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Deductibility of Currency Swap Payments: A Shift in the CCRA Position?

Debt financings in the U.S. and other foreign capital markets continue to be attractive to Canadian corporations. Such financings are frequently structured on a basis that will qualify for the so–called "medium term debt" exception from withholding tax on interest payments.

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Unless otherwise indicated, all statutory references are to the *Income Tax Act*, R.S.C. 1985 (5th Supp.), c. 1, as amended (the "Act"). Witholding tax on interest is provided for in Part XIII of the Act, subject to a number of exceptions. The medium term debt exemption is contained in subparagraph 212(1)(*b*)(vii).

However, foreign currency borrowings expose the Canadian borrower to currency gains or losses as a result of the fluctuation in the value of the foreign currency relative to the value of Canadian currency. One common method which has been used by Canadian borrowers to avoid foreign exchange gains and losses is the cross–currency swap.

Typical Currency Swap

A relatively common currency swap entails a foreign currency borrowing, say in U.S. dollars, by a Canadian borrower.

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For the purposes of this example, it will be assumed that no principal payments are required during the term of the borrowing, and therefore, all payments made by the Canadian borrower prior to the maturity of the loan will be on account of interest only.

To reduce the foreign currency risk associated with such a foreign borrowing, the Canadian borrower then enters into a *bona fide* arrangement with a counterparty, under which the Canadian borrower exchanges the U.S. dollars borrowed for the Canadian dollar equivalent. For the duration of the arrangement, the Canadian borrower will exchange, with the counterparty, Canadian dollars for sufficient U.S. dollars to meet the periodic interest payments due its U.S. borrowing obligation. On a set redemption date, the Canadian borrower will reswap the currencies at the same amounts initially swapped and repay the U.S. dollar borrowing.

The Canada Customs and Revenue Agency (the "CCRA") has a long–standing published administrative position with respect to such swap arrangements.

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See, for example, "Revenue Canada Round Table", in *Report of Proceedings of the Thirty–Sixth Tax Conference*, 1984 Conference Report (Toronto: Canadian Tax Foundation, 1985), 783, question 60, at 8:26–7, where the CCRA considered a more complex variation of a swap arrangement involving the swap of two foreign currencies. The CCRA's administrative position, as stated in 1984, has been confirmed by subsequent publications, most recently on August 25, 2000 in CCRA document 2000–0036045 entitled "Cross currency swaps".

Applying those principles to the swap arrangement described above, periodic swap payments made and received by the Canadian borrower would be considered to be on income account, the Canadian–dollar equivalent of the interest paid or payable on the U.S. dollar borrowing would be deductible by the Canadian borrower in computing its income in accordance with paragraph 20(1)(*c*) of the Act, and provided the terms of the U.S. dollar borrowing conform to the requirements specified in subparagraph 212(1)(*b*)(vii), the interest payments made by the Canadian borrower on that debt would not be subject to Part XIII tax. As a result, the U.S. dollar periodic swap payments received by the Canadian borrower would offset the U.S. dollar interest payments made by the Canadian borrower, and the Canadian borrower would be left with a net deduction of an amount equal to the amount of the Canadian dollar periodic swap payments made in each year of the swap arrangements. Further, any foreign exchange gain or loss related to the U.S. dollar principal swap payment at the end of the swap would be the same as the foreign exchange gain or loss which arose on the repayment of the principal of the U.S. dollar borrowing (most likely on capital account for long–term borrowings). Such offsetting treatment should ensure that no net gain or loss occurred on the repayment of the U.S. dollar borrowing. In effect, such arrangements would put the Canadian borrower in the same position as if it had borrowed in Canadian currency at an interest rate equal to the notional interest rate which was used to calculate the Canadian dollar periodic swap payments which were required to be made under the swap. Typically, the net borrowing cost to the Canadian borrower under the swap arrangements would be lower than the cost of a corresponding borrowing in Canadian dollars.

A Shift in the CCRA Position?

The long–standing position of the CCRA in relation to cross–currency swaps, as described above, has been called into question in a recently released technical interpretation.

