

## Debt Restructuring

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## Topics

- Debt forgiveness rules
- Equity for debt restructuring
- Debt for debt restructuring
- Debt parking rules
- Acquisition of control
- Non-resident creditors

This presentation is an overview of some of the income tax issues relevant to debt restructuring. Section references are to the *Income Tax Act* (Canada).



## Debt Forgiveness Rules

- Rules apply to:
  - 1) “commercial debt obligation” – i.e. debt incurred to earn income
  - 2) settled or extinguished for less than principal amount (or issue price, if lower)
  - 3) if forgiveness not otherwise included in income (e.g. under section 9)
- Non-interest bearing debt is “commercial debt obligation” if interest on debt would be deductible if debt were interest bearing
- Interest payable deemed obligation with principal amount equal to interest under paragraph 80(2)(b)

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## Application of Forgiven Amount

- In simplified terms, section 80 provides that “forgiven amount” (“**FA**”) reduces tax attributes in following order:
  - 1) Prior Losses
  - 2) Amortizable Amounts
  - 3) Capital Property ACB
  - 4) Current Year Capital Losses
- Once tax attributes exhausted → 50% income inclusion under subsection 80(13)
- Post-acquisition of control carryforward restrictions generally ignored for purposes of absorbing FA in respect of debt obligation issued before acquisition of control – see definition of “relevant loss balance” in subsection 80(1)

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## Application of Forgiven Amount (cont'd)

- Specifically, FA reduces tax attributes as follows:
  - 1) Prior Losses
    - a) Non-capital losses (subsection 80(3))
    - b) Net capital losses (1/2 FA) (subsection 80(4))
  - 2) Amortizable Amounts
    - a) undepreciated capital cost (“UCC”) of depreciable property, as designated by debtor (subsection 80(5))
    - b) cumulative eligible capital (“CEC”) (3/4 FA), as designated by debtor (subsection 80(7))
    - c) resource expenditures, as designated by debtor (subsection 80(8))
  - 3) Capital Property ACB
    - a) adjusted cost base (“ACB”) of capital property, other than shares and debt of corporations of which debtor is specified shareholder, provided maximum amounts designated under subsections 80(5)-(8) (subsection 80(9))
    - b) ACB of shares and debt of non-related corporations of which debtor is specified shareholder, provided maximum amounts designated under subsections 80(5)-(9) (subsection 80(10))
    - c) ACB of shares and debt of related corporations, provided maximum amounts designated under subsections 80(5)-(10) (subsection 80(11))
  - 4) Current Year Capital Losses
    - a) current year capital losses less current year capital gains, provided maximum amounts designated under subsections 80(5)-(9) (subsection 80(12))

## Transfer of Forgiven Amount

- Debtor can transfer forgiven amount to “eligible transferee” (which includes related Canadian company) under section 80.04
- In order to do section 80.04 transfer, Debtor must first maximize its designations under subsections 80(5)-(10)
- Debtor jointly and severally liable for transferee tax up to 30% of transferred forgiven amount for 4 years
- Reduction of related company ACB (shares and debt) under subsection 80(11) avoids 50% income inclusion under subsection 80(13) only if “directed person” tax attributes exhausted
- “Directed person” includes Canadian parent, subsidiary and sister of debtor

## Forgiven Amount Income Inclusion

- 50% income inclusion under subsection 80(13) applies to remaining FA not transferred to eligible transferee under section 80.04
- Debtor can claim insolvency deduction under section 61.3
  - Insolvency deduction effectively limits corporation's subsection 80(13) income inclusion to two times corporation's net asset value → if no net asset value, no income inclusion
- See also section 61.4, which permits debtor to recognize subsection 80(13) income inclusion over five years

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## Strategies to Minimize Impact of Forgiven Amount

- Minimize non-capital losses so FA applied to less valuable tax attributes:
  - Re-file prior year loss returns to reduce capital cost allowance and other discretionary deductions (where no increase in tax payable for year)
- Allocate FA to low rate amortization pools (assuming do not need to apply FA to Capital Property ACB)
- Transfer capital property with accrued loss to third party and trigger year-end (e.g. through amalgamation or acquisition of control) before forgiveness so FA can be applied to net capital loss

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## Strategies to Minimize Impact of Forgiven Amount (cont'd)

- Amalgamate with related company with lower-value tax attributes before forgiveness
- Transfer depreciable property to subsidiary before forgiveness to utilize sister tax attributes (see example next Slides)
- Ensure relative order of debt forgiveness and acquisition of control maximizes ongoing tax attributes
  - E.g. may want acquisition of control first to crystallize accrued capital losses that can then be used to absorb FA on subsequent debt forgiveness
  - E.g. may want acquisition of control after debt forgiveness to preserve current year non-capital loss

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## Pre-Forgiveness Planning – Transfer of Assets

