Goodmans LLP Update

Tax Law

March 30, 2012

Canadian Budget Proposal Affects Cross-Border Financing

The Canadian federal budget tabled on March 29, 2012 (the "**Budget**") proposed a number of important amendments that affect cross border planning with Canadian corporations. One proposal modifies the Canadian "thin capitalization" rules. This change is likely to affect a significant number of existing financing structures involving foreign-owned Canadian corporations, and may affect future planning.

The *Income Tax Act* (Canada) limits the deductibility of interest paid or payable by Canadian corporations in respect of debts owing to certain non-resident lenders (generally lenders who own more than 25% of the votes or value of the Canadian corporation, or who do not deal at arm's length with such a shareholder). The rules do not apply to third-party debt, nor does third-party debt affect the permitted ratio. The current legislated maximum debt to equity ratio is 2:1, and interest deductibility may be denied if the Canadian corporation has debt to such lenders which exceeds this ratio. The Budget, however, proposes to reduce this ratio to 1.5:1, effective for taxation years of the Canadian corporation commencing after 2012.

As a result, Canadian corporations financed with foreign debt which is subject to the thin capitalization rules will need to address their debt to equity ratios and may need to capitalize a portion of such debt if the 1.5:1 ratio would otherwise be exceeded. Assuming a current 2:1 debt to equity ratio, approximately 10% of the outstanding debt may need to be capitalized in order to comply with the new rule. Additional transactions and tax planning may be required where the value of the debt is less than its principal amount, or where foreign exchange gains may be realized because the debt is denominated in a foreign currency.

The Budget also extends the thin capitalization rules to debt owing by a partnership of which a Canadian corporation is a member. In general terms, the debt of the partnership is allocated proportionately to its Canadian corporate members.

In addition, the Budget proposes to treat denied interest as a deemed dividend subject to Canadian withholding tax, regardless of whether such interest is paid. Previously, denied interest may not have been subject to withholding tax. Taken together, these proposed changes make it even more important for Canadian corporations to ensure that they comply with the thin capitalization rules and the reduced permitted debt to equity ratio.

Goodmans will continue to monitor the Budget proposals and their progress through the legislative process. We would be pleased to assist Canadian corporations in undertaking transactions to comply with the new rules. You may contact any member of our Tax Group:

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