CANADIAN FINANCE & LEASING ASSOCIATION
ASSOCIATION CANADIENNE DE FINANCEMENT ET DE LOCATION

Enhancing Canada's International Tax Advantage

A submission by the Canadian Finance & Leasing Association to the Advisory Panel on Canada's System of International Taxation

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1. OVERVIEW

The comments in this submission focus primarily on the thin capitalization rules and, in particular, any consideration of the expansion of the application of these rules to unrelated debt or unrelated guaranteed debt. This question caused great anxiety and concern to CFLA members when proposed in the February 2000 Federal Budget.[1] It remains a serious concern.

It is the position of the CFLA that the current thin-capitalization rules should remain unchanged. Change, in particular changes involving the expansion of the scope of the rule to include unrelated debt or unrelated guaranteed debt, could result in significant harm to the finance and leasing industry, and in turn the Canadian economy -- harm that would far outweigh any potential incremental tax revenue that might be realized by such a change.

The CFLA believes that federal policy over the last three decades has sought to expand and diversify the number of financial service providers in the Canadian marketplace, including most recently by eliminating withholding tax on arm's length interest. This policy was based on the view that users of financial services, both individuals and businesses, stand to benefit most if the financial services marketplace:

- Assures an expanding diversity of choice of providers;
- Increases the pool of credit and capital;
- Improves access to credit and capital;
- Ensures access to innovative services and products; and,
- Increases available specialized technical expertise.

With $106.6 Billion of financing in place with Canadian consumers and businesses,[2] the asset-based financing, equipment and vehicle leasing industry is the largest provider of debt financing in Canada after the traditional lenders (banks and credit unions).

Twenty CFLA Members, each with assets over $500 Million, finance 95% of the market. Of those 20, 18 are subsidiaries of foreign parents.

The Canadian finance and leasing industry, represented by the CFLA and its diverse membership body, represents a unique and dynamic industry within Canada, providing specific and measurable benefits to the Canadian consumer, small and medium-sized enterprises ("SME"), the capital markets and the Canadian standard of living and economy as a whole. By ensuring that a diversity of financial providers exists to provide consumers and SME with a range of financing solutions, the industry not only assures consumer choice, but contributes to an economic environment in which technical expertise and financing innovation flourishes, foreign-based inbound investment flows into Canada, and, ultimately makes a significant contribution to Canada's competitive position within the global economy.

For the reasons presented in this brief, CFLA submits that any requirement that loans, from a third party to an asset-based financing and leasing company, that are guaranteed or secured by a non-resident parent shareholder or affiliate of that shareholder, be included in the 2:1 debt-equity ratio, would severely

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[1] CFLA's representations at that time are described in greater detail below on page 10.

[2] As at December 31, 2006: CFLA Annual Report 2006-07 at page 6, Estimates prepared by The Centre for Spatial Economics, Milton, Ontario.

undermine the industry's capacity to offer competitive financing products and services in Canada. The primary reasons are as follows:

> First, Canadian consumers and Canadian SME rely upon the asset-based financing, equipment and vehicle leasing industry, the largest provider of debt financing in Canada after the traditional lenders (banks and credit unions). By financing Canadians, CFLA members directly benefit the Canadian economy and provide a diversity of choice to consumers and SME, many of which prefer to lease assets rather than finance them with loans.
>
> Second, much of the capital used to fund CFLA members is raised in Canada through the issuance of commercial paper and secured notes, which contribute to the proper functioning of Canadian capital markets. Including parent guaranteed debt in the thin capitalization calculations would interfere with requirements of investors and impact on the methods and the degree to which CFLA members fund their businesses and would negatively impact Canadian capital markets.
>
> Third, the current rules, as applied to the asset-based financing, equipment and vehicle leasing industry, are simple, objective and straightforward. Simplicity and objectivity, when they can be achieved, increase certainty and predictability -- characteristics critical to encouraging economic investment and innovation. Uncertainty introduces risk and risk adds cost in financial transactions. Given the large sums involved in the finance and leasing industry, uncertainty is the difference between a foreign company investing in Canada, or elsewhere.
>
> Fourth, parent guarantees are essential for the asset-based financing, equipment and vehicle leasing industry. Twenty CFLA members, each with assets over $500 Million, finance 95% of the market. Of those 20, 18 are subsidiaries of foreign parents. Each of the foreign owned members relies to some extent on parent guaranteed debt. A parent guarantee is essential to obtaining the lowest cost of funding for use in the Canadian marketplace – to the benefit of Canadian consumers and businesses. Given the essential need for parent guaranteed debt for the asset-based financing and leasing industry to function, any change proposed to the current thin capitalization rules would raise compliance complexities and costs for both the industry and the government.

In short, including foreign parent-guaranteed debt within the 2:1 ratio constraints will undermine the long-standing federal policy goals as stated above.

Today's challenging financial environment underscores the critical need for direct support by the corporate parent. CFLA proposes that the thin capitalization rules should generally include short term easing provisions to permit all Canadian businesses to react in times of credit crises, when the need to obtain capital for use in Canada due to market liquidity is a paramount consideration that outweighs any perceived potential loss of tax revenues created through a higher debt-to-equity ratio.

Alternatively, if change is necessary to deal with other taxpayers, the critical test of such change should be the demonstrable benefit to Canadians, not merely a reaction to anecdotal evidence of perceived abuse. To the extent that there are clearly identified abuses - tax base erosion or earnings stripping – such specific abuses should be targeted on a specific line item basis without the need to create new rules of general application and the need for specific carve-outs. Broad rules that could encompass large portions of the economy that are not subject to potential abuse, merely to ensure that the net is cast wide enough to capture every incident, will have a profound effect on those areas, resulting in unneeded complexity in the legislation to create appropriate carve-outs.

No change should be contemplated before thorough consultation with all stakeholders. Contemplated or potential rule "adjustments" must be approached with caution. Finally, any change must allow for grandfathering of existing funding arrangements.

The following is a list of targeted recommendations presented by CFLA. A detailed consideration of each recommendation is included in this submission.

2. RECOMMENDATIONS

1. Canada should maintain its current formulation of the thin capitalization rules using an objective-standard 2:1 debt-to-equity rate.

2. Canada should not include unrelated debt or unrelated guaranteed debt in the calculation of thin capitalization, on the basis that the current rules represent a satisfactory balance between maintaining foreign investment in Canada, particularly from financial investors that operate through a Canadian presence to provide loan and lease financing and benefits to Canadian consumers and business.

3. Canada should avoid adopting subjective thin capitalization tests which would increase government bureaucracy, increase uncertainty and increase transaction costs without any additional benefit to Canada. For reasons of certainty, simplicity and minimal compliance burdens, clear bright line rules and guidelines should be maintained.

4. Changes, if any, should bring about demonstrable benefit to Canadians and not be a reaction brought on by a desire to create a perfect system; or to react to academic commentary about tax policy.

5. Changes, if any, to the objective ratios should consider that "one size does not fit all" and that different industries have different capital structures and leverage, and that reducing the rate below 2:1 will have a negative impact on the financing structures for CFLA members that provide financial services.

6. Changes, if any, should reflect that leasing in particular is a unique industry in which the lessor "owns" the asset and receives rental income and is often closely associated with the manufacturer of the financed asset. Rules appropriate to "lenders" such as banks will not necessarily be as appropriate to lessors.

7. To be consistent with most other comparable jurisdictions, there should be a complete exemption for financial services businesses, including leasing, that eliminates or at least substantially minimizes compliance or reporting obligations although CFLA remains concerned that doing so will prove difficult and result in increased complexity and administration.

8. Changes, if any, be introduced on a prospective basis with a proper appreciation of its consequences arrived at through consultation with affected groups and including practical and effective grandfathering (unless the change is targeting a visible and genuine avoidance transaction).

9. Earnings stripping or base erosion concerns be addressed on a targeted basis without making sweeping changes that impose undue burdens, uncertainty or compliance costs on all taxpayers.

3. THE CANADIAN FINANCE & LEASING ASSOCIATION (CFLA)

The CFLA represents the asset-based financing, equipment and vehicle leasing industry in Canada. The 250 members of the CFLA range from large multinationals to national, and smaller, domestic companies, crossing the financial services spectrum from manufacturers' finance companies and independent leasing companies to banks, insurance companies, and suppliers to the industry. In addition, well-capitalized manufacturing and servicing companies with substantial earnings have decided to leverage their own equity base and core competencies rather than use third parties. This has led many manufacturers to establish their own financing arms, or partner with those who manage it for them.

