The Joint Committee on Taxation of
The Canadian Bar Association

and

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Mr. Ted Cook
Director General
Tax Legislation Division
Tax Policy Branch
Department of Finance Canada
90 Elgin Street
Ottawa, ON K1A 0G5

Dear Mr. Cook:

Subject: Impact of Pangaea Case

The purpose of this submission is to request that you consider taking action to respond to the recent decision of the Federal Court of Appeal in *Pangaea One Acquisition Holdings XII S.À R.L.*[1] ("**Pangaea**"). We are concerned that the decision in *Pangaea* may result in withholding of tax under Part XIII of the *Income Tax Act* (Canada) (the "**Act**")[2] by issuers of debt in inappropriate circumstances from a policy perspective, as explained below. We suggest that Finance Canada ("**Finance**") consider issuing a comfort letter to clarify the situation for Canadian issuers of debt securities.

Pangaea Reasons

The Court in Pangaea dealt with a peculiar fact pattern involving the sale of shares of a "target" company, Public Mobile, by several shareholders, including Pangaea. Under a shareholders' agreement, Pangaea had the right to veto the sale. Under a letter agreement between Thomvest (another shareholder) and Pangaea, Thomvest agreed to pay Pangaea $3 million in consideration

[1] 2020 FCA 21.
[2] Unless otherwise stated, all statutory references in this submission are to the Act.

for Pangaea agreeing to effectively waive its veto right and sign on to the share purchase agreement. The issue in the case was whether the $3 million payment was taxable under Part XIII as an amount paid in respect of a "restrictive covenant", as defined in subsection 56.4(1).[3]

On January 22, 2020, the Federal Court of Appeal held that the payment was subject to withholding tax as a payment in respect of a "restrictive covenant". The taxpayer had argued for a narrow interpretation of "restrictive covenant" based on a view of Parliament's legislative purpose at the time of enactment (that it was to impose tax on non-compete payments that had been ruled tax-free) and having regard to the legislative context. The Court rejected these arguments. The Court held that the "inclusive language" used in section 56.4 clearly went beyond non-compete payments, adding:

> "Even if a textual interpretation of section 56.4 gives rise to some applications of the provision that were not intended by Parliament, this is not a sufficient reason to conclude that the provision only applies to non-compete agreements."

In other words, the legislative text is extremely broad, and taxpayers should not presume that it is narrowed by any theories relating to Parliament's (perhaps narrower) legislative purpose. The breadth of this provision, as it has been interpreted, may also be in conflict with other provisions in Part XIII.

The Court's reasoning, coupled with the extremely broad language used in section 56.4, may cause Canadian issuers of debt obligations to withhold Part XIII tax on certain common types of payments to arm's length non-resident creditors. In our view, in some instances such withholding would tend to frustrate the tax policy objectives of Part XIII, including in particular the policy considerations underlying the Budget 2007 amendments to eliminate withholding tax on arm's length interest. Furthermore, the decision gives rise to added, and, we believe, inappropriate uncertainty as to the scope of paragraph 212(1)(i). We believe the situation should be clarified.

General absence of withholding tax reduces Canadian businesses' cost of capital

Canadian businesses rely upon the public and private debt markets to finance their operations. They are generally able to access foreign sources of debt capital at competitive rates, in part because there is generally no withholding tax on cross-border arm's length interest payments. While this was the case for many years in the long-term (>5 year) debt market, cross-border interest on short-term debt was generally subject to withholding tax prior to the 2007 amendments. Those amendments, in the context of contemporaneous changes to the Canada-U.S. Tax Treaty, reflected a basic policy decision to reduce the cost of capital to Canadian businesses, by eliminating the withholding tax on short-term or revolving borrowings.[4]

It is now generally understood by arm's length participants in the foreign debt markets that their return from loans to Canadian debtors will be free from withholding tax; likewise, Canadian issuers of debt securities generally understand that their cost of capital will not be inflated by

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[3] Paragraph 212(1)(i) imposes withholding tax where the recipient of the restrictive covenant payment is a non-resident.

[4] The economic burden of withholding tax is normally borne by the borrower through conventional "gross-up" clauses, or higher borrowing costs associated with access to a smaller (domestic) pool of available debt capital.

gross-up payments necessary to compensate holders for any withholding tax. This result flows from the fact that arm's length payments of interest are generally not taxable under Part XIII. Other miscellaneous payments to a non-resident debt holder, such as fees associated with the debt, are generally understood as not being subject to any other charging provision in Part XIII.

It is in this setting that we are concerned about potentially anomalous consequences arising from the *Pangaea* decision. In the remainder of this submission, we describe specific fact patterns[5] that have come to our attention and provide our suggestion as to the appropriate governmental response.

