

NO.: **IT-361R3**

DATE: February 12, 1996

SUBJECT: **INCOME TAX ACT**
Exemption From Part XIII Tax on Interest Payments to Non-Residents

REFERENCE: Subparagraph 212(1)(b)(vii) (also subsection 212(3) of the *Income Tax Act*, and section 806.2 and subsection 6208(1) of the *Income Tax Regulations*)

Interpretation bulletins (ITs) provide Revenue Canada's technical interpretations of income tax law. Due to their technical nature, ITs are used primarily by departmental staff, tax specialists, and other individuals who have an interest in tax matters. For those readers who prefer a less technical explanation of the law, the Department offers other publications, such as tax guides and pamphlets.

While the ITs do not have the force of law, they can generally be relied upon as reflecting the Department's interpretation of the law to be applied on a consistent basis by departmental staff. In cases where an IT has not yet been revised to reflect legislative changes, readers should refer to the amended legislation and its effective date. Similarly, court decisions subsequent to the date of the IT should be considered when determining the relevancy of the comments in the IT.

An interpretation described in an IT applies as of the date the IT is published, unless otherwise specified. When there is a change in a previous interpretation and the change is beneficial to taxpayers, it is usually effective for all future assessments and reassessments. If the change is not favourable to taxpayers, it will normally be effective for the current and subsequent taxation years or for transactions entered into after the date of the IT.

A change in a departmental interpretation may also be announced in the *Income Tax Technical News*.

If you have any comments regarding matters discussed in this IT, please send them to:

***Director, Business and Publications Division
Income Tax Rulings Directorate
Policy and Legislation Branch
Revenue Canada
Ottawa ON K1A 0L5***

***Interpretation bulletins can be found on the
Revenue Canada Internet site at: www.rc.gc.ca***

Contents

Application

Summary

Discussion and Interpretation

General (¶s 1-9)

Changes in Terms of Debt Obligations (¶s 10-14)

Events of Failure or Default (¶s 15-18)

Partnerships and Non-Resident Borrowers (¶ 19)

Explanation of Changes

Application

This bulletin cancels and replaces Interpretation Bulletin IT-361R2, dated June 16, 1989.

Summary

The purpose of the exemption from Part XIII tax provided under subparagraph 212(1)(b)(vii) is to make it easier for Canadian borrowers to obtain medium to long term debt financing abroad.

This bulletin discusses subparagraph 212(1)(b)(vii) and the conditions in which Part XIII tax is not payable by a non-resident person on interest, including compound interest, received from a corporation resident in Canada. For a discussion of the exemption from Part XIII tax on interest payable in a foreign currency, see the current version of IT-360, *Interest Payable in a Foreign Currency*.

Discussion and Interpretation

General

¶ 1. Subparagraph 212(1)(b)(vii) provides that Part XIII tax is not payable by a non-resident person on interest (including compound interest) received from a corporation resident in Canada (see the current version of IT-391, *Status of Corporations*, for a discussion of a Canadian resident corporation) if all of the following conditions are met:

- (a) The non-resident must be dealing at arm's length (see the current version of IT-419, *Meaning of Arm's Length*) with the corporation. Subparagraph 212(1)(b)(vii) ceases to apply if the non-resident and the corporation cease to deal with each other at arm's

length. If subparagraph 212(1)(b)(vii) does not initially apply because the non-resident and the corporation do not deal with each other at arm's length, it will apply when they begin to deal with each other at arm's length and all the other conditions in that subparagraph are and continue to be met. If an event occurs which results in subparagraph 212(1)(b)(vii) ceasing or commencing to apply, in respect of the interest payable, that provision will cease or commence to apply, as the case may be, at the time of the change.

(b) The interest must have been received in connection with an obligation where the evidence of indebtedness was issued by the corporation after June 23, 1975.

(c) On an obligation, **other than a prescribed obligation**,

(i) issued or extended after February 25, 1986 (other than one issued or extended pursuant to an agreement in writing entered into on or before that date), or

(ii) under which the terms and conditions relating to the computation of interest payable thereon are changed at any time pursuant to an agreement made after February 25, 1986,

no portion of the interest may be contingent or dependent upon the use of or production from property in Canada, or be computed by reference to revenue, profit, cash flow, commodity price or any similar criterion or by reference to dividends paid or payable to shareholders of any class of shares of the capital stock of a corporation.