- Assume that:
  - Debtor will have \$100 FA and does not want to lose UCC of high rate depreciable assets
  - Debtor has sister company (“**Lossco**”) with \$100 of non-capital losses that can’t be used – e.g. Debtor can’t access losses through amalgamation with Lossco for commercial reasons
- If Debtor transfers depreciable assets to Newco subsidiary and reduces ACB of Newco shares under subsection 80(11) by \$100, Debtor will have \$50 income inclusion under subsection 80(13) because Newco has \$100 of UCC
- Debtor can avoid this income inclusion by electing under section 80.04 to transfer the \$100 FA to Lossco

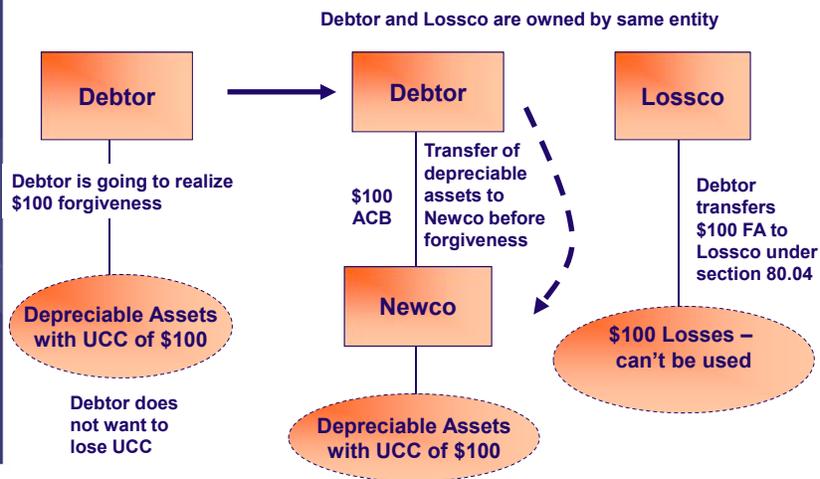
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## Pre-Forgiveness Planning – Transfer of Assets (cont'd)

- By transferring depreciable assets to Newco before forgiveness, Debtor is able to choose which group attributes will be used to absorb \$100 FA
- This is because Debtor must exhaust its subsection 80(5)-(10) tax attributes before it can make section 80.04 election – if Debtor had retained its depreciable assets, section 80.04 transfer would not have been available

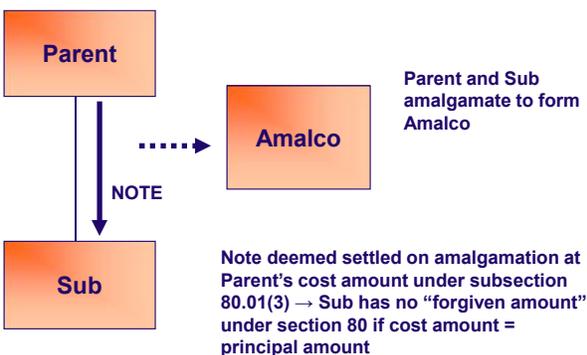
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## Pre-Forgiveness Planning – Transfer of Assets (cont'd)



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## Intercompany Debt Eliminated on Amalgamation



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## Foreign Currency Debt and Amalgamation – CRA Doc. No. 2008-0267831E5

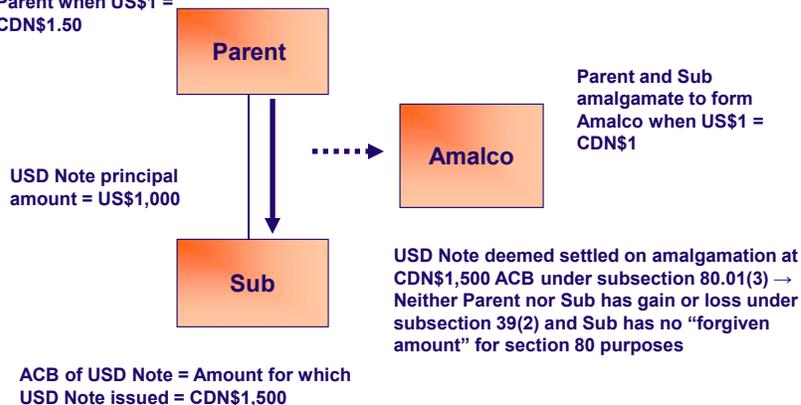
- Subsection 80.01(3) says that on amalgamation debt deemed settled immediately before amalgamation by payment equal to creditor's cost amount
- Applying Federal Court of Appeal decision in *Gaynor v. The Queen*, 91 DTC 5288 (FCA) and paragraphs 261(2)(a) and (b), cost amount of foreign currency debt is calculated in Canadian dollars using exchange rate in effect at time debt issued
- No FX gain or loss under subsection 39(2) on amalgamation if cost amount = principal amount
- Subsection 80.01(3) rule (deemed payment equal to creditor's cost amount) means also no "forgiven amount"

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## Foreign Currency Debt and Amalgamation – CRA Doc. No. 2008-0267831E5 (cont'd)

