sales can be treated as leases.

Agreements with respect to the use of property governed by the Civil Code of Quebec³² may be affected by subsection 248(3), which serves to harmonize the Act's treatment of arrangements under the Quebec Civil Code with the treatment of arrangements under the common law. In accordance with subsection 248(3), arrangements governed by the Quebec Civil Code that would be considered to vest beneficial ownership under the common law are deemed to be an ownership interest for the purposes of the Act.³³ This presumably has the effect of causing leasing agreements that include mandatory transfers of title to be treated as sales even if governed by the law of Quebec.

The Canada Revenue Agency (CRA) has changed its position on what constitutes a lease a number of times. In 2001, it withdrew *Interpretation Bulletin* IT-233R,³⁴ which had reflected a policy approach that resulted in the classification of some arrangements as sales for income tax purposes even though they were probably leases at law. The CRA's most recent statements on the matter make it clear that it considers

Canada, February 6, 2002; Jon D. Gilbert, "Principles of Leasing," in *2000 Prairie Provinces Tax Conference* (Toronto: Canadian Tax Foundation, 2000), tab 7; Walter R. Pela, "A Review of Selected Real Estate and Leasing Issues," in *2002 British Columbia Tax Conference* (Vancouver: Canadian Tax Foundation, 2002), tab 15; Ashton, *supra* note 7, at 11:8 and 11:12; and Gillespie, *supra* note 7, at 7:1.

30 A non-exclusive right to use property is generally described as a licence. While there are cases that distinguish between a lease and a licence, in practice, tangible property is seldom the subject of an agreement that provides the user with non-exclusive use of the property.

31 The case *Helby v. Matthews*, *supra* note 10, apparently is accepted as authority that an agreement that will result in a mandatory transfer of title is a sale, not a lease, at common law. Several Canadian tax cases have considered bargain purchase options. These culminated in the Federal Court decision in *The Queen v. Construction Bérou Inc.*, 98 DTC 640 (FCTD), where a majority of the court, partly in reliance on the CRA's positions, concluded that a bargain purchase option could cause an agreement to be a sale. The CRA agreed with the minority reasons in concluding that a bargain purchase option did not necessarily cause a lease agreement to result in a transfer of title.

32 SQ 1991, c. 64.

33 See David G. Duff, "The Federal Income Tax Act and Private Law in Canada: Complementarity, Dissociation, and Canadian Bijuralism" (2003) vol. 51, no. 1 *Canadian Tax Journal* 1-63, at 37; and Mark D. Brender, "Symposium: Beneficial Ownership in Canadian Income Tax Law: Required Reform and Impact on Harmonization of Quebec Civil Law and Federal Legislation" (2003) vol. 51, no. 1 *Canadian Tax Journal* 311-54, at 338.

34 *Interpretation Bulletin* IT-233R, "Lease-Option Agreement; Sale-Leaseback Agreements," February 11, 1983.

the distinction between a sale and lease to be a matter of commercial law.³⁵ The CRA's decision to simply apply the commercial law is reasonable. However, the cases in which courts have classified agreements as sales or leases cannot be easily reconciled, or reduced to reliable rules of application. Thus, the CRA's current position is of limited assistance to taxpayers in many circumstances.

The characterization of an agreement as a lease or a sale effectively determines whether paragraph 212(1)(d) and the royalties article (article 12) of the relevant treaty, or paragraph 212(1)(b) and the interest article (article 11) of the relevant treaty, will apply to payments made by a resident of Canada. For cross-border arrangements, an interesting question arises as to how Canada should distinguish between a sale and a lease governed by foreign law. A particular agreement that, for example, purported to be a lease but included a mandatory transfer of title likely would be a sale under Canadian commercial law but could be a lease under the laws of the foreign jurisdiction that apply to commercial matters in respect of the agreement.³⁶ If the definition of a lease for tax purposes is a matter of commercial law, which law should Canada apply to such an agreement? The Income Tax Conventions Interpretation Act³⁷ and the general definitions article (article 3) of Canada's treaties make it clear that the meaning that applies for Canadian tax purposes is determinative. To our knowledge, however, no Canadian tax case considers how to classify a contract that is a lease under foreign law but includes clauses that would cause it to be a sale under Canadian commercial law.