Those active in the industry include: Caterpillar Financial, Chrysler Financial, Cisco Systems Capital, CIT Financial, CitiCapital Commercial Corporation, Dell Financial Services, Ford Credit, GE Capital, GMAC Financial Services, Honda Canada Finance, HSBC Bank Canada, John Deere Credit, IBM Global Finance, Microsoft Financing, Pitney Bowes Global Credit, Royal Bank Financial Group, Scotia Leasing, Toyota Credit Canada, and Wells Fargo Equipment Finance. Most CFLA members have been active in providing financing in the Canadian marketplace for many years.

CFLA members provide finance and leasing solutions for (i) most durable goods, including energy-efficient assets, healthcare assets and financing solutions, construction equipment, office equipment, truck tractors and trailers, railcars and locomotives, industrial equipment, and petro-chemical plants and equipment; and (ii) vehicles, including loans and leases to consumers, loans and leases to dealers and fleet loan and lease programs.

CFLA members provide billions of dollars in alternative sources of financing for businesses and consumers through products and services not offered by domestic financial institutions or other domestic markets. The majority of the largest players in the industry are foreign-owned. This brings important advantages. They have the ability to attract foreign capital; to operate on a large scale; and to bring international concepts and structures to the Canadian marketplace, allowing them to provide financing at a competitive cost to Canadian consumers and businesses. Often they work in tandem with Canadian-owned members who play a role in specialized markets or single asset classes. In short, CFLA members rely heavily on external sources of debt financing. Money is inventory to CFLA members, and they must operate -- and can only compete effectively -- with significantly higher debt-to-equity ratios as compared to most other industry sectors, reaching up to 20:1 in many cases.

Funding for the industry comes from commercial markets, notably pension funds, money market funds, insurance companies, banks and public debt markets. CFLA members make use of public offerings of debt securities in the Canadian and international markets, the commercial paper market through bank sponsored and private conduits, private placements in Canada, Europe and the US, traditional bank borrowings, asset-based borrowings and, increasingly, from securitization.[3] A substantial portion of the financing for members that are foreign-owned requires a guarantee by one or more non-resident related entities to reduce cost, allow access to securities law exemptions and to avail themselves of international financial market relationships.

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[3] Securitization allows an owner of a financial asset - such as a credit card receivable, a mortgage or loan receivable (and in some cases a lease receivable) to obtain financing secured against those assets at lower cost than many other forms of financing. In general, large pools of financial assets have better credit quality than the entity that originated the financial asset. For example, a pool of residential mortgages has less credit risk generally than the bank that originated them. Capital markets lenders will lend against a special purpose entity that owns a mortgage pool at a lower rate (and higher leverage) than they would if they lent directly to the mortgage originator. Securitization therefore allows for more efficient pricing of credit. It also leads to higher debt-equity ratios.

4. FACTS ON ASSET-BASED FINANCING, EQUIPMENT & VEHICLE LEASING IN CANADA

- The asset-based financing and leasing industry is the largest provider of debt financing in Canada after the traditional lenders (banks and credit unions).

- The large majority of the industry's customers are consumers and SME.

- At December 31, 2006, the industry's portfolio of assets (owned and managed) was estimated to be worth **$106.6 billion**. The value of assets financed included:

  equipment financing = $43.1 billion.
  business vehicle fleet financing = $6.9 billion.
  consumer vehicle financing = $56.5 billion.

- 20 CFLA members, each with assets over $500 million, finance 95% of the market. Of those 20, 18 are subsidiaries of foreign parents.[4]

- According to Statistics Canada, business spending on machinery and equipment in 2007 was $114.45 billion, while$120.9 billion is planned for M&E investment in 2008.[5] Approximately 22% of annual new investment in machinery, equipment and commercial vehicles is financed by this industry.[6]

- In 1998, the federal (MacKay) Task Force on the Future of the Canadian Financial Services Sector reported that the assets of the asset-based financing and leasing industry in 1997 totaled $50 billion. By 2006, the value of the assets of the industry had increased over 100% to $106.6 billion.

- "*The rise in asset-based financing from 1992 to 2002 improved living standards in Canada by 2.3% (or about 8% of the 26.8% increase in Canada's living standards over that period).*"[7]

"*This unique study overwhelmingly demonstrates the importance of asset-based financing to Canada's economic growth by supporting greater product financial choice and innovation. The industry contributes a disproportionate share to higher living standards*."

Dr. Jack Mintz, President of the C.D. Howe Institute and
Deloitte Professor of Taxation at the Rotman School of Management,
University of Toronto, December 2004

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[4] CFLA Member Survey Results 2006: The Centre for Spatial Economics, Milton, Ontario.
[5] *Private and Public Investment in Canada, Intentions 2008*, Statistics Canada (61-205-XWE), *The Daily*, February 27, 2008.
[6] 2007 *Annual CFLA Survey: Asset-Based Financing & Leasing in Canada*, The Centre for Spatial Economics, Milton, Ontario, Fall 2007, at page 3
[7] *Asset-based Financing, Investment and Economic Growth in Canada*, The Centre for Spatial Economics, Milton, Ontario, December 2004, at page 62.

5. FUNCTION AND ADVANTAGES OF ASSET-BASED FINANCING

Asset-based financing is the financing of equipment and vehicles, and related items or services, primarily by way of lease but also by secured loan or conditional sales contract. The specific assets financed secure the borrower's unconditional obligation to make payments over the term of the agreement. In this way, users of equipment and vehicles can use the value of the asset as security to finance its acquisition. This form of financing relies on cash and cash flow-based credit analysis.

A notable advantage of asset-based financing is that, since the financing company retains legal ownership of the asset for the duration of the lease, this form of financing allows a business or individual to qualify on a generated-cash flow basis, rather than on a net-worth lending formula, as typically offered by traditional lenders.

CFLA members generally provide lease-based financing; that is, through an agreement by which the owner conveys to the user the right to use the equipment or vehicle, in exchange for a specified number of payments over an agreed period of time.

For example, when acquiring a new vehicle, a customer may purchase it, obtain a loan to do so or lease the vehicle from a financing company. A lease may be signed by the customer and the dealer with the lease being subsequently assigned to the financing company, or the financing company will be represented by the dealer, when the lease is signed by the customer. In either event, the customer will have little direct dealing with the financing company. The role of a financing company may not be visible, but it is nevertheless of substantial benefit. If the customer chooses to lease, the financing company will purchase the vehicle and provide the customer with exclusive use of the vehicle for a specified period of time, such as 36 or 48 months (although leases of vehicles may be as long as 84 months). At the end of that period, the customer usually has the option of purchasing the vehicle for the amount specified or returning it, often without making any further payment.

Leasing is a higher-spread business (due to residual risks undertaken, the credit quality of lessees and the less restrictive customer credit terms of leases generally). While not necessarily the right solution for every business or consumer, or for every situation, leasing can offer significant practical benefits to a lessee. From a customer's perspective, there are a number of features that make leasing an attractive business choice:

> *Efficient Use of Capital.* Many businesses consider leasing to be the most efficient and effective use of available capital. Cash that is tied-up in fixed assets is no longer available to finance the inventory necessary to support profit-producing activities, such as production, distribution and marketing.
>
> *Fixed Rate Financing.* Leasing typically offers long-term financing at a fixed rate over the financing term. In this way, the customer is insulated from spikes in interest rates that occur in the Canadian economy from time to time.
>
> *Flexibility.* Compared to traditional lending, leasing is generally a far more flexible means of using equipment or vehicles. This flexibility is a significant operational advantage in a number of situations where the lessor can tailor lease payments to a particular customer's revenue streams, offering a level of flexibility in timing and payment schedules unmatched in the traditional lending sector.
>
> *Lower Transaction Costs.* Lease transaction costs are generally lower. The cost of assigning collateral, legal documentation and slower processing times for traditional bank borrowing can be significant, particularly for small businesses where many of the conventional financing costs are fixed, not tailored to the size of the loan.

A lease is not the same as a bank loan. It is an asset-based financing product, where the equipment or the vehicle leased is usually the <u>only</u> collateral security for the transaction. A traditional bank loan, by contrast, is generally secured by more than one specific asset and may include additional covenants and terms. In addition, a leasing company earns rent, not interest. This difference is of critical importance in dealing with the industry. This difference should be taken into consideration when making policies and rules that govern it.

One of the hallmarks of leasing is that the leasing company often takes a residual value risk in the asset. At the end of the agreed-upon term, the asset will have invariably declined in value. It is the leasing company generally, and not the customer, that assumes the risk that the equipment, when sold or remarketed upon expiration of the lease, will not recover its book value. The assumption of this residual value risk exposes the leasing company to an additional collateral risk, over-and-above the credit risk posed by late consumer payments or default.

