Convertible Debt and the Canadian Withholding Tax Dilemma

Matthew Peters

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Canadian withholding tax on cross-border interest payments is generally much less of a concern today than it was just a few years ago thanks to taxpayer-friendly legislative and treaty-based amendments that have largely eliminated withholding tax on most arm’s length (and certain non-arm’s length) debt. However, an unusual Canadian withholding tax risk continues to exist in the context of debt issued by a Canadian-resident borrower to a non-resident lender where the debt is convertible into shares of the borrower. The potential withholding tax liability, which could be as high as 25% on both the coupon interest and the value of any premium realized upon the eventual conversion of the debt, could greatly reduce the anticipated returns to the non-resident lender if not appropriately understood and managed. The potential liability of the borrower (as well as personal liability for its directors) for failing to properly withhold and remit tax further heightens the sensitivity of the issue.

While the Canada Revenue Agency (“CRA”) has provided administrative comfort that will be helpful in the context of certain “plain vanilla” convertible debt issued by public companies, the CRA unfortunately appears content to allow a degree of uncertainty to persist in certain circumstances, leaving clients and their advisors in a frustrating state of limbo.

Best practices and strategies have evolved to assist lenders and borrowers mitigate the potential tax liability; however, a thorough understanding of the issues and careful structuring of the convertible debt at an early stage is critical to proper risk management.

This bulletin outlines the basic Canadian withholding tax landscape relating to cross-border arm’s length debt, describes the evolution of that landscape as it relates to convertible debt and describes various means of addressing the convertible debt withholding tax “problem.”

Background

Arm’s Length Interest

Prior to January 1, 2008, cross-border interest payments were generally subject to a 25% Canadian withholding tax unless the debt was structured to fall within certain statutory exemptions, including an extremely narrow and complicated exception for certain long-term corporate debt (commonly referred to as the “5/25 Exemption”). The requirements of the 5/25 Exception were largely derived from CRA’s administrative practice and were often cumbersome and difficult to satisfy in practice from a commercial perspective. However, market practice gradually developed such that a high degree of comfort could generally be obtained in many circumstances concerning the availability of the 5/25 Exemption.

Partially in response to the growing complexity and commercial burdens associated with qualifying for the 5/25 Exemption, Canada amended its domestic tax law as of January 1, 2008 to eliminate withholding tax on most interest paid or payable by a resident of Canada to an arm’s length non-resident person. One major exception to this is in respect of “participating debt interest,” which is at the heart of the convertible debt problem.

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1 Generally, the principal requirement of this exemption was that the Canadian borrower could not be compelled to repay in excess of 25% of the debt during the first five years of its term, hence the common reference to it as the “5/25 Exemption.”
Participating Debt Interest

Under Canadian tax law, participating debt interest is broadly defined to include interest payable on a debt where all or any portion of the interest is computed with reference to revenue, profitability, cash-flow, commodity prices, dividends or similar criterion. In simple terms, it is interest that resembles a return on an equity investment.

As noted above, participating debt interest is the “exception to the exemption.” If interest qualifies as participating debt interest it will be subject to a 25% withholding tax rate under Canadian domestic tax law regardless of whether the lender is arm’s length.

The rate of domestic Canadian withholding tax may be subject to a reduction under a tax treaty, but the potential rate reduction varies from treaty to treaty. For example, while most of Canada’s tax treaties reduce the withholding rate to as low as 10%, the treaty between Canada and the United States only reduces the withholding rate on certain forms of participating interest to 15%. Moreover, the availability of reduced treaty withholding tax rates depends on a number of potentially complicated factors relating to the identity of the recipient and whether any of a handful of treaty “anti-abuse” rules may apply. Additional complications may arise in determining the entitlement to treaty benefits where the non-resident recipient of the interest is a partnership or other “flow-through” entity that has multiple members in a variety of jurisdictions.

Liability for Withholding Tax

Both the Canadian-resident borrower and the non-resident lender are liable for any unremitted withholding tax, although in practice it is often more straightforward from an administrative perspective for the CRA to pursue an assessment against the Canadian-resident borrower. Moreover, the directors of the borrower are jointly and severally liable with the borrower for any unremitted withholding tax that should have been deducted, remitted or paid during the time of the director’s tenure on the board. Interest and penalties may also apply.

The Convertible Debt “Problem”

Conversion Premium and Participating Debt Interest

The fundamental issue with convertible debt from a Canadian withholding tax perspective is the characterization of any premium that might be realized by a non-resident lender at the time of conversion (i.e., the difference between the fair market value of the securities delivered upon conversion and the issue price of the converted debt). Under Canadian tax law, the premium is generally deemed to be a payment of interest by the Canadian-resident borrower to the non-resident lender.

Assuming the lender and borrower are dealing at arm’s length, one would expect that such deemed interest would not give rise to Canadian withholding tax as a result of the general exemption under Canadian domestic tax law described above. However, the issue is whether such deemed interest should be characterized as participating debt interest, in which case the Canadian domestic withholding tax rate would be 25%. This concern arises because the amount of the premium is based on the value of the securities delivered on conversion, which itself is generally based on factors including the borrower’s profitability, revenue, cash-flow, etc.

