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TAX LAW ALERT

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STRIPPED INTEREST COUPON PLANNING NOT SUBJECT TO GAAR

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On May 17, 2010, the Federal Court of Appeal allowed the taxpayer's appeal in *Lehigh Cement Limited v. The Queen*, holding that the general anti-avoidance rule ("GAAR") did not apply to a series of transactions through which Lehigh's interest payments on debt held by a related non-resident corporation were paid free of withholding tax to an arm's length non-resident bank. The debt restructuring was carried out to access the "5/25" withholding tax exemption for interest paid at arm's length on corporate debt formerly provided under subparagraph 212(1)(b)(vii) of the *Income Tax Act* (Canada). The 5/25 exemption was replaced in 2008 with a much broader withholding tax exemption for non-participating interest paid to an arm's length person.

The case is important for both broad and narrow reasons. Broadly, the case provides clear confirmation that any doubt as to whether a transaction is abusive must be resolved in the taxpayer's favour and it provides an example of how one goes about determining the purpose of a statutory provision. Narrowly, the case's reasoning implies that stripping interest coupons on non-participating debt owed to related persons may be an effective withholding tax reduction strategy under current rules. It remains to be seen whether the case will be appealed to the Supreme Court of Canada.

Lehigh, a member of an international corporate group led by a German parent, borrowed \$140 million from a consortium of Canadian banks in 1986 (the "Lehigh Debt"). Sometime after 1986, the Lehigh Debt was acquired by the Lehigh group. Prior to the 1997 restructuring, Lehigh withheld Canadian non-resident withholding tax on interest payments made to a related Belgian corporation which held the Lehigh Debt. In 1997, the terms of the Lehigh Debt were amended to change the interest rate from the Canadian prime rate at that time (4.75%) to a fixed rate of 7% for the first five years (the then market rate), and to provide that Lehigh was not obliged to repay more than 25% of the principal amount within five years from the time the debt was amended (to fit within the 5/25 exemption). The Belgian corporation was also granted the right to, and did, sell all of its right to interest payable on the Lehigh Debt to an arm's

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length Belgian bank. Following the restructuring, Lehigh paid directly to the Belgian bank all interest payable on the Lehigh Debt and did not withhold any amount in respect of the interest payments on the basis that the 5/25 exemption applied.

The Minister reassessed Lehigh for failure to withhold and remit withholding tax on the interest payments on the basis that the GAAR applied. The Crown argued that the 5/25 exemption was not intended to benefit a non-resident person who is legally entitled to be paid interest on a debt as a result of a transaction by which the right to be paid the interest is split from the right to be paid the principal amount. Since the restructured loan did not result in Lehigh accessing funds in the international capital markets, it was inconsistent with the underlying rationale of the 5/25 exemption.

As the taxpayer had conceded that the restructuring of the Lehigh Debt was an avoidance transaction intended to achieve the tax benefit of avoiding non-resident withholding tax on interest payments, the Court focused on whether there was abusive tax avoidance. Following the principles established by the Supreme Court of Canada in *Canada Trustco Mortgage Co. v. The Queen*, the Court conducted a textual, contextual and purposive analysis of the 5/25 exemption to determine whether the tax benefit would be inconsistent with the object, spirit or purpose of the exemption.

The Court noted that the wording of the exemption was broad enough to include any interest payable by a Canadian resident corporation to a non-resident, “no matter how the non-resident may have become entitled to receive that interest”. The exemption also required the arm’s length test to be met only in respect of the relationship between the person required to pay the interest and the person entitled to be paid the interest, and not in respect of the relationship between the person required to pay the principal amount of the debt and the person entitled to be paid the principal amount of the debt. The Court also commented that the splitting of interest and principal on a debt is a long-standing practice in commercial financing transactions and that there was no evidence that the restructuring of the Lehigh Debt was unusual. Furthermore, Parliament was aware that these transactions existed in 1975 when the 5/25 exemption was first enacted, as the Act provided for the predecessor rule to section 240 of the Act (which deals with the stripping of interest coupons).

Reviewing the evidence presented by the Crown, the Court found that the Crown’s argument that the purpose of the 5/25 exemption was to enable Canadian corporations to access funds in international capital markets was based on the following sentence from a brief description of the first version of the 5/25 exemption contained in the 1975 Federal Budget papers:

“The proposed relief from withholding tax is intended to increase the flexibility of Canadian business to plan long-term debt financing and facilitate access to funds in international capital markets”.

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In the Court's view, the Crown's reliance on the 1975 budget papers was a "shaky foundation" and an insufficient basis on which to apply the GAAR to the restructuring of the Lehigh Debt. The Crown's argument found no other support in either the Act, the jurisprudence or any other authority. The Court noted that while a transaction may misuse a statutory exemption containing bright line tests (e.g., the arm's length and five-year tests for the 5/25 exemption) since Parliament cannot possibly describe every transaction inside or outside of the intended scope of the exemption, claiming an exemption in an unforeseen or novel manner does not necessarily mean that the exemption has been misused. Accordingly, the Crown cannot meet its burden of proving a misuse by simply asserting that the transaction was unforeseen or exploited a legislative loophole.

The Court also noted an "irreconcilable inconsistency" in the Crown's argument, as the Crown had conceded that, in contrast to the Lehigh Debt restructuring, the GAAR would not apply to a hypothetical sale by the Belgian corporation to the Belgian Bank of the right to be paid both the principal amount of, and the interest on, the Lehigh Debt. As the hypothetical sale would not have enabled Lehigh to access funds in the international capital markets, the Court concluded that there was no relevant distinction, in terms of the underlying rationale of the 5/25 exemption, between the hypothetical sale and the Lehigh Debt restructuring. The lack of such a distinction was similarly fatal to the Crown's argument that the restructuring of the Lehigh Debt was abusive on the basis that the corporate group was able to extract part of Lehigh's Canadian source profits free of Canadian withholding tax.

Finally, the Court concluded that there was no merit to the Crown's argument that the 5/25 exemption was misused based on the assertion that while the exemption was intended to reduce the cost of borrowing, the interest rate on the Lehigh Debt was increased from 4.75% to 7%. In the Court's view, the fact that the 5/25 exemption applied only if the interest payer and the interest recipient dealt at arm's length with each other indicated Parliament's intention that "the exemption be available only where the relationship between payer and payee provided some assurance that the rate of interest would reflect a fair market rate". In any event, the Court concluded that it was not reasonable to conclude that the 7% interest rate was abusive since it was a fair market rate.

The *Lehigh* decision provides a detailed and reasoned analysis of the misuse or abuse test under the GAAR (following the analytical framework mandated by *Canada Trustco*) and emphasizes that it is the Crown's responsibility to provide sufficient evidence and reasoned argument to meet its burden of establishing the purpose and misuse/abuse of the statutory provision(s) at issue.

To read the full text of the Federal Court of Appeal's decision in *Lehigh*, please click [here](#).

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If you have any questions on this topic or would like to know how these rules will apply to a particular corporation or transaction or would like to discuss any other tax matters, please do not hesitate to contact one of the professionals in the **Tax Group**.

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