Leasing companies that are affiliated with the manufacturer of the asset – the so-called "captive" leasing companies - are in a superior position to properly price the residual value exposure of an asset due to their unique knowledge of the asset, its long term value, information regarding the typical customer who will typically purchase such an asset, and the appropriate remarketing of the asset. Consequently, captive lessors are able to offer very competitive financing rates on an asset. These competitive rates, however, depend upon the ability of a leasing company to obtain unrestricted capital in the market. They are only competitive if the cost of their capital is comparable to alternative financing sources operating within Canada and internationally: foreign owned entities usually need to borrow based upon a related-party guarantee to do so. So called "financial leases," which are treated by the lessee as debt, may involve a sharing of residual value risk or an assumption of residual value risk by the lessor.

CFLA members are in the business of borrowing money in order to finance the use of vehicles and equipment by Canadian businesses and individuals. The return they earn is based upon the difference between the rate of their cost of funds and the market rate offered to the customer. CFLA members maintain sufficient equity to cover the business risk associated with their assets; however, unlike non-financial industry participants, they generally maintain a higher degree of leverage compared to other companies in the marketplace.

In addition to facilitating financing and shifting the residual value risk of assets, leasing also provides a competitive solution for would-be borrowers operating with legal and financial constraints resulting from their other financial arrangements. For example, leases characterized as operating leases for accounting purposes are generally not consolidated on the financial statements of the lessee as a debt obligation. This provides a distinct benefit to lessees that have undertaken financial obligations and are subject to restrictive covenants precluding them from obtaining general financing and/or encumbering their assets. Often such would-be borrowers are able to obtain incremental financing for specific assets through an off-balance sheet operating lease in which they are merely making regular payments to maintain the use of the asset rather than incurring debt and running afoul of their restrictive covenants.

The financial products of the asset-based financing, equipment and vehicle leasing industry are unique primarily because asset-based financiers are usually exposed to value risk associated with specific assets. In many leases, CFLA members regularly assume the residual value risk associated with the assets. This industry is extremely capital intensive, earning its profit from a combination of the interest rate spread (the difference between borrowing costs and income from loans and leases and from the pricing of residual value risk).

In addition, the leasing industry performs essential non-financial functions, such as maintenance and global remarketing, customer credit approvals, customer billing and collections, call centres and promotions. The ability to remarket an asset after the end of its lease term provides a substantial benefit in creating a market for used equipment and vehicles in Canada.

Asset-based financiers are essentially financial intermediaries, providing financing solutions to Canadians. In many instances, other lenders would not lend directly for the purpose of purchasing the assets that CFLA members finance (due to the cost of placing the loans, the cost of servicing them, their inability to "price" the credit of the borrower or lessee and their inability to price the residual value risk associated with the asset). CFLA members are positioned to price, and absorb, these risks and thereby facilitate what would otherwise be unobtainable, and very important, financing for Canadians.

6. THE CURRENT BUSINESS ENVIRONMENT AND FUNDING CHALLENGES

This past year has seen unprecedented turmoil in the Canadian and international capital markets. Sources of funding, particularly asset-backed commercial paper conduits that typically advanced funds to CFLA members to fund their business, stopped investing. However, Canada's consumers and businesses were still buying vehicles and equipment, and consequently still required financing. During this period, some CFLA members were unable to continue to securitize their portfolios as they would in ordinary circumstances. As a result, short term liquidity issues arose.

In CFLA's 2007 Annual Survey[8] (based on member-provided data as at December 31, 2006), the Centre for Spatial Economics ("C_4SE") found that:

> The reduction of liquidity resulting from the collapse of the asset-backed commercial paper market and a less certain demand environment may result in a significant shift in the competitive environment in the next year or two. Mergers and acquisitions activities have been relatively quiet over the last few years following the frantic activity of the late 1990s. This may change as smaller companies find trying to operate in a market with reduced funds and, perhaps, fewer deals a challenge and opt to be acquired by larger and better capitalized competitors.

The C_4SE also noted[9] that:

> After a sustained period of high liquidity, the collapse of the US sub-prime mortgage market has thrown the financial markets into a period of instability. The value of asset-backed commercial paper has come under increased scrutiny with placements becoming difficult without assistance. The market for asset backed commercial paper in Canada is not likely to operate without significant banking system intervention for some time yet. This will continue to complicate business for lessors in Canada. **In 2006, about 27% of assets owned and managed by equipment lessors were either securitized or syndicated. Lessors that securitized their portfolios to provide the funds to operate and grow their business will have to operate with reduced liquidity.** [Footnotes omitted, emphasis added]

Over the last nine to twelve months, some CFLA members have had to receive significant amounts of debt financing from their foreign parent due to an inability to obtain any funding within the Canadian market.

Some members had related non-resident parents with existing committed bank facilities that could provide liquidity on a short-term basis. These funds were generally more expensive than the commercial paper that CFLA members depend upon to securitize. Such funds are also not a viable long-term solution, but represented temporary, bridge-type financing. **The important point to note is that, on a temporary basis, this may cause a company to exceed the 2:1 limitation ratio under the current thin capitalization rules. Absent the ability to inject funds into Canada on an equity basis rather than on an emergency debt funding basis, CFLA members may be impaired by the rules this year. Situations such as this, resulting from changes in the capital markets, should not result in a loss of interest deductibility within the Canadian market; these funds represent amounts that could have been borrowed within the domestic Canadian market but for the temporary systemic dislocation in that market.** In short, these companies were not engaging in any tax avoidance, but rather, due to a temporary dislocation in the financial markets, they required the injection of temporary foreign funds in order to fulfill their mandate of financing consumer and business demand.

The Canadian market is simply too small to provide liquidity in times of crisis. Bank lines and other sources of capital that could normally be drawn on by CFLA members became insufficient

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[8] 2007 *Annual CFLA Survey: Asset-Based Financing & Leasing in Canada*, The Centre for Spatial Economics, Milton, Ontario, Fall 2007, at page 7.

[9] *Ibid*. at page 14.

when the commercial paper market was in turmoil, and consequently these companies could only obtain sufficient funding through direct loans from their foreign parents.

For this reason, CFLA supports a broadening of the thin capitalization rules applicable to all Canadian businesses to alleviate hardship in difficult times. Accordingly, the CFLA recommends that Canada consider a safe harbour exemption for temporary capital obtained from specified non-residents where temporary market circumstances require such capital, provided that such amounts are repaid within a prescribed period, are not part of a series of advances and repayments and during the time such amounts are outstanding the debt-equity ratio does not exceed 3:1 (this would provide temporary capital relief during times of market disruption and lack of liquidity such as those arising this past year and still seriously affecting the industry today and for the foreseeable future).

7. ENHANCING CANADA'S INTERNATIONAL TAX ADVANTAGE

The Advisory Panel is currently considering Canada's system of international taxation. This initiative appears similar to initiatives completed or currently in progress in many countries, including the United States, the United Kingdom, Australia and New Zealand. Not all such studies have or will result in changes to legislation. The Advisory Panel has indicated that it is reviewing, among other things, the thin capitalization rules.

Section 3.10 of the Advisory Panel report notes[10] that:

> In some cases, the unrestricted deductibility of interest expense incurred by foreign-owned Canadian corporations may not be appropriate. It is reasonable to review whether Canada's thin capitalization rules are effective in dealing with these situations.

It is useful as a first step to review the history of the thin capitalization rules and the February 2000 Federal Budget.

a. Brief History of Thin Capitalization Rules and the 2000 Federal Budget

Canada has had thin capitalization rules since 1972. When introduced they were recognized as an instrument of Canadian government fiscal policy to ensure that foreign-owned corporations could not choose to capitalize a Canadian company with greater debt to specified non-residents than the amount of equity to such specified non-residents. This prevented the tax arbitrage strategy of taking a deduction in computing income at normal corporate rates, while only being subject to a 15% withholding tax (under treaties at that time).

The rules worked relatively well and did not provide any substantial impetus for change. In April 1998, the Technical Committee on Business Taxation, appointed by the federal Minister of Finance and chaired by Dr. Jack Mintz, (the "Mintz Report") conducted an in-depth review of Canada's thin capitalization regime.[11] This review considered the approaches that had been used in other countries and assessed the numerous alternatives. The Mintz Report recommended that the debt-equity ratio be changed from the then 3:1 debt-equity ratio to a 2:1 debt-equity ratio.

The Mintz Report expressly rejected including guaranteed debt. The Committee expressly rejected any inclusion of guaranteed debt in the thin capitalization test due to the potential for capital market distortions. Rather, it was suggested that this issue of guaranteed debt be reviewed periodically by the government to identify possible abuses. Much of the international tax literature contains a similar conclusion: although this is an issue that deserves monitoring, it is not one that has seen significant abuse.