Sub issues USD Note to  
Parent when US\$1 =  
CDN\$1.50



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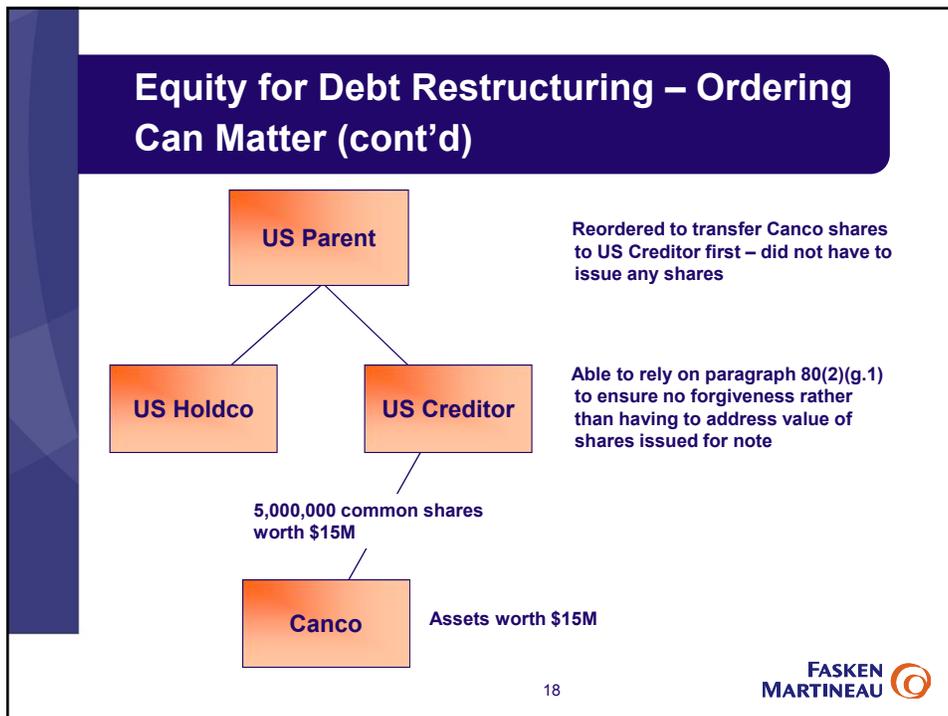
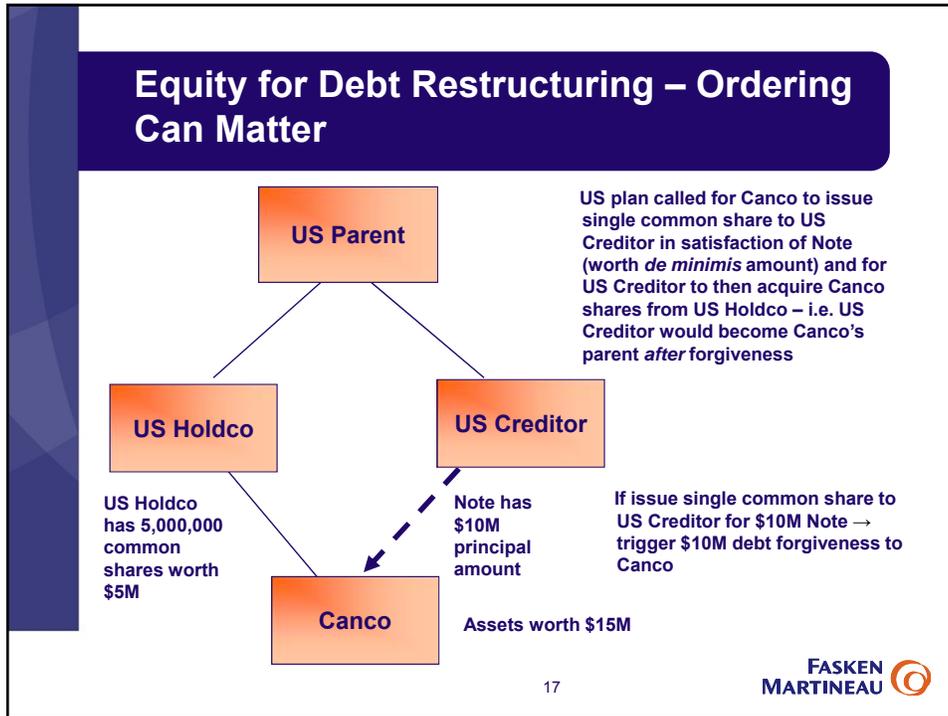
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## Equity for Debt Restructuring

- Amount paid on debt settlement:
  - when shares issued in satisfaction of debt = fair market value of issued shares (paragraph 80(2)(g))
  - where no shares issued in satisfaction of debt but creditor already owns shares = increase in value of creditor’s existing shares (paragraph 80(2)(g.1))
- Therefore, no forgiveness if e.g.
  - debtor issues preferred shares with fair market value equal to principal amount of debt, or
  - 100% parent receives no shares from debtor but existing shares go up in value by principal amount
- No relief on subsequent redemption of deficient value preferred shares