Before considering the specific examples, it is worth noting that prudent advisors will normally advise issuers to withhold Part XIII tax if there is any well-founded risk that such tax is payable, even where there are plausible arguments that the tax is not payable. This is because issuers of debt are liable to pay such tax (with penalties and interest) if it is ultimately found to be payable on amounts paid or credited by them to non-resident taxpayers holding their debt. While debtors have a statutory right of recovery against the non-resident taxpayer, this would be difficult or impossible to enforce in this context and usually rendered meaningless through a gross-up clause that would typically make the issuer responsible for such tax in any event. Furthermore, there is personal liability on directors for failure to withhold Part XIII tax, a feature that is especially relevant where the issuer is in financial difficulty.

The bottom line is that prudent issuers may feel compelled to withhold Part XIII tax on payments such as those described below. As discussed below, this ratchets up the cost of foreign capital – clearly at odds with the underlying policy rationale of the 2007 amendments.

Commitment Fees Paid to Arm's Length Lenders

In many contexts, fees and charges are payable by a borrower as consideration for the lender agreeing to lend money or make money available. In the context of a loan facility, these fees would often be referred to as "standby charges". These types of fees are pervasive, affecting a wide range of lending facilities in which lenders are paid amounts as consideration for agreeing to advance funds in connection with a current or future drawdown.

Such commitment fees and standby charges would not generally constitute interest.[6] It has generally been the view of most advisors (prior to *Pangaea*) that such fees and charges are not subject to Part XIII tax when paid to a non-resident of Canada.[7] This view was not based on a specific exception in the legislation, but rather on the simple fact that no provision in Part XIII

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[5] For clarity, these examples are those that have occurred to us to date and should be construed as illustrative rather than exhaustive. Other examples may be identified over time.

[6] Paragraph 214(15)(b) deems such fees to be interest only where the non-resident would be liable to Part XIII tax on the actual interest paid on the debt. Where the lender and borrower deal at arm's length, that would not normally be the case.

[7]Such amounts are generally understood to be taxable as ordinary income under Part I for a resident of Canada, either by virtue of such amounts constituting income from property or a business, or as a result of the application of paragraph 12(1)(x).

applies to subject these amounts to tax under that Part, including paragraph 214(15)(b). Commitment, standby and similar fees and charges are standard features of loan financing.

In view of the approach adopted by the Federal Court of Appeal in *Pangaea*, this analysis needs to be reconsidered. As noted by the Court, the definition refers to an "agreement … that affects, or is intended to affect, in any way whatever, the acquisition or provision of property or services by the taxpayer …". Is the agreement under which these fees are paid "intended to affect, in any way whatever, the acquisition or provision of property or services by the taxpayer [i.e., the lender]"? Arguably it is – it affects the provision of funds. The agreement is also intended to affect the acquisition of property by the lender, namely the debt obligation.[8] The *Pangaea* Court's rejection of a purpose-based approach to "read down" the extremely broad text leaves advisors with a well-founded concern that another Court may follow that approach and treat commitment fees, standby charges and other fees for agreeing to make money available as consideration for a "restrictive covenant", which puts paragraph 212(1)(i) in direct conflict with paragraph 214(15)(b) in such circumstances.

It seems clear that the imposition of Part XIII tax on such commitment fees and standby charges was not intended by Parliament, under any theory of the intended scope of section 56.4. Moreover, it seems to frustrate the Part XIII policy direction taken in recent years, as well as the long-standing policy reflected in paragraph 214(15)(b) that such fees should not be subjected to Part XIII tax if the underlying interest would not have been. Corrective action should in our respectful submission be taken, as described in more detail below.

Consent Fees Paid to Arm's Length Holders of Debt

From time to time, issuers of debt may seek to amend the terms of the debt. This may happen if the issuer is concerned that a positive or negative covenant may otherwise be breached by a corporate action the issuer wishes to take for business reasons. For example, the issuer may wish to enter into a merger, acquisition or combination agreement that may not be permitted under the original indenture. Alternatively, the issuer may be in financial difficulty and may wish to amend or restructure the debt, perhaps to loosen a financial covenant, or to delete other onerous covenants.

Typically, the issuer will require the consent of a specified majority, say two-thirds, of holders of the debt. It is not uncommon for issuers to seek such consent through a "consent solicitation" process. It is typical in such cases for the issuer to offer to pay an amount, in cash or otherwise, to each holder that consents to the proposed amendments by a specified date. The amount so paid may be relatively small or large, depending on the circumstances; we do not believe it is safe to assume such amounts will invariably be trivial – and, in any event, there is no authority under the Act to ignore trivial liabilities. Our specific concern relates to the treatment of such consent fees, when paid cross-border.

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[8] The exception in the definition of "restrictive covenants" for agreements that dispose of the taxpayer's property (the lenders' cash) will not assist because these fees are paid whether or not the funds ultimately are advanced. The fees constitute consideration for the lender putting itself in the position to be able to advance the funds.