It was a surprise then when the February 2000 federal budget not only lowered the debt-equity ratio from 3:1 to 2:1, but extended the definition of "debt" to include loans to Canadian subsidiaries from third parties that were guaranteed or secured by a non-resident shareholder owning 25% or more of the subsidiary or by an affiliate of such shareholder.

CFLA members were extremely concerned. The CFLA membership provided submissions to the Department of Finance. The thrust of its first submission was that the budget papers had simply explained the proposed changes as "minor technical amendments to tighten up existing tax avoidance measures." CFLA believed that the proposal, if enacted, would have had a significant impact on its members, and business, in Canada. The CFLA continues to hold that belief. CFLA worked with its

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[10] *Enhancing Canada's International Tax Advantage*, Advisory Panel on Canada's System of International Taxation, April 2008, at page 30.

[11] Report of the Technical Committee on Business Taxation, April 6, 1998.

members, the Association of International Automobile Manufacturers of Canada, the Canadian Vehicle Manufacturers Association and the Association of Canadian Finance Companies in a concerted effort to avoid the implementation of these rules and the difficulty that they were anticipated to create.

In the context of the February 2000 budget proposals, the Investment Dealers Association of Canada (IDA) wrote to the then Minister of Finance, the Honourable Paul Martin P.C. on March 31, 2000, under the heading *General Observations* as follows:

> The IDA submits that the proposed changes to the thin capitalization rules will radically reduce the borrowings of foreign owned Canadian companies that carry on a financing business in Canada ("Canadian Near-bank Subsidiaries"). This will trigger a cutback in their business operations, particularly in the leasing, asset-based finance, factoring and consumer lending markets which Canadian-owned financial institutions do not fully service. The resulting reduction in the supply of financing in Canada will increase lending costs to businesses and consumers, particularly lower-income Canadians, and limit competition in the leasing sector. Such a decrease in the scale of business is at odds with the direction of the imminent legislative reforms aimed at enhancing competition in the near-bank financial sector by the easing of the regulations governing Canadian Near-bank subsidiaries and branches of foreign financial institutions.[12]

CFLA and others met with the Department of Finance during the month of April 2000. Members present included ABN Amro, Ford Credit, GE Capital, GMAC, Honda Canada Finance, Household Finance, Toyota Credit and Trans Canada Credit Corporation. In addition, representatives of manufacturers, sales, finance companies, independent financial companies, consumer finance companies and international bank leasing operations attended. **A common priority position existed: the new thin capital limitations, by including third party guaranteed debt of an international parent, would cripple the business of the Canadian subsidiaries. All believed that there would be direct and negative impacts on the availability of alternative sources of credit and capital for Canadian consumer and business customers, as well as a significant negative impact on Canadian capital markets.**

Industry rejects notion that financial services could be carved out. At one point in time, the Department of Finance proposed that an exemption for financial services companies could be considered. This suggestion was rejected by the industry, for several reasons:

- those meeting with Finance believed that it would be extremely difficult to craft a definition of a "financial services company," particularly for those businesses which not only include traditional lending and leasing, but also conduct manufacturing activities or are related to a manufacturing entity. Tremendous diversity exists among CFLA member companies, and their businesses, products, structures and funding arrangements vary significantly.

- it was considered that this would not provide for a level playing field in that if a Canadian subsidiary acting as a lessor in Canada were to obtain third party debt, the interest would not be subject to any thin capitalization or leverage ratio, but it would be for a foreign-owned entity. Moreover, a Canadian lessor could have obtained financing either domestically from a non-resident (under the then so-called 5/25 exemption under paragraph 212(1)(b)(vii) of the Income Tax Act (Canada)). If it borrowed abroad, a significant amount of interest would have been deductible in computing Canadian interest even though paid to a non-resident without any withholding tax.

Industry argued that financing enhanced Canadian economy. Further discussions revealed a belief among government officials that international companies were deliberately funding their Canadian operations with a higher level of debt than equity. As a consequence, interest that might otherwise be

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[12] Letter from Investment Dealers Association of Canada to The Honourable Paul Martin, P.C., Minister of Finance, March 31, 2000 at page 2.

taxable as income in Canada was being deducted from Canadian income and paid to the parent located outside of Canada -- at a withholding tax rate lower than that payable as Canadian corporate tax. The Department of Finance viewed the international parent guarantee as merely another method of achieving the same result.

CFLA argued that the financing brought to Canada by subsidiaries of international corporations constituted a direct investment in the Canadian economy. In general, CFLA members are providing this financing to Canadians for use by them, either in their businesses or as consumers. Industrial corporations invest in plant equipment and create jobs. CFLA members finance Canadian consumers and businesses. Each contributes to a healthy, growing Canadian tax base, which in turn provides significantly increased government tax revenue that would not otherwise be realized.

CFLA was also joined by the joint Canadian Bar Association-Canadian Institute of Chartered Accountant Tax Committee Chairs in further meetings with the Department of Finance. Officials indicated that they had decided to reduce the ratio from 3:1 to 2:1 based on a review of policies in other countries that suggested Canada's rules were generous in light of changes in the USA (to 1.5:1) and the UK (to 1:1). The Department of Finance had also reviewed the domestic Canadian company ratios that were averaging close to 1:1 and considered that doubling the ratio to 2:1 for companies with international parents was generous. While that may hold true for many of the domestic industries in Canada, it is not true for the financial services sector; the financial services sector relies on increased leverage and increased access to capital in order to conduct its business. The industry's inventory is capital.

The Minister-deferred implementation. On May 11, 2000, the Department of Finance issued a news release dealing with a number of the budget proposals. The full text of the relevant part of the release read as follows:[13]

> The thin capitalization rules in the Income Tax Act prevent foreign owned corporations resident in Canada from using an excessive amount of debt when they capitalize their Canadian operations.
>
> Minister Martin today announced the deferral of the budget measure that broadened the kind of debt covered by the thin capitalization rules to include loans to a Canadian corporation from a third party that are guaranteed or secured by a specified non-resident. In certain circumstances, including guaranteed debt in the scope of the thin capitalization rules has raised concerns. Deferring this element of the thin capitalization provision will enable officials to consult broadly with a view to reaching a consensus on how best to define those guarantees that are the equivalent to related party debt. Any resulting proposals will be brought forward on a fully prospective basis.
>
> As indicated in the 2000 Budget, interested parties will also be consulted on matters related to other business arrangements such as partnerships, trusts, branches and the use of leases.

This news release confirmed that any new rules would be brought forward on a prospective basis. Since then, to the CFLA's knowledge, the government has not conducted any further studies or consultations on this question prior to the appointment of the Advisory Panel.

These issues are still important today. Since 2000, the importance of the financial services sector, including the foreign banks and non-bank financial companies, to the Canadian economy and the Canadian capital markets, has grown substantially, and the CFLA submits that the concerns expressed in 2000 are even more important today, particularly in light of the current credit crisis. As noted below, most other jurisdictions with thin capitalization or earnings strippings rules have recognized the unique nature of financial services businesses and have allowed them to operate exempt from the general application of such rules or with appropriate relief so as not to harm the respective economies in capital market systems. It is important to note that, of all the jurisdictions to which it is usually compared, Canada's

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[13] Department of Finance, News Release, May 11, 2000.

current thin capitalization system with respect to financial services companies is more restrictive and less competitive.

b. Tax Policy Balanced Against the Economy

Under the heading "Taxation of Inbound Direct Investment," the Advisory Panel has indicated that the taxation of inbound direct investment should aim to balance two objectives:

- seek to treat foreign investors and domestic investors equally; and
- ensure that foreign entities doing business in Canada pay an appropriate amount of Canadian tax on what is properly considered Canadian source income.

The Competition Policy Review Panel, commissioned by the Government of Canada, notes in its June 2008 Final Report that:[14]

> **Tax policy involves more than deciding how much revenue must be raised. An equally important policy issue is the design of a scheme of taxation and its impact on individual and corporate incentives and behaviour.**
>
> [emphasis added]

To this end, the Competition Policy Review Panel notes further that:[15]

> [b]usiness investment in machinery and equipment, including advanced information and communications technology, has been shown to contribute to productivity and prosperity. In this regard, a study by economists from the Department of Finance suggests that a reduction of taxes on investment that results in a permanent and significant decline in the cost of capital will lead to a significant increase in investment.

It is that calculus that must be undertaken of the thin capitalization rules.