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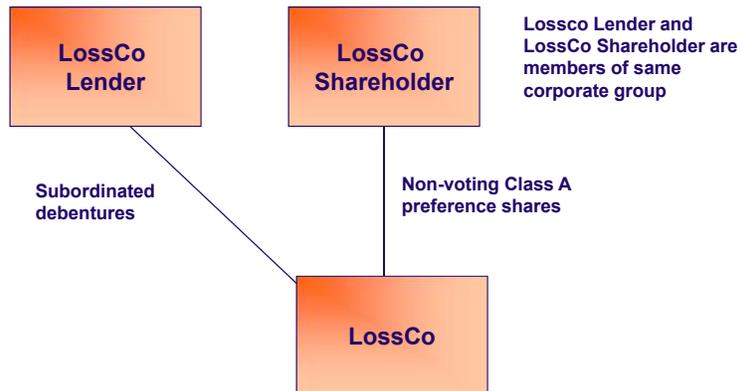


## CRA on Equity for Debt Restructuring

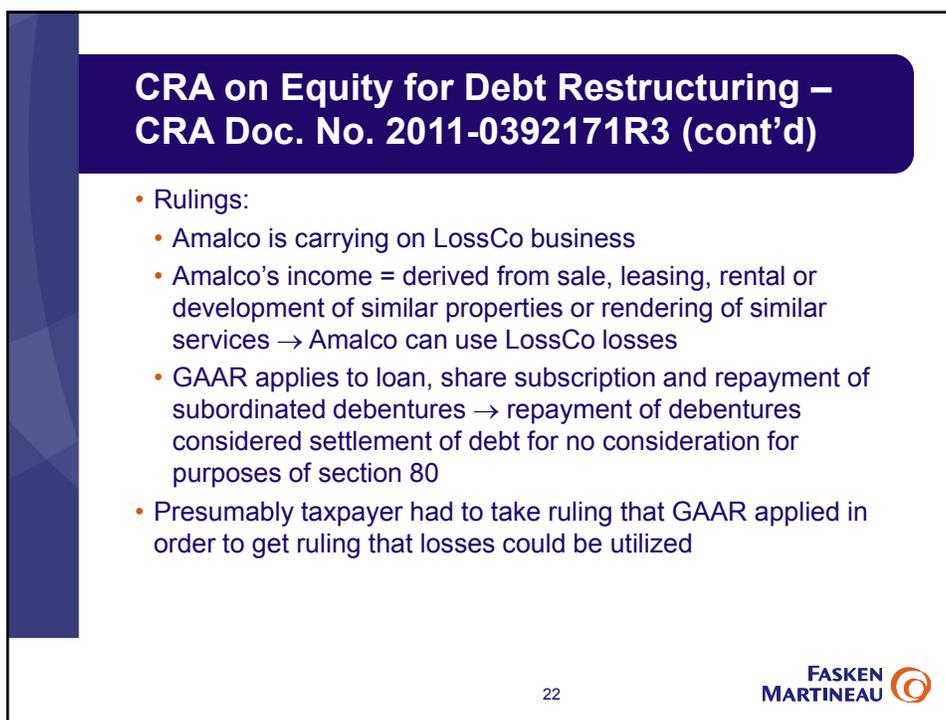
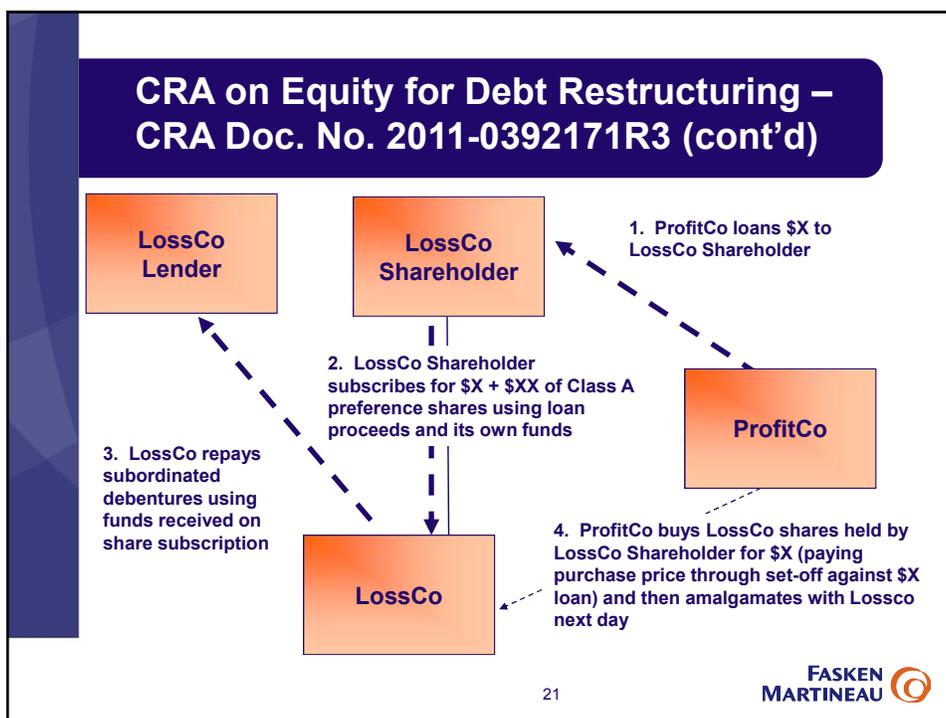
- CRA Doc. No. 2003-0022357 clarifies CRA's GAAR position on cash subscription for shares followed by cash debt repayment:
  - Paragraph 80(2)(g) does not apply
  - Whether GAAR applies will be determined based on facts and circumstances in context of ruling application – CRA will not address GAAR in technical interpretations