The CRA recently considered how foreign entities should be classified and endorsed an approach (advocated in this feature by Marc Darmo)³⁸ that considers foreign commercial law to determine the relevant rights created under the agreement, but classifies the agreement on the basis of the most closely analogous category under

35 *Interpretation Bulletin* IT-233R was withdrawn by *Income Tax Technical News* no. 21, June 14, 2001. ITTN no. 21 cited *Shell Canada Ltd. v. R.*, [1999] 4 CTC 313 (SCC) as authority for the proposition that the economic realities of a situation cannot be used to recharacterize a taxpayer's bona fide legal relationships, implicitly confirming that IT-233R was not an accurate description of the law. The CRA has longstanding concerns about agreements "where the documents that are intended to govern the transaction are, in substance, far different from their form": "Revenue Canada Round Table," in *Report of Proceedings of the Thirty-Third Tax Conference*, 1981 Conference Report (Toronto: Canadian Tax Foundation, 1982), 726-66, question 24, at 745. In ITTN no. 21, the CRA stated, "Therefore, in the absence of sham, it is our view that a lease is a lease and a sale is a sale." Some practitioners chose to interpret this comment literally, and proposed various tax structures that were premised on the expectation that any document with the word "Lease" at the top would be treated as a lease. The CRA has since clarified that, in stating that a lease is a lease, it only meant that a lease at law is a lease for tax purposes: see CRA document no. 2008-030365, "Tax Implications of Leasing Arrangements," April 20, 2009.

36 This is presumably most likely to occur with contractual arrangements governed by civil law. The analysis of such a contract would be unaffected by subsection 248(3), which applies only to arrangements governed by Quebec law.

37 RSC 1985, c. I-4.

38 See Marc Darmo, "Characterization of Foreign Business Associations," *International Tax Planning* feature (2005) vol. 53, no. 2 *Canadian Tax Journal* 481-505.

Canadian commercial law. As mentioned, under Canadian law, agreements with mandatory transfers of title are likely sales. However, a lease with a mandatory transfer of title might still be a lease under foreign law. If the CRA were to classify agreements governed by foreign law on the basis of analogous Canadian law, as it does with foreign entities, non-residents might be prepared to finance Canadians using contracts that are leases under foreign law but sales under Canadian law. Presumably, for part XIII purposes, payments under these contracts would be treated as payments of principal and interest, and thus would not be subject to Canadian withholding tax. There may be some logic to Canada's applying its income tax rules on the basis of the Canadian commercial-law concept of a lease, rather than on the basis of the rules that apply in foreign countries. However, it is by no means certain how the CRA will treat such agreements. Unfortunately, the potential non-resident withholding tax on rental payments is significant, and non-residents are not likely to enter into finance contracts with residents of Canada if it is possible that the CRA might consider the agreements to be leases for part XIII purposes.

FOREIGN TAX CREDITS: LOAN OR LEASE?

The amount of tax that Canada levies on non-residents in respect of Canadian-source leasing income is an important consideration for a foreign financing entity when deciding whether to offer lease financing to Canadians. Assuming that the lessor is taxable in its country of residence, and that it is not possible or practical for the lessor to establish a permanent establishment in Canada, the primary concern will be whether any taxes that Canada levies can be recovered as a foreign tax credit against the lessor's domestic income tax liability. The following example illustrates the typical foreign tax credit consequences of a loan and of a lease, and demonstrates how part XIII withholding tax effectively precludes many cross-border leases because of the higher tax cost.

EXAMPLE

Assumed Facts

ChemicalCo, a chemical company based in Sarnia, Ontario, is negotiating financing with Foreign Bank, which is resident in a treaty country with domestic income tax and foreign tax credit rules similar to Canada's. ChemicalCo requires \$1,000 to acquire specialized equipment for a refinery development project. Foreign Bank and ChemicalCo negotiate financing with a 7 percent cost of capital, repayable over two years, the same period as the useful life of the specialized equipment. Foreign Bank will finance the transaction with a two-year 4 percent loan from its deposits.

To determine its potential after-tax return, Foreign Bank models the following alternatives:

1. lend \$1,000 to ChemicalCo at 7 percent in a fully amortizing loan, or
2. purchase the equipment, at a cost of \$1,000, and lease it to ChemicalCo under a two-year lease, with payments based on a 7 percent interest rate and nil residual value.

Loan Option

Assume that Foreign Bank and ChemicalCo do not deal at arm's length. As a result, interest payments to Foreign Bank will be subject to Canadian withholding tax under the applicable tax treaty, at an assumed rate of 10 percent.³⁹ For the two-year period, Foreign Bank computes the results as shown in the table below.