For the purposes of paragraph 212(1)(b), a "prescribed obligation," is defined under section 806.2 of the Regulations, as an indexed debt obligation where no amount is payable, (other than an amount determined by reference to a change in the purchasing power of money), which is contingent or dependent on the use or production of property in Canada, or computed by reference to revenue, profits, cash flow, or commodity prices (or other similar criteria), or computed by reference to dividends to shareholders of any class of capital stock of a corporation. An "indexed debt obligation" is defined in subsection 248(1). The definition of prescribed obligation applies to debt obligations issued after October 16, 1991.

(d) On an obligation entered into after November 12, 1981, and before February 26, 1986, other than one entered into pursuant to a commitment in writing made on or before November 12, 1981, no portion of the interest may be contingent upon the use of or production from property in Canada.

(e) Under the terms of the obligation or any agreement relating thereto the corporation may not, under any circumstances, be obliged to pay more than 25 percent of the principal amount thereof within 5 years of the date of its issue except in the event:

(i) of a failure or default under the said terms or agreement;

(ii) the terms of the obligation or any agreement relating thereto become unlawful or are changed by virtue of legislation or by a court, statutory board or commission;

(iii) the non-resident person exercises a right under the terms of the obligation or any agreement relating thereto to convert the obligation into, or exchange the obligation for, a security prescribed (see below for definition of prescribed security) for this purpose, by subsection 6208(1) of the Regulations; or

(iv) if the non-resident person's death (applicable to amounts paid or credited after 1991).

With respect to (iii) above, in the case of a debenture which is convertible at the option of the lender into shares which are "prescribed securities," the fact that the borrower, could, at its option, choose to pay cash to a lender that exercised its right to exchange the obligation for such shares would not, in itself, cause denial of the relief provided by clause 212(1)(b)(vii)(E). However, the exemption is not available under an arrangement where the borrower could, in any circumstances, be obligated to pay cash because of the exercise of an exchange right by the lender. In general terms, a "prescribed security" for this purpose is defined as:

- a share of the capital stock of the corporation that issued the debt obligation unless the corporation or a "specified person" (a person with whom the corporation or a shareholder of the corporation does not deal at arm's length) is or may be required to, or, can be reasonably be expected to redeem, acquire or cancel the share or reduce its paid-up capital, within 5 years of the date of issue of the debt obligation; or
- a right or warrant to acquire a share of the capital stock of the corporation of the debt obligation that would be a prescribed security if issued.

Under this provision, all the consideration receivable upon conversion or exchange has to be a share or warrant as described above. An exception is made for consideration received in lieu of a fraction of a share.

With respect to (e) above, where the obligation is one of a number of obligations which are identical in their terms and constitute a single issue, the principal amount is the total principal amounts of all of them.

Subparagraph 212(1)(b)(vii) only applies to interest which is "payable" by a corporation resident in Canada and therefore would not generally apply to prepaid interest. For this purpose, "payable" is considered to mean accrued and owing.

¶ 2. Generally, an obligation includes bonds, debentures, notes, mortgages, guaranteed investment certificates, and other debt obligations having a fixed term to maturity of not less than 5 years. An obligation payable on demand fails to

qualify as does one which is convertible (whether into another obligation or in any other manner, other than as noted in ¶ 1(e)(iii) above) within 5 years of its issue.

Subsection 212(3) provides that, for the purposes of the subparagraph 212(1)(b)(vii) exemption, a debt obligation issued after June 1993 by a corporation resident in Canada in financial difficulty to replace an obligation which qualifies for the exemption will be treated as having been issued at the same time as the former obligation.

Subsection 212(3) only applies if:

- the interest on the former obligation was exempt from Part XIII tax under subparagraph 212(1)(b)(vii) (or would be if the person to whom that interest was paid or credited was a non-resident); and
- the proceeds from the issuance of the replacement obligation can reasonably be regarded as having been used by the issuing corporation (or a Canadian resident corporation with which it does not deal at arm's length) in financing its active business carried on in Canada before the replacement obligation was issued.

For a discussion of the Department's views on financial difficulty, see the current versions of IT-507, *Small Business Development Bonds and Small Business Bonds*, and IT-527, *Distress Preferred Shares*.

¶ 3. If there is a written agreement which sets out:

- the selling price of a property;
- the unpaid balance owing by the purchaser; and
- the terms of payment,

the agreement will represent an evidence of indebtedness issued for the obligation to pay the balance owing. The interest paid pursuant to the terms of the agreement will be exempt under subparagraph 212(1)(b)(vii) provided all the other conditions in the provision are met.