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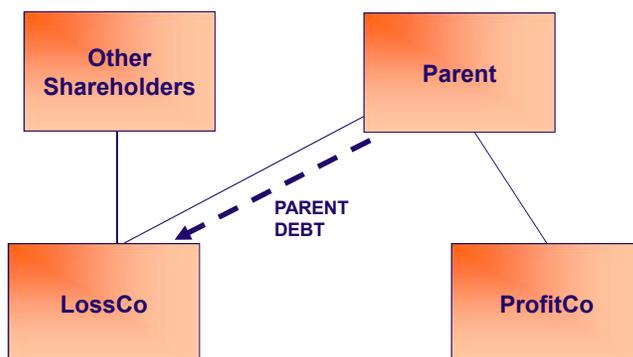
## CRA on Equity for Debt Restructuring – CRA Doc. No. 2011-0392171R3



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## CRA on Equity for Debt Restructuring – CRA Doc. No. 2011-0402571R3



**KEY FACT:** Realizable value of LossCo's assets less than amount owing under Parent Debt → LossCo under water

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## CRA on Equity for Debt Restructuring – CRA Doc. No. 2011-0402571R3 (cont'd)

- Transactions:
  - 1) LossCo disposes of assets, repays creditors and compromises liabilities other than Parent Debt
  - 2) LossCo and ProfitCo amalgamate – Parent receives common shares and Other Shareholders receive non-voting redeemable shares
  - 3) Amalco redeems shares held by Other Shareholders for cash
  - 4) Parent subscribes for additional common shares for cash equal to outstanding Parent Debt
  - 5) Amalco uses cash to repay Parent Debt

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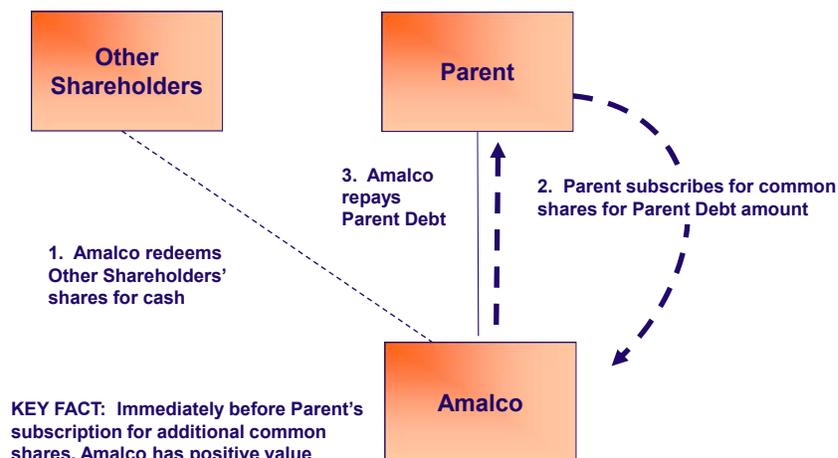
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## CRA on Equity for Debt Restructuring – CRA Doc. No. 2011-0402571R3 (cont'd)

- At time of Parent share subscription in Step 4, realizable value of Amalco's assets exceeds its liabilities
- ISSUE: Does GAAR apply on repayment of debt owed by insolvent predecessor?
- POSITION: Not in these circumstances
- REASON: Repayment of Parent Debt "is not against the scheme of the Act"

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## CRA on Equity for Debt Restructuring – CRA Doc. No. 2011-0402571R3 (cont'd)