CFLA believes that financial services policy in Canada should focus on the needs of Canadian users of financial services. A diversity of providers of financial services is the best assurance of user choice. The users of financial services, both individuals and businesses, stand to benefit most if the financial services marketplace:

- Assures an expanding diversity of choice of providers;
- Increases the pool of credit and capital;
- Improves access to credit and capital;
- Ensures access to innovative services and products; and,
- Increases available specialized technical expertise.

The asset-based financing, equipment and vehicle leasing industry meets those needs.

CFLA supports the goal of maintaining a system that continues to promote Canada's international competitiveness by promoting, attracting and retaining foreign investment in Canada. Recent academic debate has focused on the ability of multi-national corporations to adjust their external borrowings and capital investment and take advantage of differences in the tax rate between countries. Academics observe that the potential loss of revenue in such situations may not be offset by a greater domestic benefit, especially if the multi-national deliberately shifts investment out of the country in which expenses -- usually interest expense -- is born. Such shifting is not occurring in the finance and lease industry.

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[14] *Compete to Win: Final Report -- June 2008*, Competition Policy Review Panel, Government of Canada (June 2008) at p.63.

[15] *Ibid*. at p.63.

CFLA and its members believe that the current thin capitalization rules provide for an appropriate balance between facilitating the benefits that subsidiaries of foreign corporations provide to Canadians through businesses and investments made here in Canada, and realizing the amount of tax that should be properly considered to be imposed on Canadian source income and in particular those providing asset and equipment finance. CFLA members carry on business and provide benefits here in Canada. The money borrowed to fund their business is used here and not abroad; the industry has consistently provided benefits to Canada for an extensive period of time despite changes in economic conditions, and changes in domestic and international tax rates. CFLA members generally continue to carry on business as they always have. Moreover, Canada's tax rates are now competitive with those of our trading partners and as such rates converge, the risk of reduced tax revenue also diminishes.

Many countries have been removing withholding tax on foreign lenders making loans into their countries. This reflects a policy choice that it is more important to the domestic economy to obtain investments in the form of loans from non-residents than the amount of tax that such lenders pay in Canada. A foreign lender, lending directly into Canada to unrelated Canadians, pays no Canadian taxes - no withholding tax or business tax is imposed. Such lenders are not subject to any thin capitalization rule. Do they pay a share of Canadian taxes? Not at all. But they do provide benefits to Canada, the most important of which is the benefit Canadians receive from being able to access foreign capital within Canada. CFLA members do pay tax in Canada. They are subject to thin capitalization rules and normal corporate tax rates. They maintain offices and staff in Canada. They not only provide financing, they also provide a meaningful benefit to the Canadian economy through their presence in Canada.

Under Canadian rules for withholding tax, CFLA members who make loans into Canada (including vehicle loans) would pay less Canadian tax if they were to operate from outside Canada. CFLA submits that increasing the tax burden on foreign owned entities that provide financing will lead to the reduced presence in Canada for credit card, mortgage and loan business. Is that a desirable policy outcome? The paradox is that lease financing (which remains subject to withholding tax and cannot be conducted on a cross border basis) will become more expensive and less available whereas loans will remain available, but from outside Canada. Yet Canadian customers use lease financing to acquire more than 40% of all new vehicles in Canada. Where is the lease financing going to come from?

The largest players in the industry are foreign-owned. As noted above, twenty CFLA Members, with assets over $500 Million each, control 95% of the market. Of those 20, 18 are subsidiaries of foreign parents. The ability to attract foreign capital, the ability to operate on a large scale, and the ability to bring international concepts and structures to the Canadian marketplace allow them to provide financing at the lowest cost to Canadian consumers and businesses.

For these reasons, CFLA submits that, from a policy perspective, the current rules do provide an appropriate balance between realizing the benefit to the Canadian economy and the amount of tax revenue generated. The current system has been in place for many years and it has produced excellent results.

Where perceived abuses are identified, however, CFLA urges reform to occur on a targeted basis, rather than using broad strokes. Change is expensive, and often has unintended consequences and collateral spin-off effects. CFLA believes that, in general, within the finance and leasing industry (described below) there are no specific abuses or indications that legislative change to the thin capitalization rule is needed, or desirable.

The consequences of changes to the industry. CFLA submits that any restrictive changes to the existing thin capitalization rules – through inclusion of unrelated debt or unrelated guaranteed debt – could produce severe, and unintended, consequences:

(i) on consumers and their ability to obtain financing for automobiles and consumer goods;

(ii) on the ability of small to medium businesses to obtain asset-based financing for items including office equipment, manufacturing and processing machinery and equipment, computer hardware, trucks, tractor-trailers, and construction equipment;

(iii) by limiting the availability of and raising the cost of capital for Canadian business and consumers, bringing about severe and lasting disruption to Canadian capital markets;

(iv) by driving investment, employment and a tax-base out of Canada – particularly those industries such as consumer vehicle finance, mortgages and credit cards for which direct lending, now free of withholding tax, is a substitute;

(v) by resulting in massive new compliance and reporting burdens for Canadian businesses, as well as an additional massive bureaucratic load to Canadian government employees;

(vi) by creating significant uncertainty for businesses operating in Canada;

(vii) by effectively activating a tax on international business operating in Canada by forcing foreign parent corporations to maintain suboptimal levels of debt; and

(viii) by adding complexity to the Canadian tax system and Canadian tax rules without a demonstrable benefit to Canadians.

c. International Experience

Most other OECD countries employ some variation of the thin capitalization regime. In general, such regimes are intended to prevent a foreign entity from investing all of its capital into a related domestic entity by way of deductible interest-bearing debt rather than equity. In this manner, presumably such a domestic entity will be subject to a minimum tax payable within the jurisdiction. Approaches include (i) an objective ratio test, (ii) subjective arm's length tests or (iii) hybrid approaches.

A recent Canadian study, "*Debit-Equity Limitations in Thin Capitalization Rules: Canadian Evidence*,"[16] Farrar and Mawani review the Canadian thin capitalization rules. The international rules are summarized as follows:

> Thin capitalization rules can be generally classified as objective or subjective. Objective rules use a quantitative measure, such as a debt-equity ratio, to limit interest deductions. Subjective rules are qualitative and require a firm to limit its interest deductions if the amount of interest is unreasonable according to facts and circumstances. To illustrate, consider the situation where a US corporation lends money to a Canadian corporation. Objective rules would limit the interest deduction if the Canadian corporation has a debt-equity ratio exceeding 2:1, whereas subjective rules would limit the interest deduction if the amount of the loan, the repayment terms, and the interest rate offered by the US corporation were not similar to what a bank would offer. Some countries use modified subjective rules, which are subjective rules with a quantitative measure or 'safe harbor' embedded therein.
>
> Italy, for example, has modified subjective rules. There is a 4:1 debt-equity ratio in the rules, but a borrower can remove the restrictions on its interest expense deduction if it can demonstrate that its financing to foreign related parties is justified by its own credit capacity, and consequently that a third party would have granted financing for the same amount (Polacca 2004). Japan is another country that uses modified subjective rules. The objective part is a debt-equity ratio of 3:1 that an interest payee must not exceed. However, the Japanese Tax Bureau has issued 'reasonable multiples' meant to be consistent with the debt-equity ratios of comparable companies in an industry, which corporations may choose instead of the 3:1 ratio (KPMG 2005).

The policy rationale for thin capitalizations gets mired in other debates revolving around the question of what the appropriate base rate is for enterprises conducting business in multiple jurisdictions. Thin capitalization should involve a weighting between appropriate benefit for inbound investment and tax

[16] Jonathan Farrar and Amin Mawani, "*Debt-Equity Limitations in Thin Capitalization Rules: Canadian Evidence*", January 4, 2008, Working Paper, York University, at pages 4-5.

revenue. It does not and should not be used as a tool to address issues such as base erosion or earnings stripping by tax exempt and flow through entities.

CFLA found the 2007 U.S. Treasury Department "*Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties*"[17] to be relevant as it relates to the relative perceived harm of various financing methods. The U.S. has an earnings stripping test aimed at preventing erosion of the U.S. tax base by means of excessive deductions for interest paid by a taxable corporation to tax-exempt (or partially tax exempt) related persons (which includes entities which are tax exempt because they are non-U.S. taxpayers). This rule applies where a corporation's debt-to-equity ratio exceeds 1.5:1 and its net interest expense exceeds 50% of its adjusted trade income. These rules, however, create issues for entities that earn rental income. They do not produce a satisfactory result for financial services participants, particularly lessors.

In its report, the Department of the Treasury reviewed the U.S. anti-strippings rule to determine whether foreign-controlled domestic corporations (FCDCs) had opportunities to reduce their U.S. taxable income by leveraging the U.S. operations with debt, the interest on which was not subject to U.S. tax in whole or in part.