¶ 4. An obligation will not mature "within 5 years of the date of its issue" if it matures on or after the fifth anniversary of the date of its issue. Thus an obligation issued on July 1, 1995, will not mature within 5 years if its date of maturity is July 1, 2000, or later. If there is a delay between the date appearing on the bonds and the date the bonds are taken up by the lender, the date appearing on the bonds is considered to be the date of issue of the evidence of indebtedness, provided the delay is reasonably attributable to marketing the bonds.

¶ 5. An obligation which otherwise qualifies under subparagraph 212(1)(b)(vii) is not disqualified only for the reason that it was acquired during a period in which the lender was a Canadian resident.

¶ 6. If the issuer of bonds, debentures or guaranteed investment certificates habitually redeems or converts them to new evidences of indebtedness within 5 years of their date of issue at the request of the lender, such a practice or policy constitutes part of the agreement related to the original debt

obligations and the interest on such obligations would not qualify for the exemption under subparagraph 212(1)(b)(vii).

¶ 7. Generally, an obligation which otherwise qualifies under subparagraph 212(1)(b)(vii) is not disqualified only because repayment is permitted, at the issuer's discretion, of more than 25 percent of the principal amount within 5 years of the date of its issue; that is, there is no obligation on the part of the issuer to make the payment. On the other hand, where there is a provision for repayment of the obligation (or at least of an amount in excess of 25 percent of its principal amount) on the death of a person, other than the non-resident lender (see ¶ 16 below), the obligation fails to qualify for the exemption. If the obligation is in foreign funds, any fluctuation in the Canadian dollar relative to the particular foreign currency is not a factor in determining at a particular time whether the Canadian borrower is obliged to pay more than 25 percent of the principal amount of the loan. In addition, if there is a provision in the agreement requiring the borrower to pay an additional amount to the non-resident lender in the event that there are changes to Canadian withholding laws for the payments on the debt, the requirement will not, by itself, disqualify payments which otherwise qualify for the exemption. Note that the substance of the transaction cannot be such that the debtor may effectively be obliged to repay more than 25% of the debt within 5 years of the issue date of the obligation.

¶ 8. If a borrower is required to make deposits in excess of 25 percent of the total principal amount within 5 years to a sinking fund controlled by the borrower, it is not considered that there is an "obligation to pay more than 25 percent of the principal amount" provided the borrower is not obliged under the terms of the obligation to redeem more than the 25 percent within the 5-year period. However, there may be an "obligation to pay more than 25 percent of the principal amount" if the borrower is required to irrevocably place more than 25 percent of the principal amount with an independent trustee or third party within the 5-year period, notwithstanding any limitation placed on payments which the trustee or third party may make to the lender. If under the terms of the obligation, there is a requirement that amounts be contributed by the borrower to a sinking fund or cash collateral account in the event of a contingency beyond the control of the lender, such a requirement will not otherwise disqualify the interest payable on the obligation from the exemption. For example, if an obligation is secured by a building as collateral and insurance or expropriation proceeds on the destruction of the building are not used to rebuild the building, a requirement in the terms of the obligation that the funds be set aside as collateral for the obligation will not, by itself, result in the loss of the exemption.

¶ 9. Financial leases are not obligations that meet the requirements of subparagraph 212(1)(b)(vii) since payments of "rent" to the lender-lessor under the "lease" are not considered to be blended payments of principal and interest

and, as such, the purported interest is not exempt from tax under Part XIII.

Changes in Terms of Debt Obligations

¶ 10. If the terms of the original issue of an obligation permitted those terms to be altered, any alteration in accordance therewith is not considered to result in a new obligation. For example, if an agreement provides for currency conversions with a simultaneous adjustment of the interest rate to accord with a particular currency and the currency is in fact changed, such a transaction would not be regarded as a repayment of the loan and the reissue of a new loan and the provisions of subparagraph 212(1)(b)(vii) would continue to apply.

¶ 11. It is not ordinarily considered that a new “evidence of indebtedness” is created where, even though not provided for under the terms of the original obligation, the obligation is amended to allow the borrower to convert from one currency to another, provided that the lender’s other rights and obligations under the amended contract remain the same.

¶ 12. It is a question of fact whether or not a particular obligation which qualifies within subparagraph 212(1)(b)(vii) in respect of one non-resident qualifies in the hands of a second non-resident who subsequently acquires it. If it is the same obligation and the second holder is at arm’s length with the Canadian issuer, it will normally continue to qualify. If the acquisition by the second holder has the effect of replacing the original obligation by a new obligation, the new obligation must be re-tested against the provisions of subparagraph 212(1)(b)(vii) to determine the status of the interest paid on it.