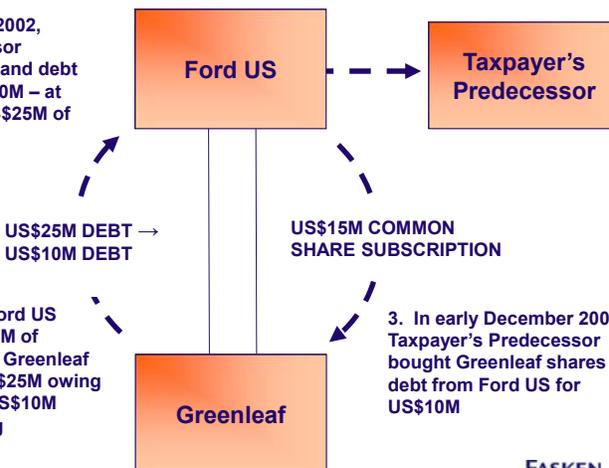
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## *Pièces Automobiles LeCavalier Inc. v. The Queen*, 2014 DTC 1126

1. In late September 2002, Taxpayer's Predecessor agreed to buy shares and debt of Greenleaf for US\$10M – at that time debt was US\$25M of principal and interest

2. In October 2002, Ford US subscribed for US\$15M of Greenleaf shares and Greenleaf repaid US\$15M of US\$25M owing to Ford US, so only US\$10M remained outstanding

3. In early December 2002, Taxpayer's Predecessor bought Greenleaf shares and debt from Ford US for US\$10M



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## *Pièces Automobiles LeCavalier Inc. v. The Queen*, 2014 DTC 1126 (cont'd)

- Cash circling through equity injection reduced indebtedness to correspond to Greenleaf value
- Other transactions would have triggered debt forgiveness:
  - If Greenleaf had issued shares in repayment of US\$15M of debt, paragraph 80(2)(g) would have triggered debt forgiveness of US\$15M
  - If taxpayer's predecessor ("**taxpayer**") had purchased debt of US\$25M for US\$10M (as originally contemplated), section 80.01 would have triggered US\$15M forgiveness under debt parking rules (discussed below)
- Neither paragraph 80(2)(g) nor section 80.01 applied
- Issue therefore was whether GAAR applied to trigger debt forgiveness rules

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### ***Pièces Automobiles LeCavalier Inc. v. The Queen, 2014 DTC 1126 (cont'd)***

- Taxpayer conceded tax benefit – argued was not avoidance transaction and not abusive
- Maintained that Ford US had insisted on debt repayment to ensure it could claim capital loss on Greenleaf shares for US tax purposes
- Taxpayer also argued that Canadian tax advisor unaware of Canadian tax implications of US\$15M share subscription and debt repayment
- Tax Court judge did not believe taxpayer's witnesses and drew adverse inference from fact neither Ford US nor US tax expert testified regarding US tax motivation for debt repayment

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### ***Pièces Automobiles LeCavalier Inc. v. The Queen, 2014 DTC 1126 (cont'd)***

- Tax Court held that GAAR applied:
  - Debt repayment and purchase of Greenleaf shares and debt were part of same series of transactions
  - Taxpayer failed to establish *bona fide* business purpose – motivation was to avoid debt forgiveness
  - Share subscription and debt repayment transactions violated object and spirit of section 80 and debt parking provisions in section 80.01 – temporary capital injection circumvented debt parking rules
  - If no misuse or abuse of section 80 or 80.01, transactions abused paragraph 80(2)(g) – legislature intended to prevent taxpayers from avoiding debt forgiveness consequences by transforming debt into shares with little value

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## *Pièces Automobiles LeCavalier Inc. v. The Queen*, 2014 DTC 1126 (cont'd)

- First case to consider whether cash circling to repay debt is subject to GAAR
- Note that easy for Tax Court to conclude on facts that transactions were part of series since original transaction was purchase of shares and US\$25M of debt for US\$10M – time between agreement on price, refinancing and transfer was less than three months
- Taxpayer argued that GAAR should not apply since by repaying debt it had just put itself in same position it would have been in had it financed with more equity initially
- Court disagreed and said that debt funding had its own advantages and disadvantages

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## Debt for Debt Restructuring

- Paragraph 80(2)(h) says no forgiveness if new debt issued for old debt has same principal amount
  - On debt restructuring therefore may be preferable to issue new debt rather than equity
- If new debt bears no interest or low rate interest and is held by related non-resident, need to check foreign jurisdiction accrual rules so no asymmetry of treatment
- If new debt bears no interest or low rate interest and has very long term, query whether principal amount could be challenged (e.g. under subsection 16(1)) or whether GAAR could apply – is likelihood of ultimate repayment relevant?