Results for Foreign Bank: Loan

	Year 1	Year 2	Total
Tax cost			
Interest income	\$70.00	\$36.18	\$106.18
Less: cost of financing	(40.00)	(20.39)	(60.39)
Taxable income.	30.00	15.79	45.79
Domestic income tax @ 35%.	10.50	5.53	16.03
Less: foreign withholding tax credit	(7.00)	(3.62)	(10.62)
Domestic income tax payable	<u>\$ 3.50</u>	<u>\$ 1.91</u>	<u>\$ 5.41</u>
Foreign tax credit summary			
Foreign withholding tax incurred	\$ 7.00	\$ 3.62	\$ 10.62
Foreign withholding tax utilized	(7.00)	(3.62)	(10.62)
Excess foreign tax credits	<u>nil</u>	<u>nil</u>	<u>nil</u>
Cash flow			
Interest income	\$ 70.00	\$ 36.18	\$ 106.18
Less: cost of financing	(40.00)	(20.39)	(60.39)
Less: Canadian withholding tax.	(7.00)	(3.62)	(10.62)
Less: domestic income tax	(3.50)	(1.91)	(5.41)
Financing cash flow	<u>19.50</u>	<u>10.26</u>	<u>29.76</u>
Repayment of principal	<u>\$483.09</u>	<u>\$516.91</u>	<u>\$1,000.00</u>

In this example, Foreign Bank's pre-tax return on investment is 4.58 percent, and its after-tax return on investment is 65 percent of this amount, or 2.98 percent.⁴⁰

The effect of the foreign tax credit is to leave Foreign Bank with the same after-tax return as it would receive if no withholding tax applied. Ultimately, the interest income is only subject to domestic tax at the 35 percent rate.

39 If Foreign Bank and ChemicalCo dealt at arm's length, payments of interest would be exempt from withholding pursuant to paragraph 212(1)(b).

40 Foreign Bank's net interest income over the two years is \$45.79 on a \$1,000 investment. After domestic tax at 35 percent and Canadian withholding tax at 10 percent, with a full foreign tax credit, Foreign Bank is left with a return of \$29.76.

Lease Option

Presumably, Foreign Bank will be prepared to lease the asset to ChemicalCo only if it can obtain at least the same return on its investment as it can achieve with a loan. As a result of the royalties article of the tax treaty, Foreign Bank will pay a 10 percent withholding tax on lease payments received from ChemicalCo. For the two-year period, Foreign Bank computes the results as shown in the table below.

Results for Foreign Bank: Lease

	Year 1	Year 2	Total
Tax cost			
Leasing income	\$553.09	\$553.09	\$1,106.18
Less: cost of financing	(40.00)	(20.39)	(60.39)
Less: asset depreciation	(500.00)	(500.00)	(1,000.00)
Taxable income.	13.09	32.70	45.79
Domestic income tax @ 35%.	4.58	11.44	16.03
Less: foreign withholding tax credit	(4.58)	(11.44)	(16.03)
Domestic income tax payable	nil	nil	nil
Foreign tax credit summary			
Foreign withholding tax incurred	\$55.31	\$55.31	\$110.62
Foreign withholding tax utilized	(4.58)	(11.44)	(16.03)
Excess foreign tax credits	\$50.73	\$43.86	\$ 94.59
Cash flow			
Leasing income	\$553.09	\$553.09	\$1,106.18
Less: cost of financing	(40.00)	(20.39)	(60.39)
Less: Canadian withholding tax.	(55.31)	(55.31)	(110.62)
Less: foreign income tax	nil	nil	nil
Financing cash flow	\$457.78	\$477.39	\$ 935.17

ChemicalCo pays \$1,106.18 to Foreign Bank over two years, the same amount paid in the case of a loan.⁴¹ However, because the form of financing is a lease, the withholding tax cost is applied on a larger payment of rent as compared with interest on a loan. As a result, the withholding tax borne by Foreign Bank is significant. Because Foreign Bank's pre-tax margin on this financing transaction is only

41 In the loan scenario, \$1,000 of principal is repaid plus \$70 of interest in year 1 and \$36.18 of interest in year 2, for a total of \$1,106.18.