Potential Tainting of Coupon Interest

Interest paid to an arm’s length non-resident lender pursuant to a stated coupon interest rate should generally be exempt from Canadian withholding tax; however, there is a risk that withholding tax may
apply to such interest in the context of a convertible debt if the deemed interest realized on conversion is itself considered to be participating debt interest. This is because of the extremely broad wording of the definition of participating debt interest, which refers to circumstances where “all or a portion” of the interest on the debt is contingent on profitability, revenue, cash-flow, etc. Accordingly, if the conversion premium is participating debt interest, the concern is that all interest payable in respect of the convertible debt (including the coupon interest) could also be tainted as participating debt interest.

Ambiguity in the Law and CRA Guidance

The problems described above rest in the ambiguity of the law – the legislation simply is not clear as to why, when or how a conversion premium and/or related coupon interest should be characterized as participating debt interest that is subject to Canadian withholding tax. This leaves considerable room for the CRA to provide guidance to the tax community as to how the law will be applied.

While the CRA has issued guidance that will provide a meaningful degree of comfort in respect of certain convertible debt issuances, a range of grey territory persists that the CRA appears hesitant to clarify.

In this respect, the CRA has provided some administrative comfort that coupon interest payable in respect of a convertible debenture would generally not be considered participating debt interest where the borrower is a Canadian public company.²

However, concerning the conversion premium, the “best” guidance that has been issued to date suggests that a conversion premium should not be considered participating debt interest only where the borrower is a Canadian public company and the debt has the features of what the CRA refers to as a “standard convertible debenture.” A few of the more pertinent features of a standard convertible debenture include:

- the debt must be for a fixed amount of money (but may be denominated in any currency);
- the rate of interest may be fixed or floating (but cannot be participating) and must be paid by the issuer at least annually;
- the debt must have a specified maturity date;
- the debt carries a fixed conversion price or fixed conversion ratio (subject to standard anti-dilution provisions).³

It should generally be possible to accommodate these features in many convertible debt offerings; however, uncertainty exists where, for example, the borrower is not a public company or where the conversion price/formula contains anything other than standard “plain vanilla” adjustment language (e.g., the conversion formula attempts to track realized profits).

Of particular note is a recent statement by the CRA that it is not inclined to provide any additional administrative guidance as to how it intends to apply the rules in respect of convertible debt or to otherwise clarify the parameters of a “standard convertible debenture” in the absence of a request by a taxpayer for a formal tax ruling based on “live” facts and circumstances.⁴ This is unlikely to happen in practice given, for example, the significant time, cost and uncertainty associated with the pursuit of a formal tax ruling in the context of a fast-paced financing transaction.

² See, e.g., CRA Ruling 2011-0418721R3.
³ See the comments of the CRA from the 2013 Canadian Tax Foundation Annual Tax Conference on November 26, 2013, referring to the earlier recommendations of The Joint Committee on Taxation of The Canadian Bar Association and The Canadian Institute of Chartered Accountants, dated May 10, 2010.
What Can You Do?

Structuring a convertible debt to fall as squarely as possible within the parameters of a “standard convertible debt” is the safest course of action where commercially possible.

If that is not practical (or possible), it may be difficult to obtain a high degree of comfort that Canadian withholding tax will not apply. Consideration must then be given to the applicable rate of withholding tax, taking into account any potential relief under tax treaties. Mechanics should also be considered and put in place in respect of compliance with any necessary withholding obligation. If the non-resident lender believes that the rate of Canadian withholding tax that has been applied by the borrower is excessive, it may generally request a refund from the CRA, although in certain circumstances it is clearly undesirable for the non-resident lender to be placed in a position where it is required to undertake this type of action.

Even where the terms of the convertible debt appear to comply with the CRA’s administrative position concerning a standard convertible debenture, it is often difficult to conclude with certainty that withholding tax will not apply – there may simply be too much grey area to offer a high degree of comfort. In this respect, in the absence of obtaining a formal tax ruling, there is always a risk that the CRA could take a contrary position depending on the precise facts and circumstances of any given convertible debt, as the CRA has recently reiterated.

One alternative that may provide a higher degree of comfort is to structure the terms of the debt in compliance with the requirements of the 5/25 Exception described above. The 5/25 Exception was previously the principal means of managing the potential Canadian withholding tax on long-term corporate debt and the exception remains applicable today in the context of convertible debt. However, in many circumstances it may prove challenging to fit the desired commercial terms of the convertible debt within the onerous confines of the 5/25 Exemption.

As well, parties may wish to consider the appropriateness in their particular circumstances of gross-up and/or indemnity language relating to any potential withholding tax on the conversion premium or coupon interest.

Alternative financing arrangements that seek to achieve similar commercial objectives while minimizing the potential Canadian withholding tax concerns may also be available. However, lenders and borrowers should proceed with caution and fully explore the possible undesirable Canadian or foreign tax implications that such alternatives may trigger. For example, exchangeable debt (i.e., debt that may be satisfied by the delivery of property other than shares of the borrower) may appear to provide a similar commercial outcome but may raise a number of potentially adverse Canadian tax issues that may not materially improve the structure (or may make it worse), depending on the facts.

At a minimum, lenders and borrowers must be made aware at an early stage in the structuring process of the potential Canadian withholding tax consequences of issuing cross-border convertible debt so as to properly explore any available means of minimizing the tax liability.

To discuss this or any other tax-related issue, please contact Matthew Peters (mpeters@casselsbrock.com | 416 860 6772) or any other member of Cassels Brock & Blackwell’s Taxation Group.