¶ 13. Whether a new evidence of indebtedness is issued on the assumption of a debt by a corporation resident in Canada from the original debtor corporation resident in Canada depends on the characterization of the assumption agreement. Unless there is a novation (where the liability of the original debtor is totally discharged), a new evidence of indebtedness is not considered to be issued by the new debtor because the debt remains that of the original debtor and the evidence of indebtedness is that which is issued by the former debtor. Accordingly, where the assumption of a debt does not take the form of a novation and the new debtor deals at arm’s length with the non-resident creditor, the provisions of subparagraph 212(1)(b)(vii) would continue to apply. See the current version of IT-474, *Amalgamations of Canadian Corporations*, for comments on indebtedness following an amalgamation or merger of two or more corporations.

¶ 14. If an obligation is renegotiated otherwise than as provided for in the terms of the original obligation, it is a question of fact whether a new obligation has been created.

Events of Failure or Default

¶ 15. An “event of failure or default” under the terms of a loan agreement is one that has commercial reality, is beyond the control of the lender and is therefore not contrived. Such an event that occurs as a consequence of an act by a person or persons who are not a party to the loan agreement is usually not considered a failure or default under the terms of the loan agreement. In interpreting the phrase “event of a failure or default under the said terms of agreement,” it is recognized that lenders need to protect their loans and, in this regard, would include any event which places one of the parties in breach of the undertaking or guarantees given in the agreement. Usually, if the borrower fails to meet the repayment program or undertakes actions which materially increase the lender’s risk, the lender may demand repayment in full.

Some examples that may constitute an event of failure or default, if specified as such in the loan agreement, are:

- a breach or non-compliance with credit covenants in the loan agreement;
- failure to achieve or maintain certain financial ratios as required under the loan agreement; and
- a change of control of the borrower.

¶ 16. For amounts paid or credited after 1991, interest payable on an obligation is not disqualified from the exemption solely because of the requirement to repay more than 25 percent of the principal amount of the obligation, within 5 years of the issue date, on the death of the non-resident lender. This exception does not apply to interest payable on an obligation if the terms of the obligation require repayment of more than 25 percent of the principal amount of the obligation within 5 years of the issue date, on the death of a person, other than the non-resident lender, assuming that this event is not “an event of default or failure” under the terms of the obligation.

¶ 17. In the case where, under the terms of the obligation, a non-resident lender may require that the insurance proceeds resulting from the destruction or loss of property which is held as security for the obligation, be used to repay the obligation and there is a possibility that such a payment would result in repayment of more than 25 percent of the principal amount of the obligation within the 5-year period, the interest payments on the obligation would not qualify for the exemption. It is a question of fact whether the non-resident lender has the right to require that such insurance proceeds be used to repay the obligation. The interest payments, however, would not be disqualified from the exemption if, under the terms of the obligation, the corporation would be required to deposit the insurance proceeds with an independent third party for the repair or reconstruction of the property and the non-resident lender would not be entitled to require that the proceeds be used to repay more than 25 percent of the obligation within the 5-year period.

In addition, if the loss or destruction of the property is defined as an event of default or failure under the terms of the obligation, and because of the occurrence of such an event, the borrower would be required by the terms of the obligation to use the insurance proceeds to repay more than 25% of the principal amount of the obligation within 5 years of the issue date, the requirement under the terms of the obligation for the repayment would not, by itself, disqualify the interest payments on the obligation from the exemption.

¶ 18. In the event of a failure or default by the borrower, amounts paid by a guarantor resident in Canada in satisfaction of interest owed by the borrower under the obligation are not subject to Part XIII tax if the payments, had they been paid by the original resident borrower, would have been exempt under subparagraph 212(1)(b)(vii). If an obligation owing to a non-resident lender is in default and the non-resident lender, instead of demanding repayment of the loan, requires that the demand for payment will be deferred as long as certain financial conditions are met by the corporation, the interest payments on the obligation, if they

were exempt from withholding tax under subparagraph 212(1)(b)(vii) before the default, will continue to be exempt as long as all the requirements of that subparagraph are met and a new obligation has not been created.