4.58 percent, it is unable to fully utilize the foreign withholding tax paid as a credit against its domestic income tax, and the after-tax return is negative.⁴²

Thus, for the provider of the funds, a lease is not equivalent to a loan. In the circumstances described, a leasing arrangement is uneconomical, solely because of the withholding tax and foreign tax credit results.

ChemicalCo's Preference

ChemicalCo should be indifferent as to the choice between borrowing and leasing.

The CCA rules may change the timing of certain deductions. However, assuming that they allow ChemicalCo to amortize the asset for tax purposes over two years, the results from a lease and a loan are as shown below.

Comparison of tax results to ChemicalCo

	Year 1	Year 2	Total
Tax implications of leasing			
Leasing deduction	\$553.09	\$553.09	\$1,106.18
Tax savings @ 35%	<u>\$193.58</u>	<u>\$193.58</u>	<u>\$ 387.16</u>
Tax implications of borrowing			
Interest deduction	\$ 70.00	\$ 36.18	\$ 106.18
Tax depreciation (½ year rule applied)	<u>250.00</u>	<u>750.00</u>	<u>1,000.00</u>
Total tax deductions	<u>320.00</u>	<u>786.18</u>	<u>1,106.18</u>
Tax savings @ 35%	<u>\$112.00</u>	<u>\$275.16</u>	<u>\$ 387.16</u>

In both scenarios, ChemicalCo will pay \$1,106.18 to Foreign Bank. In both scenarios, ChemicalCo will receive tax deductions for \$1,106.18 and save \$387.16 of income tax. Only the characterization and timing of the deductions will differ as between a lease and a loan. Depending on the materiality of the timing differences, ChemicalCo may prefer to own or to lease.⁴³ Otherwise, ChemicalCo will be indifferent.

Foreign Bank's Preference

Arguably, there ought to be no difference in Foreign Bank's after-tax cash flow as a result of the decision to lend or lease. However, because of the withholding tax and

42 Total financing cash flow is \$935.17. Foreign Bank borrowed \$1,000 from its depositors. As a result, Foreign Bank loses \$64.83 of principal on this transaction plus the \$60.39 cost of financing (\$40 in year 1 and \$20.39 in year 2).

43 For example, an asset with a favourable CCA rate may depreciate over a much shorter time than its useful life, a period that may be more appropriate for a lease term.

foreign tax credit results, lending is the superior alternative. Accordingly, Foreign Bank will prefer to lend rather than lease.

CROSS-BORDER CANADA-US LEASING AND THE FIFTH PROTOCOL

USE OF AN UNLIMITED LIABILITY CORPORATION

As demonstrated, it is not economically feasible for a foreign lessor to lease directly into Canada. However, US lessors have been able to use unlimited liability corporations (ULCs) to make leasing into Canada a viable financing alternative.⁴⁴ Unfortunately for US lessors and Canadian lessees, this alternative will lose its attractiveness as of January 1, 2010, as a result of the fifth protocol to the Canada-US treaty. Pursuant to the protocol, after 2009 treaty benefits to ULCs will be denied, and payments of dividends, interest, and royalties by ULCs will be subject to Canadian withholding tax at the full statutory rate of 25 percent.

US residents use ULCs because the default US tax characterization for this type of corporation is to treat it as a disregarded entity. This characterization causes the ULC's income earned in Canada to pass through the ULC and be included in the US shareholder's income for US tax purposes.⁴⁵ As a result, a US lessor will deduct its financing cost and depreciation against its foreign leasing income. A particular advantage of using a ULC is that the Canadian income tax paid will be available immediately as a foreign tax credit.

For Canadian tax purposes, a ULC is a taxable Canadian corporation, regardless of its common-law residence, and is subject to tax on its worldwide income.⁴⁶ A lease through a ULC will be considered to be a transaction between two Canadian residents; accordingly, the lease payments will not be subject to part XIII tax, and the lessee may be eligible for a section 16.1 election, discussed below. A ULC can also be financed with cross-border arm's-length debt and be exempt from withholding tax on interest payments. A ULC must comply with Canadian income tax rules, including the thin capitalization rules, the principal business corporation restrictions to claiming CCA (regulation 1100(15)), and the specified leasing property rules (regulation 1100(1.1)). Nevertheless, the arrangement has been a favourable alternative for US residents seeking to lease into Canada, because of the ability to access an immediate foreign tax credit for Canadian income tax. This alternative has perhaps been even

44 See John Jakolev, "Find Your Partners" (March 2001) *CA Magazine* 37-38.

45 For an explanation of how the US entity classification system applies to ULCs, see Don R. Sommerfeldt, Benjamin C. Evans, Curtis R. Stewart, Kurt G. Wintermute, and James Yaskowich, "Unlimited Liability Corporations: Recent Developments," in *2006 Prairie Provinces Tax Conference* (Toronto: Canadian Tax Foundation, 2006), tab 1.