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## Debt Parking Rules

- Debt parking rules ensure can't avoid debt forgiveness by parking debt instead of settling it
- "Parked obligation" (subsection 80.01(7)):
  - 1) specified obligation, AND
  - 2) held by non-arm's length OR significant interest holder
- "Significant interest" (subsection 80.01(2)) = shares with  $\geq$  25% votes or value
  - Include non-arm's length shareholdings when determining whether at 25% threshold

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## Debt Parking Rules (cont'd)

- "Specified obligation" (subsection 80.01(6)):
  - 1) at previous time holder of debt dealt at arm's length with and did not have significant interest in debtor, OR
  - 2) at previous time holder purchased debt from unrelated person, OR
  - 3) holder claimed bad debt loss under subsection 50(1)
- Order irrelevant:
  - debt holder becomes significant interest shareholder, OR
  - significant interest shareholder becomes debt holder

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## Debt Parking Rules (cont'd)

- Deemed settlement of debt where (subsection 80.01(8)):
  - 1) Debt becomes parked
  - 2) Tax cost to holder < 80% principal amount, i.e. there is 20% safe harbour
- Debt deemed settled at tax cost to creditor so that forgiven amount = principal amount - tax cost
- If debtor later repays debt that was previously subject to debt forgiveness rules as parked debt, debtor can deduct 50% of payment subject to anti-avoidance rule (subsection 80.01(10))

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## Debt Parking Rules (cont'd)

- Anti-avoidance rule in subsection 80.01(10) requires that “it cannot reasonably be considered that *one of the reasons* the obligation became a parked obligation ... was to have [subsection 80.01(10)] apply to the payment”
- E.g. instead of having debtor pay third party creditors 50¢ on dollar, debtor’s parent purchases debt from those creditors for 50¢ on dollar
  - Does anti-avoidance rule apply?

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## Debt Slide Transaction

- Assume that:
  - 1) Canadian Vendor wholly-owns Target
  - 2) Target owes Canadian Vendor \$100 million, but debt worth only \$1 million – Canadian Vendor has not claimed subsection 50(1) deduction
  - 3) Canadian Vendor wants to sell Target to arm's length Purchaser – Purchaser does not want Target's non-capital losses to be eroded by debt forgiveness
- If Canadian Vendor sells Target shares and debt to Purchaser for \$1 million → parked debt and \$99 million FA
- To avoid this result, parties implement debt slide transaction
- Canadian Vendor needs to have full cost in debt – ensure no grind in cost due to previous acquisition of control

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## Debt Slide Transaction (cont'd)

- Debt slide steps:
  - 1) Canadian Vendor transfers debt to new 100% subsidiary of Target ("**Newco**") for \$1 million note – paragraph 40(2)(e.1) denies Canadian Vendor loss on transfer and paragraph 53(1)(f.1) adds loss to cost of debt to Newco
  - 2) Newco wound up into Target – debt deemed settled at cost to Newco under subsection 80.01(4) election
- Paragraph 53(1)(f.1) applies only if transferor = taxable Canadian corporation, so restructuring not available if vendor non-resident
- Debt does not become parked debt on transfer to Newco because transferred within group

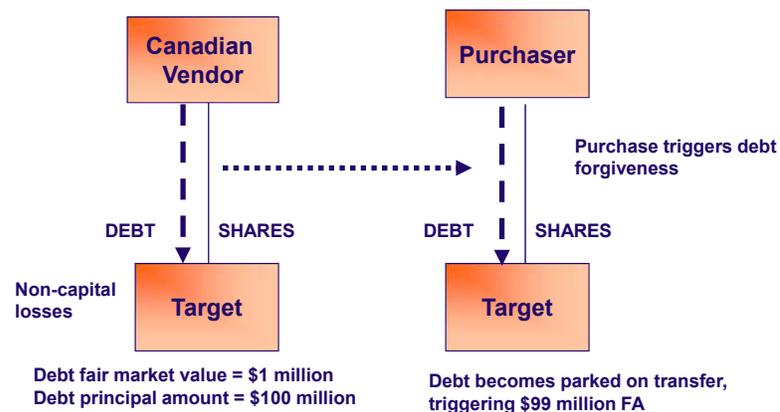
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## Debt Slide Transaction (cont'd)

- CRA issued favourable ruling on debt slide transaction in ATR-66 under old debt forgiveness rules and stated that GAAR would not apply
- GAAR N/A because Canadian Vendor forgoes loss on debt as trade-off for eliminating debt forgiveness
- CRA cancelled ATR-66 in 2012 because statutory references were out of date – confirmed that GAAR position remained same (CRA Doc. No. 2014-0522501E5)

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## Debt Slide Transaction (cont'd)

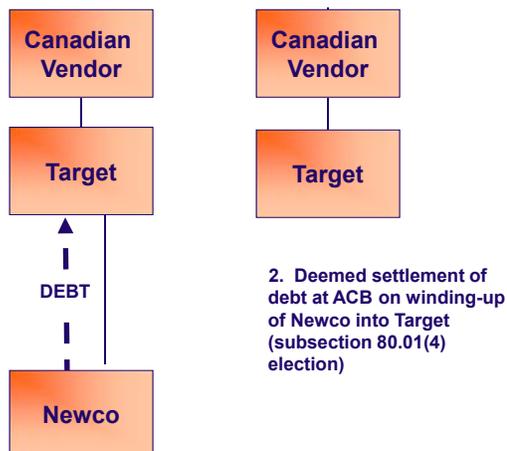


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## Debt Slide Transaction (cont'd)