In reviewing the tax return data for 2004, the Department of Treasury did not find conclusive evidence of a higher ratio of interest expense to cash flow for FCDCs as compared with domestic-controlled corporations (DCCs) in the non-financial sector and the manufacturing sector. The report noted that corporations in the financial sector generally have much greater leverage than corporations in the non-financial sector:[18]

> [as] financial corporations are much more likely to be highly leveraged than non-financial corporations, a threshold ratio of interest expense to cash flow of 90 percent, rather than the 50 percent threshold discussed above, may be a more appropriate measure of high interest expense.

The report noted that in the financial sector, FCDCs in securities dealing and investment banking did appear to have a very high interest expense relative to cash flow. The report stated, however, that "in general it is difficult to make precise estimates or to draw firm conclusions because of the possibility of alternative explanations and the problems with using DCCs as a comparison group."[19]

The report noted further that, in contrast to the data on all FCDCs, data on ICs [inverted corporations] "strongly suggest that these corporations are shifting substantially all of their income out of the United States, primarily through interest payments."[20] The report concluded that there was a genuine bias to ICs of using increased leverage to reduce their U.S. source income. The report stated:

> [p]roponents of rules like those found in section 1637 often argue that there is no evidence of earnings stripping outside the context of ICs and, consequently, if there is any need to strengthen the rules of section 163(j), these amendments should apply only to corporations that have engaged in inversion transactions. In fact, this study was unable to quantify accurately the extent of earnings stripping by FCDCs, but did find strong evidence that ICs are stripping a significant amount of earnings out of their U.S. operations. Proponents of such a proposal may assert that this study supports their view.[21]

The Treasury Department did not conclude that no stripping was occurring, rather that there was less than overwhelming evidence for such behaviour. With respect to guaranteed debt, the report stated:

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[17] U.S., *Report to The Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties* (Washington, D.C.: United States Government Printing Office, 2007).

[18] *Ibid.* at page 19.

[19] *Ibid.* at page 21.

[20] *Ibid.* at page 8.

[21] *Ibid*. at page 29.

> Some have argued that guaranteed debt does not increase the likelihood of base erosion as compared with non-guaranteed debt because borrowers typically obtain guarantees to reduce the interest rate on a loan and such interest is paid to an unrelated party. In fact, these commentators, like the proponents of section 1475, argue that the rules relating to guaranteed debt should be relaxed or eliminated altogether. However, others argue that third-party debt guaranteed by a foreign-related party is a close substitute for direct borrowing from that foreign-related party, so if the former is restricted less than the latter, the former can be used to circumvent restrictions on the latter. In this view, the rules for guaranteed debt serve as a backstop to the general rules of section 163(j). **The Treasury Department believes that guaranteed debt does not raise the same level of concern that the related-party debt raises under section 163(j) and, consequently, there is no need to lower the excess-interest-expense threshold for guaranteed debt. However, the Treasury Department continues to study the rules relating to guaranteed debt.**[22]

Most jurisdictions, including the U.K., France, Switzerland, Sweden, the Netherlands, Korea, Japan and India, do not include unrelated debt in the thin capitalization regime. The CFLA submits that there is no pressing need to include guaranteed debt in the thin capitalization rules in order to avoid any income stripping. To the extent that there is a concern of base erosion or of other transactions in which income is being shifted between countries, it should be addressed through the transfer pricing mechanisms or through specifically targeted rules to address those concerns. In general, although possibly highly leveraged, the spread that CFLA members earn is taxed in Canada and that is the appropriate income that should be subject to tax in any event for a financial institution.

Most recently New Zealand has adopted a base erosion test as a method to measure the amount of borrowings that would be made in an open economy within their home jurisdiction compared to those that would be made on a consolidated basis across the entire enterprise. Their concern is that a company would raise funds in the country in which it has the highest interest expense and either on-lend those funds or otherwise use those funds in its worldwide operations thereby achieving a tax rate arbitrage between the tax rate in the home country and the tax rates abroad. A safe harbour would exist for debt that exceeds a fixed debt equity ratio so long as it was within 110% of the group average.

CFLA is very concerned by such rules. In the finance and lease market, different Canadian entities will have different financial ratios because they exist as separate groups. Some of our members are affiliated with manufacturers; others are not. Depending on their business structure, a Canadian subsidiary may not be capitalized as high (or as low) as its parent. A lot will depend on the relation between finance and manufacturing activity in Canada. Part will depend upon the relative mix of financing product – and of related loans, leases, trade credit and other factors such as the amount of securitization undertaken. CFLA submits that Canada does not have the same concerns as some other countries.

From time to time, the tax rates within various countries shift; where Canada was once perceived as a very high rate tax jurisdiction, it is not currently so. Accordingly, although from time to time companies have an incentive to obtain funding either within Canada or outside Canada, there is considerably less pressure on that at present. For example, Canadian corporate tax rates are now currently lower than those in the US – our largest treaty partner – and the incentive is therefore to raise financing within the United States rather than in Canada.

The British experience relating to financial institutions is also instructive. The UK provides for complete exemption or specific formulated relief from thin capitalization for financial services businesses. In some cases, this allows for debt-equity ratios of up to 20:1. It is unclear whether such exceptions would work for leasing companies or companies operating with a combination of leasing and other activities.

UK subjective approach is very difficult to administer. In general, the UK uses an arm's-length test whereby taxpayers are required to negotiate specific debt-equity ratios with the UK tax administration for

[22] *Ibid.* at pages 30-31.

specific periods of time – typically only 3 to 5 years. This approach, while at first glance appealing, poses significant hurdles for the finance and lease industry. A 3 to 5 year time horizon is insufficient to conduct the planning and financing necessary to make long-term capital decisions involving leased assets. Railcars, for example, are often under leases longer than 10 years, and even motor vehicles are now under leases lasting between 36 and 84 months. The modification of a debt-equity ratio based upon administrative concession would create a great deal of uncertainty and difficulty for businesses involved in long-term planning.

Negotiating under a significantly subjective approach requires a tremendous amount of resources from both taxpayers and the tax administration. With current resources, the Canada Revenue Agency is not equipped to undertake these negotiations. A significant backlog already exists dealing with transfer pricing adjustments and competent authority proceedings, in which neither Canada nor its treaty partners are able to satisfactorily resolve the amount of appropriate transfer pricing for many multi-nationals. In addition, experience with advanced pricing agreements has shown that they are an extremely difficult procedure to administer and are extremely expensive. Furthermore, any such negotiations would be on a confidential basis; consequently, the information regarding what ratios are available to particular participants in the industry will not be known. As a result, a significant, and undesirable, degree of variation would exist between taxpayers who are otherwise similarly situated.

Canada has an economy and need for access to credit that is different to the US or UK. In fact, with changes in the withholding tax regime, CFLA members are now facing increasing pressure to compete with offshore entities that have no Canadian presence and are therefore subject to no Canadian taxes. As a result of the withholding tax exemption, non-Canadians can now purchase loans and other interest-bearing instruments free of any Canadian withholding tax. These entities do not need to have a permanent establishment or otherwise carry on business in Canada and yet they can receive significant amounts of interest from Canadians. Moreover, our members earn rent income and these changes make leasing more expensive relative to lending and constrain customer choice.

This change is important to the Canadian capital markets and for providing credit to Canadians. It will, however, have an impact on CFLA members and on others who provide credit within Canada. Effectively those entities can be completely capitalized from outside Canada, obtaining funding in markets where they are not subject to Canadian thin capitalization rules. Those entities are not subject to any Canadian tax on the interest they receive and they are not subject to any spread that is taxed in Canada. Our members continue to be subject to Canadian tax on the difference between what they borrow for and the amount that they lend out at.

d. Third Party Guaranteed Debt

The Advisory Panel provides in Section 2.14:

> If Canada's thin capitalization rules need further revisions, different approaches are available. The maximum allowable debt-to-equity ratio could be adjusted or extended to cover third-party borrowings guaranteed by a related foreign corporation.[23]

In addition, the Advisory Panel also recognized that guaranteed debt may not necessarily be used to create excess debt to achieve a particular tax result.

There appears to be a perception in the Department of Finance that third party guaranteed debt is a direct substitute for equity and, in the absence of the ability to obtain a deduction, the foreign parent would have borrowed in their home country and made an equity contribution to Canada.

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[23] *Enhancing Canada's International tax Advantage*, Advisory Panel on Canada's System of International Taxation, April 2008, at page 30.