46 A corporation incorporated in Canada is resident in Canada and taxed on its worldwide income in accordance with paragraph 250(4)(a). In the context of the Canada-US treaty, the "tie-breaker" rule in article IV(3)(a) will also ensure that a ULC is resident in Canada.

more advantageous during the recent economic downturn, since a ULC may qualify to compute its Canadian tax results using the US dollar as its functional currency, provided that its leases are denominated in US dollars (as is common in some industries).⁴⁷ However, as mentioned above, the use of ULCs in leasing transactions may be discontinued after 2009, when the fifth protocol amendments come into effect.

In the meantime, returning to our example, if Foreign Bank used a ULC to finance ChemicalCo, the tax consequences shown below would result.

Results for Foreign Bank: Lease through a ULC

	Year 1	Year 2	Total
Tax cost in Canada			
Leasing income	\$553.09	\$553.09	\$1,106.18
Less: cost of financing	(40.00)	(20.39)	(60.39)
Less: asset depreciation	(500.00)	(500.00)	(1,000.00)
Taxable income.	13.09	32.70	45.79
Canadian income tax @ 35%	4.58	11.44	16.03
Canadian dividend withholding tax.	na	na	\$ 1.49
Tax cost in US			
Leasing income	\$553.09	\$553.09	\$1,106.18
Less: cost of financing	(40.00)	(20.39)	(60.39)
Less: asset depreciation	(500.00)	(500.00)	(1,000.00)
Taxable income.	13.09	32.70	45.79
US income tax @ 35%	4.58	11.44	16.03
Less: foreign tax credit.	(4.58)	(11.44)	(16.03)
US tax cost	nil	nil	nil

Foreign Bank's return on the financing transaction would be \$28.28 (\$45.79 of income less income tax of \$16.03 and withholding tax of \$1.49). This return on investment is the same as the return on investment from a loan in the earlier scenario, less withholding tax (at the treaty-reduced rate of 5 percent) on the dividend required to repatriate the profit.

The foregoing calculations show the advantage to a US lessor of using a ULC to lease into Canada in order to access an immediate foreign tax credit for the Canadian income tax payable. Apart from the added cost of the dividend withholding tax, leasing through a ULC is economically equivalent to lending.

⁴⁷ This is assuming that if the functional currency reporting in section 261 applies, as discussed below.

EFFECT OF THE FIFTH PROTOCOL

The fifth protocol will deny treaty benefits to a US resident that receives income, profit, or gain from an entity resident in Canada that is fiscally transparent, or disregarded, under US tax law but not disregarded for Canadian tax purposes, where this results in different treatment under domestic tax law. In many situations, this change to the Canada-US treaty will make the use of ULCs impractical in Canada-US cross-border planning, because dividends, interest, and royalties paid to such entities after 2009 will be subject to the full domestic withholding tax rate of 25 percent. US and Canadian government officials have acknowledged that denying this type of treaty benefit on the payment of dividends was not one of the objectives of the fifth protocol.⁴⁸ However, despite the apparent lack of policy intent, in our example, this change to the treaty will result in the dividends paid by a ULC being taxed at 25 percent instead of the 5 percent treaty rate.

OPENING UP THE CROSS-BORDER LEASING MARKET

Canada has the ability to change the rules in part XIII to facilitate cross-border leasing. One approach might be to remove the reference to payments for the use of equipment in the definition of royalties under Canada's treaties; however, revising treaties is a time-consuming process. An easier solution is for Canada to consider changes in the domestic tax law. Two provisions in the Act, subsection 216(1) and section 16.1, suggest models for these changes.