1. Canadian Vendor transfers debt to Newco

- Paragraph 40(2)(e.1) denies Canadian Vendor loss on transfer of debt to Newco
- Paragraph 53(1)(f.1) adds denied loss to ACB of debt to Newco



2. Deemed settlement of debt at ACB on winding-up of Newco into Target (subsection 80.01(4) election)

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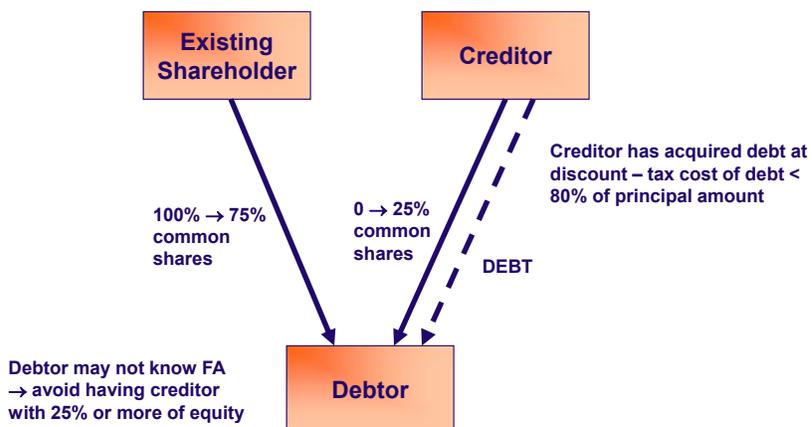
## Creditor Acquires Significant Interest

- If creditor acquires debt at discount of more than 20% and creditor then acquires debtor shares in restructuring:
  - debt becomes parked and there is debt forgiveness if creditor acquires significant interest in debtor, i.e. at least 25% of votes or value
- Note that debtor does not necessarily know FA since may not know creditor's tax cost
- Ideally keep creditor below 25% threshold (recall aggregation of non-arm's length shareholdings)

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## Creditor Acquires Significant Interest (cont'd)



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## Acquisition of Control

- Acquisition of control triggers year-end, crystallization and streaming of non-capital losses, crystallization and elimination of net capital losses etc.
- Sometimes acquisition of control desirable: (1) changes accrued losses (e.g. on depreciable property) into non-capital loss carryforwards, and/or (2) may minimize debt forgiveness consequences – see discussion above re strategies to minimize forgiveness consequences
- Creditors often become new shareholders and debt holders of ongoing entity – check re new deemed acquisition of control rules in section 256.1 (person or group with equity having > 75% total equity value)

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## Cross-Border Trade Receivables

- Assume that USco indebted to Canco under trade receivables outstanding on date USco filed under Chapter 11 of US Bankruptcy Code
- Deemed dividend from Canco to USco (under subsections 15(2) and paragraph 214(3)(a)) unless:
  - USco pays receivables within one year after end of Canco's taxation year in which they arose (subsection 15(2.6)), OR
  - trade receivables arose in ordinary course of Canco's business and *bona fide* arrangements were made for repayment within reasonable time (subsection 15(2.3))
- On one matter CRA accepted that subsection 15(2.3) applied to trade receivables even they were though outstanding for long period due to Chapter 11 filing – but CRA reassessed on basis section 17 applied to accrue interest to Canco because receivables were non-interest bearing

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## Canco Outbound Loan to USco

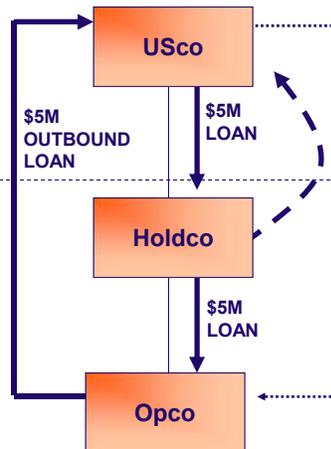
- Assume USco in insolvency proceedings and indebted to Canadian Opco
- Outbound loan has triggered deemed dividend under subsection 15(2) and paragraph 214(3)(a) – 15% withholding tax because Canadian Holdco owns Opco
- Subsection 227(6.1) provides for refund of withholding tax if debt repaid (not as part of series etc.) – refund at rate applicable to hypothetical dividend paid by Opco at time of repayment
- Can't repay in cash due to US insolvency – obtain withholding tax refund by having USco repay Opco via (cashless) set-off against pre-existing inbound financing from USco

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## Canco Outbound Loan to USco (cont'd)

1. Want to eliminate outbound loan from Opco to USco to recover deemed dividend withholding tax

2. Holdco repays its \$5 million loan from USco by transferring to USco Holdco's \$5M loan to Opco (cash in Opco at least \$5M)



3. After transfer in 2., Opco owes \$5M to USco and USco owes \$5M to Opco

4. Subsection 227(6.1) withholding tax refund at 15% on repayment of outbound loan by way of set-off against inbound loan – if instead of transferring loan, Holdco and Opco had amalgamated to get privity before set-off, withholding tax refund rate would have been 5%

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## Presenters

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