In an article entitled "*Canadian Budget: Corporate Tax Cuts Tighter Thin Cap Rules*," in the Journal of International Taxation, Andrew H. Kingissepp states that the application of the thin capitalization rules to guaranteed debt may produce unfair results. He states that:

> Debt guarantees by a foreign parent are a normal part of business financings, as are cross-guarantees of debt between Canadian companies and related foreign parties. These arrangements do not represent the surplus stripping by foreign parents that the thin capitalization rules are intended to thwart. The extension of the rules to guaranteed debt would apply, for example, to borrowings by a Canadian company from a Canadian bank that is secured by the guarantee of the company's foreign parent corporation.[24]

In international debt transactions, commercially it is usually more efficient (from a cross currency and relationship basis) to borrow in local markets and in local currency. Thus, regardless of the thin capitalization rules, a multi-national enterprise is not likely to borrow all of its credit needs in one country and then on-lend the proceeds as equity within a foreign country. Moreover, this would lead to loading all debt of the enterprise in its home jurisdiction leading to a base erosion in its own country. Multi-national enterprises will desire to cause their subsidiaries to borrow in their local jurisdiction to match currency and income.

Guarantees are needed in today's capital markets. Lenders and investors focus on the financial strength and willingness of the parent to support the local company. Financial markets, including "Wall Street", research the parent in great detail and do not have the ability or the perceived necessity to research subsidiaries in each foreign jurisdiction on a stand-alone basis. The parent guarantee acts as a proxy for creditworthiness so that the global presence of the parent can be leveraged to obtain best available funding. Moreover, rating agencies often base their rating of debt issued by a subsidiary company on the rating of the parent. As well, under Canadian securities law, a Canadian subsidiary is able to access capital markets using a prospectus and continuous disclosure materials based on the parent's home market filing under applicable securities laws, which allows the subsidiary to access funding within Canada rather than raising money abroad. Changes to include parent guaranteed debt in the thin capitalization calculations would interfere with capital markets and these requirements from investors. Canadian subsidiaries access capital markets through parent guarantees to satisfy creditor requirements, not as a substitute for parent equity.

Each local entity will not achieve the benefit of reputation, lending relationship, covenant pattern or lowest cost of funds without the possibility of unrestricted access to a related-party guarantee. In many circumstances, lenders in the domestic market provide funding only because there is a parent guarantee and therefore would not provide this financing to a standalone entity even if it was similarly capitalized to its parent largely due to its relative size. In most cases, the enterprise could not borrow in the domestic market on the same terms as it could with the guarantee. Moreover, to duplicate an enterprise within Canada that could operate on a standalone basis without the benefit of the parent guarantee would be near impossible and very expensive. Among CFLA members, a significant percentage of all leasing is undertaken by foreign-owned domestic members. In addition, the nature of the Canadian economy and the need for capital within this marketplace is so great that it cannot be fulfilled solely by Canadian domestic operations. The economy needs access to these sources of capital.

In addition, the Canadian multi-jurisdictional security system is designed to permit a foreign-owned entity in Canada easy access to the Canadian capital markets based on the guarantee of its parent. For example, a Canadian subsidiary that was otherwise trying to make a public offering of its notes would be unable to do so without issuing its own prospectus and its own standalone financial information. The costs of obtaining financing by this method would be prohibitive. Fortunately, the Canadian securities markets provide for an exemption that a Canadian subsidiary can, on the strength of the parent guarantee, use all of the financial statement reporting and securities law filings that have been made by its parent in the United States to allow it to file in Canada and raise financing in Canada.

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[24] Andrew H. Kingissepp, "*Canadian Budget: Corporate Tax Cuts Tighter Thin Cap Rules*", Journal of International Taxation, May 2000, at page 23.

The IDA, as noted above, in their March 31, 2000 letter, submitted that:

> the proposed changes will have a devastating impact on the liquidity and efficiency of domestic debt markets. Canadian Subsidiaries are active issuers in the short-term corporate paper market, and are also significant borrowers in the mid-term note market.[25]

The loss of these participants would damage market liquidity and there would be insufficient domestic Canadian paper of a liquid highly-rated nature both short-term and mid-term available for Canadian investors. The Canadian market is already sufficiently small such that there are not enough alternatives to government-rated Canadian dollar securities to meet the market appetite. The IDA further noted:

> The shrinkage of activity in the short-term and mid-term money markets will be completely contrary to the long-standing policy of the Government of Canada of encouraging the development of these markets which are seen as critical to the underpinnings and growth of the Canadian economy. In this regard we note that while this letter is focused primarily upon the capital markets impact of the proposed changes, it should be clear that a shrinkage in capital markets activity will have a corresponding negative effect on a number of other sectors of the economy, including, in particular, manufacturing and retailing.[26]

The IDA pointed out that there was no substantive evidence of tax abuse by Canadian subsidiaries of foreign corporations that would justify these proposed changes. As stated at the outset, any change should bring about a demonstrable benefit to Canadians and should be a real and pressing policy alternative to a demonstrable policy issue. The IDA concluded that:

> Canadian Near-Bank Subsidiaries supply competitively priced quality products and services to Canadian businesses and to individual Canadians which to a very significant degree are not currently available from Canadian-owned financial institutions. Thus, we believe that Canadian Near-Bank Subsidiaries should be encouraged rather than discouraged to expand their operations in Canada.[27]

Using a related-party guarantee reduces the costs of borrowing large amounts, because international financial institutions who are familiar with the parent corporation do not have to make an independent credit decision regarding the Canadian subsidiary as a stand-alone entity, including understanding the Canadian market, the unique business of the subsidiary in Canada and its collateral.

Alternatively, if change is necessary to deal with other taxpayers, the CFLA believes that appropriate exemptions for the finance, equipment and vehicle leasing industry must be provided. While the CFLA believes that such exceptions may be difficult to achieve, those changes should be implemented with an aim of minimizing administrative complexity and administrative uncertainty. Increased compliance complexities themselves will have a serious negative impact on the industry. If change is necessary, it should include clear bright line rules with no discretion for the CRA, a full exemption for financial services including leasing, an appropriate period for consultation with industry to resolve identified technical issues, a grandfathering for existing debts, simplicity in calculations, and an indefinite grand-fathering for non-deductible expense.

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[25] Letter from Investment Dealers Association of Canada to The Honourable Paul Martin, P.C., Minister of Finance, March 31, 2000, at page 3.

[26] *Ibid*. at page 3.

[27] *Ibid.* at pages 3-4.

8. IF CHANGES OCCUR, THE ASSET FINANCE AND LEASING INDUSTRY SHOULD BE TREATED DIFFERENTLY

Throughout the world, countries recognize that the financial services sector is of critical importance to their country's development and to the proper functioning of their markets. Most countries recognize that the financial services sector requires a greater degree of leverage than any other, and that comparisons between it and the general manufacturing base are not necessarily appropriate or desired.

What differentiates the financing, equipment and vehicle leasing industry from other lenders is that CFLA members generally receive rent income, not interest income. This difference has a large impact on the complexity of rules relating to the industry and in treating it comparably to other financial services. Lessors generally do not earn interest income but rather earn rent. Lessors generally have deductible interest expenses and capital cost allowance, as well as proceeds from the disposition of the financed asset (which itself may result in recapture of capital cost allowance or terminal losses). Lessors are also subject to a number of unique tax rules including the specified leasing property rules, the leasing property rules, the available for use rules and specified energy property rules. Moreover, lessors are usually part of a larger commercial enterprise and may be affiliated with non-leasing businesses, including entities that make loans or engage in factoring and entities that operate manufacturing businesses. The financing of such entitles may be on a combined basis for some financing and on a stand-alone basis for others. Finally, lease securitizations are more complex than for credit cards or mortgages due to the residual value risk and the fact that the lessor actually uses the financed asset -- it is not just a financial asset.

The December 2007 report of the New Zealand International Tax Review recognized the issue as follows:

> Submissions have pointed out that the general interest allocation rules may not be appropriate when applied to financial institutions, matters dealt with at present through the on-lending concession. However, for financial institutions that concession can lead to a different result than it does for foreign-owned banks which have to comply with the minimum capital requirements.
>
> Australia has dealt with this problem by introducing specific interest allocation rules for financial intermediaries. We are considering whether special rules should be introduced in New Zealand to deal with this situation. If such rules are to be contemplated, they would be subject to consultation with interested parties at a later date.[28]

CFLA notes that academic work regarding the incidence of the thin capitalization rules is growing but hampered by access to appropriate data. There are several recent macro-economic papers that posit that rational multi-national entities will have incentives to shift income to low tax jurisdictions and expenses to high tax jurisdictions (the base erosion conundrum). This issue is exacerbated where tax rules allow a deduction for interest in one country for income that is earned in another. It is less of an obvious issue where the interest is deducted in the same country as the income earned therefrom. The New Zealand experience referred to above attempts to ensure that an enterprise has consistent gearing across each country -- therefore it is not leverage itself that is bad, rather it is substantially higher leverage existing in New Zealand, as compared to another country, that poses a problem.