EXTENDING THE ELECTION UNDER SUBSECTION 216(1)

Subsection 216(1) allows a non-resident lessor to pay tax under part I of the Act rather than part XIII in respect of income from certain rentals. If the non-resident elects to use this provision, its income from rents is taxed in Canada on a "net basis" under part I, after the deduction of permitted expenses. While a non-resident lessor could also qualify for part I taxation by creating a Canadian permanent establishment, it is not always easy to do so for the purpose of leasing tangible personal property. As currently drafted, however, the scope of the section 216 election is limited to rent from real property and timber royalties. A Canadian lessee may still be required to withhold tax under paragraph 212(1)(d) on rents paid to a non-resident

48 For an explanation of the unexpected effect that the fifth protocol will have on ULCs, see Nathan Boidman and Michael Kandev, "Is the Nova Scotia Unlimited Liability Company Dead?" (2009) vol. 53, no. 13 *Tax Notes International* 1199-1203. Of further concern to tax practitioners is the effect of US President Obama's international tax proposals. Among other things, effective 2011, these proposals are expected to deny disregarded status to second-tier foreign corporations and first-tier foreign corporations that are disregarded for the purpose of US tax avoidance. Because the proposals have yet to be codified, it is not certain whether they will affect US corporations with first-tier ULC subsidiaries. For the full text of the proposals, see US Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals* (Washington, DC: Department of the Treasury, May 2009).

that has elected under section 216. However, the non-resident lessor can receive a refund of excess withholding tax once the required subsection 216(1) tax return is filed. It may also be possible for a lessor to elect under subsection 216(4) to pay part XIII tax on a “net basis,” thereby reducing the short-term loss of cash flow that otherwise occurs with part XIII withholding.

There are some problems with the rules in section 216 that Canada should address if this provision is to be extended to make tangible personal property leases a practical alternative for non-resident lessors. For example, a non-resident lessor that has a loss in Canada from another source cannot use this loss to reduce income reported on a subsection 216(1) return.⁴⁹ In addition, a non-resident lessor cannot deduct losses realized in previous years.⁵⁰ Non-residents may have to manage discretionary CCA claims to minimize the risk of lost deductions. With respect to financing expenses that are deducted from income, the CRA already considers the thin capitalization rules in subsection 18(4) to apply to non-resident lessors that elect under subsection 216(1).⁵¹ Codifying this interpretation may ensure that non-resident lessors are not able to reduce their part I taxes to levels that the Department of Finance considers unacceptable.

EXTENDING THE ELECTION UNDER SECTION 16.1

The rules in section 16.1 allow a lessee of tangible property to elect to be taxed under part I as if it had acquired the leased asset by borrowing funds from the lessor under a hypothetical loan, the principal amount of which is equal to the fair market value of the asset. Rental payments are treated as blended payments of principal and interest on the loan. The lessor must be either a resident of Canada or a non-resident that carries on business in Canada through a permanent establishment. The lessee and the lessor must also deal at arm’s length.

Although the election is filed jointly by the lessee and the lessor, the tax results to the lessor are not affected. Instead, the lessor is subjected to the complementary specified leasing property rules (which apply whether or not it elects under section 16.1), which limit the CCA claimed by the lessor to the amount of principal that would be received on the repayment of the hypothetical loan.

One way of opening up the cross-border leasing market is to extend the fiction created by section 16.1 to compute the part XIII tax results of non-resident lessors. Lessors that received blended payments of principal and interest could avoid tax under part XIII if they were subject to paragraph 212(1)(b) instead of paragraph 212(1)(d)

49 The preamble to subsection 216(1) states, among other conditions, that the provision will apply “without affecting the liability of the non-resident person for tax otherwise payable under Part I.” As a result, income taxed under subsection 216(1) is separated from other income of the non-resident taxed under part I.

50 Paragraph 216(1)(c) precludes deductions from income for the purpose of computing the non-resident’s taxable income.

51 CRA document no. 9638945, July 23, 1997.

on rental payments. If a section 16.1 election were permitted between a non-resident lessor and a related resident of Canada, the non-resident lessor could be taxed on any deemed interest at the applicable treaty rate. Canada could extend the fiction further by, for example, treating any deemed loan as a debt for the lessee's thin capitalization computations.

CONCLUSION

The Department of Finance will no doubt have concerns about opening up the cross-border leasing market. For example, it will be important to ensure that resident lessors can still compete with non-residents. While this is a significant consideration, we note that lenders are forced to compete with non-residents who may not be subject to Canadian taxation. In addition, the Department of Finance will have to consider the effect on the tax revenue that Canada collects. Nevertheless, the existing rules have effectively shut down the cross-border leasing market. The current crisis in the credit markets, together with Finance's demonstrated willingness to tackle serious policy issues with respect to financing, suggests that this may be the time for Canada to reconsider the cross-border leasing rules.