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Budget Increases Taxes on Income Earned Here By Non-Residents; Raises Questions About Possible Impacts on Foreign Investment

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While the Spring federal budget has been advertised as one of “belt-tightening,” it is not only Canadians who are sharing in the pain. One budget proposal will have a significant impact on non-residents who own and finance Canadian operations.

In a nutshell, some non-residents will now have to pay the Government of Canada new or increased taxes on income that they earn from these operations.

What that may mean for the continuation of the businesses, the production of goods and services of Canadian companies that they create, and the Canadian jobs that go along with them, remains to be seen.

All that can be certain for the moment is that because income that has escaped Canadian tax will now be assessed, the cost to non-residents of operating a business in Canada will rise and the number of after-tax dollars with which they will be left will fall.

If a non-resident entity wishes to carry on business in Canada through a Canadian corporation, it will often choose to finance this venture through debt in order to minimize its Canadian tax burden. (As interest payments on this debt generally will be deductible to the Canadian corporation, the Canadian profit will be minimized). Furthermore, at present, Canadian withholding tax does not apply to interest payments on most arm’s length debt and is reduced under Canada’s tax treaties (in some cases to zero) on non-arm’s length debt. Some foreign entities can thus extract their Canadian profits with no Canadian tax whatsoever.

“Thin capitalization” rules exist under the *Income Tax Act* to moderate this “leakage.” These rules prohibit the deduction of interest payments when taxes are calculated if the Canadian corporation's debt-equity ratio is greater than 2:1. Specifically, if the debt owing to "specified non-residents" (those owning 25 per cent or more of the shares of the Canadian company) exceeds twice the equity invested in the corporation, interest on the excess debt is not deductible.

The budget proposes that this rule be amended in three significant ways:

1. The debt-equity ratio is reduced from 2:1 to 1.5:1. (It is interesting to note that until the year 2000 this ratio was 3:1. So, this is not the first time that we have seen a reduction.),
2. the rule will now apply to partnerships, and
3. disallowed interest will be characterized as dividend income.

The change in the debt-equity ratio from 2:1 to 1.5:1 is a straightforward reduction by 25 per cent of the amount of profit that a Canadian corporation can pay to its non-resident shareholders tax-free. While interest rates are currently at record lows, this change may not seem material. If rates were to rise again to levels in the teens, however, this could amount to a significant cost.

Second, the thin capitalization rules have not applied to partnerships until now. Therefore, in the past, it has been possible for a foreign entity to structure its Canadian operations through a partnership of corporations and to lend unlimited funds to this partnership. All of the Canadian partnership's profits, therefore, have been extractable through interest payments to the foreign entity. Under the budget proposals, partnership debt will now be attributed to the corporate partners based on their respective profit sharing ratios in the partnership. This debt will therefore become subject to the thin capitalization rules. Rather than disallowing the deduction of the interest payment at the partnership level, however, it will be added back to the income of the corporate partner.

Finally, as stated, Canadian withholding tax on interest payments to non-arm's length parties is reduced under many of Canada's international tax treaties, in some cases to zero (as is the case under the Canada-U.S. Tax Treaty). There is therefore a strong preference to pay profits out of Canada by way of interest. The third thin capitalization proposal converts any disallowed (or added back) interest to dividends, which are subject to withholding tax at rates as high as 25 per cent. This rate may be reduced under a tax treaty as well but, in no case, is the rate reduced to zero.

The proposal lowering the debt-equity ratio will apply to taxation years that begin after 2012. The other proposals began to apply on March 29, 2012, the date that Finance Minister James Flaherty presented the budget to Parliament.

Although the budget documents talk about aligning the Canadian rules with other jurisdictions, the government's intent, clearly, is to reduce tax revenue leakage by limiting the ability of foreign entities to avoid tax on their Canadian operations.

Whether it discourages investment in Canadian operations by foreign-based multinational corporations and other non-resident entities remains to be seen.