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CCRA document 2000–0051017, entitled "Strong Currency Loan Hedged by a Cross–Currency Interest Rate Swap".

While all of the facts that were under consideration by the CCRA in relation to this technical interpretation are not known, it appears that a Canadian borrower borrowed Yen at a relatively low rate of interest and then entered into a cross–currency swap, similar to that described above, of Yen for Canadian dollars. It is understood that the spread between the interest rate on the Yen borrowing and the interest rate on the Canadian dollar notional principal amount (which determines the amount of the Canadian dollar periodic swap payment) was relatively large, possibly as much as 500 basis points. The CCRA took the position that the Canadian dollar principal swap payment that was payable by the Canadian borrower in order to receive the Yen principal swap payment at the maturity of the loan was "much more favourable to the [Canadian borrower] than the exchange rate the market was predicting" when the swap was entered into, and concluded that a portion of the Canadian dollar periodic payments made by the Canadian borrower (which would otherwise be deductible to the Canadian borrower) during the term of the swap, should be regarded as the cost of the right to acquire the Yen principal swap payment at the favourable rate. The CCRA stated that "the cost of such right would, in our view, be included in the computation of the gain or loss on a hedge in respect of the principal amount of the loan". In other words, the reallocated cost would produce a loss (which the CCRA determined to be a capital loss) on the principal swap payment and the repayment of the Yen loan.

The Technical Interpretation gives no indication as to how the "capital" portion of the Canadian dollar periodic swap payments should be determined. Moreover, it is unclear what was meant by the reference to a "much more favorable" exchange rate in relation to the Canadian dollar principal swap payment. One possibility is that a comparison was made to the exchange rate that would have applied to a forward purchase of the amount of Yen that would have been required to repay the principal amount of the borrowing on its maturity date. Whether it would be appropriate for the CCRA to disregard the actual transaction that was undertaken because of a perceived fiscal benefit is questionable.

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Such an approach was rejected in *Shell Canada Ltd. v. The Queen*, [1999] 3 S.C.R. 622, as indicated by the following excerpt from the judgment of Madam Justice McLachlin (now Chief Justice) at para. 46:

Inquiring into the "economic realities" ... has an unfortunate practical effect. *This approach wrongly invites a rule that where there are two ways to structure a transaction with the same economic effect, the court must have regard only to the one without tax advantages.* With respect, this approach fails to give appropriate weight to the jurisprudence of this Court providing that, in the absence of a specific statutory bar to the contrary, taxpayers are entitled to structure their affairs in a manner that reduces the tax payable ... An unrestricted application of an "economic effects" approach does indirectly what this Court has consistently held Parliament did not intend the Act to do directly. [Emphasis added]

The CCRA's concern is apparently that the Canadian dollar periodic payments were inflated with the result that the Canadian borrower would have a "larger than appropriate" annual deduction during the term of the foreign currency loan. This concern appears to be misguided in circumstances in which the amount of the Canadian dollar periodic payments is less than the amount of interest that would have been payable if the borrowing had been denominated in Canadian dollars, rather than in the foreign currency.

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It is noteworthy that in *Shell, supra*, the Crown argued that the deduction available to the taxpayer on a so–called "weak currency" borrowing should be limited to the amount that it would have been able to deduct if its borrowing would have been made in Canadian dollars. Subsequent to *Shell*, section 20.3 was enacted to limit the otherwise currently deductible amount of interest expense on "weak currency debt" to, in essence, the amount of interest payable on a comparable borrowing in the currency that the borrower uses to earn income.

Whether or not the position described in the Technical Interpretation will be the basis for reassessment of cross–currency swaps remains to be seen.

Footnote

We have recently observed cross–currency swaps in relation to U.S. dollar borrowings in which the spread between the implicit Canadian dollar interest rate (used to determine the Canadian dollar periodic swap payments) and the interest rate on the U.S. dollar borrowing has been as low as 15 to 30 basis points. It is not clear that the approach embodied in the Technical Interpretation would produce a material net benefit to the CCRA in such circumstances.

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