Partnerships and Non-Resident Borrowers

¶ 19. Interest paid to a non-resident under an obligation that otherwise satisfies the requirements of subparagraph 212(1)(b)(vii) is not disqualified from the exemption where the borrower is a partnership all the members of which deal at arm's length with the lender and are corporations resident in Canada, non-resident corporations whose business is carried on principally in Canada, or a combination of both. However, with respect to the non-resident corporate borrowers, subsection 212(13.2) provides that the exemption will apply to the extent that the interest is deductible in computing the non-resident corporations' taxable income earned in Canada.

Explanation of Changes

Introduction

The purpose of the *Explanation of Changes* is to give the reasons for the revisions to an interpretation bulletin. It outlines revisions that we have made as a result of changes to the law, as well as changes reflecting new or revised departmental interpretations.

Overview

Interpretation bulletin IT-361R3 explains the rules in subparagraph 212(1)(b)(vii) that allow for an exemption from Part XIII withholding tax on interest payable by a corporation resident in Canada to a non-resident lender.

The revision to IT-361R2 was undertaken to reflect amendments to the *Income Tax Act* enacted in S.C. 1994, c. 7 (formerly Bill C-15), and S.C. 1994, c. 21 (formerly Bill C-27). It also reflects the addition of subsection 6208(1) to the *Income Tax Regulations* promulgated in 1990 by P.C. 1990-854, SOR/90-285, and section 806.2 to the Regulations promulgated in 1993 by P.C. 1993-1331, SOR/93-345.

The comments in this bulletin are not affected by any draft legislation released before October 12, 1995.

Legislative and Other Changes

¶ 1(a) of the bulletin is revised to further discuss the Department's interpretation of the requirement that the non-resident lender must be dealing at arm's length with the corporation in order for the interest payments to qualify for the exemption.

¶ 1(c) of the bulletin is changed to reflect the addition of section 806.2 to the *Income Tax Regulations*, which relates to the definition of "prescribed obligation" for the purposes of paragraph 212(1)(b).

¶ 1(e) of the bulletin is expanded to discuss the addition of clause 212(1)(b)(vii)(F), applicable to amounts paid or credited after 1991, regarding the death of a non-resident lender. Bullet (i) of ¶ 1(e) reflects an amendment to clause 212(1)(b)(vii)(C), applicable to amounts paid or credited after 1986, in which "terms or agreement" replaced "terms of the agreement." Bullet (iii) of ¶ 1(e) has been replaced due to the passage of subsection 6208(1) of the Regulations in 1990. ¶ 1(e) clarifies the Department's view regarding convertible obligations and also reflects the definition of "prescribed security" in subsection 6208(1), which applies after December 19, 1986.

The postamble to ¶ 1 has been changed to clarify the Department's position that subparagraph 212(1)(b)(vii) does not generally apply to prepaid interest.

¶ 2 is expanded to discuss subsection 212(3), which relates to replacement obligations issued after June 1993.

¶ 7 is revised to reflect the addition of clause 212(1)(b)(vii)(F) which provides that interest is not disqualified from the exemption solely because the borrower may be required to make an early repayment as a consequence of the death of the lender. In addition, the Department's views are discussed regarding a situation where, under the terms of the obligation, the non-resident lender requires that the corporation pays an additional amount if there is a change to Canadian withholding tax laws such that the interest payable to the non-resident lender on the obligation no longer qualifies for the exemption from withholding tax.

¶ 8 is expanded to discuss whether the exemption applies in a situation where, in the event of a contingency beyond the control of the lender, there is a requirement under the terms of the obligation that amounts be contributed by the borrower to a sinking fund.

¶ 15, which relates to the meaning of "an event of failure or default," is expanded to provide additional comments on the Department's position that an event of failure or default has to have commercial reality, is beyond the control of the lender, and is therefore not contrived. In addition, a change of control of the borrower, which may constitute an event of failure or default, is discussed.

¶ 16 is changed to reflect the addition of clause 212(1)(b)(vii)(F), in which interest payable on an obligation is not disqualified from the exemption solely because of the requirement to repay more than 25 percent of the principal amount of the obligation, within 5 years of the issue date, on the death of the non-resident lender.

¶ 17 explains the Department's position regarding the exemption where a non-resident lender requires that the insurance proceeds be used to repay the obligation and there is a possibility that such a payment would result in repayment of more than 25 percent of the principal amount of the obligation within the 5-year period.

¶ 18 is expanded to clarify the Department's views on whether the exemption still applies to interest payments made following the default of an obligation.

We have made a number of other changes to improve the overall clarity and readability of the bulletin.

Think recycling!



Printed in Canada