Prior to the *Pangaea* decision, tax advisors were generally of the view that such consent fees were not subject to tax under Part XIII.[9] This view was not based on a specific exception in the legislation, but rather on the simple fact that no provision in Part XIII applies to subject these amounts to tax under that Part. While advisors might turn their minds to the possibility that such consent fees constituted consideration for a "restrictive covenant", as defined in subsection 56.4(1), and that they were therefore subject to Part XIII tax under paragraph 212(1)(i), it was widely considered that the admittedly broad statutory language could not really have been intended to capture such amounts, and that a properly directed Court would therefore conclude that this provision should not apply having regard to the provision's context and purpose.[10]

In view of the approach adopted by the Federal Court of Appeal in *Pangaea*, the prevailing analysis needs to be reconsidered. When a debt issuer offers to make a payment in consideration for a holder's consent, and the holder accepts that offer by consenting, an agreement is formed. Is the agreement "intended to affect, in any way whatever, the acquisition or provision of property or services by the taxpayer [i.e., the debt holder]"? It may be. The debt holder is consenting to changes in the terms of the underlying property (the debt). The agreement could be viewed as affecting the (ongoing) provision of property by the taxpayer, being the loaned funds, especially if the consent relates to an amendment of a covenant that could otherwise have been breached and allowed the taxpayer to demand repayment under an acceleration clause (or, more generally, to the extent the amendments affect the ongoing terms under which the loan will continue to be provided). Finally, if the amendments are significant enough to result in a novation, the debt holder also arguably "acquires property", i.e., the novated debt. There are of course reasonable arguments that consent fees should not be treated as consideration for a restrictive covenant, but *Pangaea* shifts the analysis by taking a highly textual approach. While borrower consent fees obviously differ from the facts in *Pangaea*, the Court's rejection of a purpose-based approach to "read down" the extremely broad text leaves advisors concerned that another court may well follow that approach and treat the consent fee as consideration for a "restrictive covenant".

Again, it seems clear that the imposition of Part XIII tax on consent fees in this context was not intended by Parliament, that the imposition of such tax would frustrate the Part XIII policy direction taken in recent and prior years, and therefore that corrective action should be taken, as described in more detail below.

Payments to Arm's Length Holders of Debt in a Restructuring Context

Another example of concern involves a distress restructuring situation.

Suppose an issuer is in severe financial difficulty, such that its debt is "under water", i.e., worth less than its face amount. Issuers in such circumstances will often propose an exchange of debt for shares. For example, the issuer may propose that holders exchange each debenture having

[9] Such amounts are generally understood to be taxable as ordinary income under Part I for a resident of Canada, either by virtue of such amounts constituting income from property or a business, or as a result of the application of paragraph 12(1)(x).

[10] In this regard, the reasoning in the 2018 Tax Court decision in *Pangaea* was widely discounted as erroneous and likely to be reversed or significantly narrowed on appeal.

a principal amount of $100 for shares having a fair market value of $40. Clearly, debt holders will be incurring a loss, and the issuer will have a "forgiven amount".

The issuer will often include a feature whereby debenture holders who agree to the exchange by a specified date will receive additional shares; for example, such an "early consenting" debenture holder might receive shares having a fair market value of $50. The additional $10 of value may properly be viewed as consideration for the debenture holder having agreed to consent to the restructuring plan by the specified date, rather than as consideration for the exchange itself, having regard to paragraph 68(c).

However, a similar analysis to that noted above could apply in this situation, potentially causing the issuer's advisors to warn that there is a material risk that the $10 "payment", when paid cross-border, would be subject to Part XIII tax for which the issuer is liable, and for which the members of the board are personally liable if the issuer does not have the resources to satisfy any assessed tax, penalty and interest. The situation is severely exacerbated by the fact that withholding is not a practical alternative, since the "payment" is not in the form of cash, and the issuer will be conserving cash for operations.

Canadian businesses engaged in a restructuring may simply dismiss this conventional approach as infeasible because of the withholding tax uncertainty. We do not believe Parliament intended to erect barriers to a restructuring of this nature.

Recommendation

We recommend that the Act be amended to treat payments of the sort described herein as deemed payments of interest (other than participating interest) under the related debt for Part XIII purposes.

This could be achieved by modifying subsection 214(15).

Paragraph 214(15)(b), which deals with standby and similar fees, could be modified by simply deleting the condition that the actual interest on the debt be taxable under Part XIII. This would have the effect of treating fees for making money available or agreeing to lend money, as interest for Part XIII purposes.

In order to address consent fees of the sort described above, a new paragraph could be added to subsection 214(15) to deem such fees to be interest for Part XIII purposes. We would be pleased to provide suggested wording if that would be helpful.

Finally, paragraph 212(1)(i) – the Part XIII charging provision for restrictive covenant payments - should be amended to specifically carve out amounts that are, or are deemed to be, interest for Part XIII purposes.

In order to provide certainty to Canadian debt markets, we would recommend that a comfort letter be issued stating (with the usual caveats) that Finance intends to recommend such amendments to the Minister.

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Members of the Joint Committee and others in the tax community participated in the discussion concerning this submission and contributed to its preparation, including:

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- Ian Crosbie – Davies Ward Phillips & Vineberg LLP
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- Carrie Smit – Goodmans LLP
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We trust that you will find our submission helpful. We would be pleased to discuss it further at your convenience.

Yours very truly,

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