As pointed out above, if the enterprise is homogenous across each country, that seems a sensible rule. In practice, that is not true. Captive financial institutions are much less homogenous because the relative size and scope of their financial operations differs significantly across divisions and countries. Accordingly, CFLA strongly submits that any rules of general application be tested against its members to ensure that their unique circumstances can be accommodated. The lack of homogeneity among participants can lead to difficulty in crafting rules that allow desirable activity to continue.

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[28] Report of the Policy Advice Division of Inland Revenue and by the New Zealand Treasury, "*New Zealand's International Tax Review: The Treatment of foreign dividends and transitional issues*" (December 2007).

In the recent Canadian study, "*Debt-Equity Limitations in Thin Capitalization Rules: Canadian Evidence,*" referred to above,[29] the authors concluded that the gearing ratios among Canadian enterprises differ across industries. Their data set includes both Canadian-owned and foreign-owned enterprises. CFLA discussed the study with its authors who shared their data set. In reviewing various industries, the publicly available data, particularly for "Commercial Banks" and "Other Credit Institutions", did not contain data of specialized financing entities or unconsolidated special purpose entities of financial institutions. It was clustered on Canadian banks and mezzanine lenders. It is not clear in the context of the Canadian banks measured in the study that the ratio of long term debt to equity is an appropriate measure given the risk capital structure of such regulated financial institutions. As well, as the authors note, they measured long term capital to equity. Many industries may have short term or medium term inter-company amounts that fall within the thin-capitalization rules but otherwise did not fall in the study. Thus, some industries may in fact exceed a 2:1 ratio.

CFLA submits that the report's conclusions are generally not applicable to the leasing industry which was not part of their data set. In addition, long term debt is not necessarily a proxy for related party debt as in many situations related party debt is used to bridge temporary funding shortfalls or to provide warehouse financing until a securitization or other source may be used. Thus, we disagree with the assumption set out below that only long term debt would be owing to parents. Thus, the ratios may be higher than stated. The general conclusion that each industry is different, however, seems correct.

The study concluded:[30]

> The objectives of this study were to examine whether the constraining of the debt-equity ratio test from 3:1 to 2:1 in Canada's thin capitalization rules reflects leverage ratios of actual Canadian firms, and to assess how firms responded to this change in tax law across industries.
>
> This study uses two measures of leverage as a proxy for the technical definition of leverage contained in subsection 18(4) of the ITA. **Results show that leverage is statistically associated with industry.** When the debt-equity ratios are analyzed according to industry, the average debt-equity ratio is 1.102:1 under the narrow definition (LEV1) and 2.917:1 under the broader definition (LEV2). Approximately 51% of the total observations using LEV2 exceeded 2:1, and thus it may appear that the constraining of the ratio to 2:1 may not have been justified. However, the LEV2 definition is more of an economic definition of leverage than a technical definition per the ITA. If Canadian firms tend to have only long-term debt owing to their foreign parents, the narrow definition of leverage (more closely aligned to the tax definition) is more appropriate. In these instances, the reduction in debt-equity ratio appears to be warranted because the mean debt-equity ratio of 1.102 is well below 2:1, and 92.0% of firms report leverage ratios below 2:1.
>
> The Department of Finance justified the reduction by commenting that 2:1 ratios represented "actual Canadian industry debt-equity ratios". This study provides evidence that the new rules may not be punitive since the mean debt-equity ratio using the technical definition of leverage, which approximates the definition in the ITA, is well below 2:1. The sole exception to the above is the real estate industry which had a mean debt-equity ratio (using the technical definition of leverage) of 2.831:1, and which was significantly higher than the 2:1 threshold.
>
> …
>
> **It may be appropriate to alter the objective approach to Canadian thin capitalization so that certain industries are not penalized.** One solution is to adopt 'reasonable multiples' for industries, as Japan has done (KPMG 2005). This option would provide industry-specific ratios for industries such as banks, real estate and insurance. **However, it is difficult to identify and define specific industries, and to decide on a ratio for an industry, as well as difficult to assign firms to a specific industry if they operate in multiple industries.**

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[29] Jonathan Farrar and Amin Mawani, "*Debt-Equity Limitations in Thin Capitalization Rules: Canadian Evidence*", January 4, 2008, Working Paper, York University.

[30] *Ibid.* at pages 24-25.

The report also referred to "equipment rental and computer services business" (although this data set did not generally include CFLA members) as follows:

> Results from LEV2 suggest there were firms in four other industries – equipment rental & computer services, forestry, insurance, and motion picture services – whose leverage ratios exceeded 2:1 post-legislation. It is unclear whether these industries were penalized by the thin capitalization restriction because LEV2 is not a proxy for tax purposes.[31]

CFLA submits that, if changes occur, the leasing and asset-based finance should and needs to be treated differently. Its business is conducted in Canada. It provides substantial and unique benefits to Canada. Imposing additional taxes on such businesses is counter-intuitive to recent legislative changes such as the elimination of the withholding tax on interest, which the Advisory Panel states were implemented "to make Canada a more attractive place to conduct business".[32]

Creating appropriate carve-outs will, however, be difficult. One of the reasons why the CFLA advocates that no change be made is that it is not clear that the financial services businesses could be carved out. Most of our members are not regulated in Canada and many of them use special purposes entities such as trusts and other bankruptcy remote entities as part of their corporate groups. Most are linked with other entities such as equipment manufacturers, auto manufacturers, high tech equipment manufactures and other non-financial institutions. It will be difficult to either trace or make allocations of debt to them and their related industrial groups and would create unnecessary complexity.

The need for consultation. If changes are considered necessary, the CFLA requests that appropriate industry consultation be undertaken so that the rules can be introduced in a way that reduces complexity and minimizes the potential for harm to the Canadian economy. As stated above, the finance and leasing industry in Canada is unique and is not directly analogous to banks and other financial institutions. The nature of leasing, whereby the lessor receives rent and actually owns the underlying financed equipment means that rules that would otherwise be applicable to financial enterprises may not work well for leasing companies. As well, securitization and other financing techniques used by leasing companies are different than those used by traditional lending enterprises.

Most leasing companies, as well, have long-term financial commitments because leases have terms that run for many years. Even automobile leasing transactions today have terms longer than 36 months; many as long as 72 or 84 months. The ability of the industry to react quickly to changes in tax law or in changes that would require them to adjust their funding, including the amount of capital that they may be required to maintain in Canada can not be done quickly. As well, broad rules should be discussed with members of the industry to determine whether they may have subtle consequences that the draftspersons are not aware of due to the nature of the industry. These types of issues only surface during a consultation period in which industry works through the rules and identifies how they might apply to their particular circumstances.

The need for grand-fathering. In addition, grand-fathering is needed for existing relationships and mechanisms in order to permit sufficient time for long-term commitments to be run off, and so that decisions that were made at the time of inception of a financing transaction can be seen through to the end. Moreover, a transition period is also recommended to address conditions such as the current dislocation in the capital market where the implementation of new rules for new funding transaction might have unanticipated effects. In our industry, the number of individual transactions which are being undertaking with consumers is immense. Changes to these rules, including changing the pricing mechanism under which consumers and SME obtain credit can not usually be done on a dime. It is important that a sufficiently lengthy period of discussion and transition be undertaken so as not to create shocks in the marketplace or unanticipated effects.

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[31] *Ibid.* at page 22.

[32] *Enhancing Canada's International tax Advantage*, Advisory Panel on Canada's System of International Taxation, April 2008, at page 28.

9. CONCLUSIONS

CFLA submits that the current thin capitalization regime is working well, and that no demonstrable benefit would result to Canadians by making changes at this time. The results have worked since 1972 despite changes in the economy and to comparative international tax rates, and the rules do not appear to suffer any significant abuse. To the extent that abuses might be found to exist, they should be targeted on a specific line-item basis. New rules of general application and the need for specific carve-outs is an approach that should be avoided. Creating broad rules that will encompass large portions of the economy that are not subject to potential abuse, merely to ensure that the net is cast wide enough to capture every incident, will have a profound negative effect on those areas of the economy and will result in unneeded complexity in the legislation and compliance and audit burdens to create and administer appropriate carve-outs.

Canadian Finance & Leasing Association
Association canadienne de financement et de location

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