

Pertinent Loan or Indebtedness

Issue

In 2012, in response to several submissions (including one from the Canadian Chamber of Commerce) in connection with certain newly-proposed Budget tax measures, the Department of Finance introduced an exception from the shareholder benefit rules and the foreign affiliate dumping rules for a pertinent loan or indebtedness. In general, where a loan or indebtedness qualifies and is elected to be treated as a pertinent loan or indebtedness, such rules do not apply as they otherwise would. Instead, interest income is imputed for Canadian tax purposes to the extent that the actual interest earned is less than what would have been earned under a specified percentage.

While we agree that the direction Finance Canada took in this regard was necessary, the Canadian Chamber believes this measure should be modified, as set out below, to maintain Canada's competitiveness and its position as an attractive place for multinationals to invest.

Background

The Canadian Chamber believes Finance Canada's goal of protecting the Canadian tax base, while allowing Canadian corporations to more effectively deploy cash within a related global group, would be achieved through a lower rate of interest imputation.

At present, a pertinent loan or indebtedness will trigger imputed interest to the extent that the actual interest earned is less than that which would be earned under the prescribed rate in Regulation 4301(b.1), which is generally equal to the average yield of the Government of Canada 90-day T-bill rate sold during the first month of the preceding quarter (rounded to two decimal places) plus four percentage points (4.0%). That effectively places the interest rate for a pertinent loan or indebtedness at (or within a percent of) an amount equal to the prescribed penalty rate for late tax under Regulation 4301(a).

Example:

- Corporation A, a non-resident corporation, controls Corporation B, a corporation resident in Canada (CRIC) with a December 31st tax year-end. On January 1, 2014, Corporation A borrows \$5,000,000 from Corporation B at an interest rate equal to the rate prescribed in Regulation 4301(c), plus 1.5 percentage points (1.5%), in accordance with applicable transfer pricing principles. By December 31, 2015, Corporation A has not repaid the loan. If Corporation A and Corporation B choose to elect under subsection 15(2.11) of the *Income Tax Act* for the debt between them to be a pertinent loan or indebtedness, the loan is not deemed to be a dividend for Canadian withholding tax purposes and, instead, Corporation B would, in addition to the actual interest earned on the loan, be deemed to have earned additional interest income on the loan, beginning January 1, 2014, at 2.5%. As a result, for Canadian tax purposes, Corporation B would have to report taxable income on the loan equal to the regular prescribed rate (rounded to two decimal places) plus four percentage points (4.0%), notwithstanding that Corporation A would have only deducted interest payments for its tax purposes at the Regulation 4301(c) prescribed rate, plus 1.5 percentage points (1.5%)

In discussions with our members and their tax advisors, the consensus view is that such a rate is excessively high and cost-prohibitive to many taxpayers who would otherwise be interested in electing into the pertinent loan or indebtedness regime. As a result, the Canadian Chamber believes that the pertinent loan or indebtedness regime is not being used nearly as much as it would be if there was a lower effective interest rate.

Similarly, the Canadian Chamber believes that the Government of Canada is missing out on an opportunity to benefit from greater tax revenues that would result from lower effective interest rates applying to a much broader base of pertinent loan or indebtedness activity.

In addition to triggering greater participation in the pertinent loan or indebtedness regime, to the benefit of Canadian taxpayers and the Government of Canada, a lower effective interest rate would be more consistent with international transfer pricing principles and ultimately better achieve the Department's original goals in having introduced the pertinent loan or indebtedness regime.

Recommendation

That the federal government revise the prescribed interest rate in Regulation 4301(b.1) to be equal to the applicable Government of Canada 90-day T-bill rate, unrounded, plus two percentage points (2.0%).