(March 2002), 6 International Tax News Letter 1.

General Electric Capital Equipment Finance Inc. v. The Queen

Subparagraph 212(1)(b)(vii): A Change in Obligation Differs from Novation

In structuring debt financing arrangements in foreign capital markets, Canadian corporate borrowers often rely upon subparagraph 212(1)(*b*)(vii), [1]

Footnote

Unless otherwise indicated, all statutory references are to the *Income Tax Act*, R.S.C. 1985 (5th Supp.), c. 1, as amended (the "Act").

the so-called "medium term debt" exception from withholding tax on interest payments. Under this provision, interest payable by a Canadian corporation to an arm's length non-resident lender is exempt from withholding tax as long as certain requirements are met. One such requirement is that the borrower cannot be required to pay more than 25% of the principal amount of the debt obligation within five years from the date of its issuance. In its recent decision in *General Electric Capital Finance Inc.*, [2]

Footnote

General Electric Capital Finance Inc. v. The Queen, 2001 FCA 292, affirming 2000 DTC 6513 (TCC) ("*General Electric*").

the Federal Court of Appeal had the opportunity to consider an issue that has often troubled practitioners: whether amendments to a debt obligation which initially meets the requirements of subparagraph 212(1)(*b*)(vii) will create a "new" obligation, such that the requirements of subparagraph 212(1)(*b*)(vii) will have to be re-satisfied as of the date of such amendments.

The CCRA Administrative Practice

Somewhat surprisingly, prior to *General Electric*, there was little tax jurisprudence which dealt with the issue of whether amendments to an outstanding debt obligation result in termination of such original obligation and creation of a new one. As a result, taxpayers were left to rely on the administrative position of the Canada Customs and Revenue Agency (the "CCRA"), which has itself changed over the years.

The CCRA has stated that, if an obligation is renegotiated otherwise than in accordance with its terms, it is a question of fact whether a new obligation has been created. [3]

Footnote

Interpretation Bulletin IT-361R3, *Exemption from Part XIII Tax on Interest Payments to Non-Residents* (February 12, 1996), para. 14.

In assessing whether amendments to the terms of a debt obligation will constitute a disposition of that debt obligation, the CCRA has historically endeavored "to establish whether or not it is reasonable to regard the amended security being the same property as that which underwent the change", stating that certain changes are so fundamental to the holder's economic interest in the property that they almost invariably will constitute a disposition.

Footnote r

Interpretation Bulletin IT-448, *Dispositions — Changes in Terms of Securities* (June 6, 1980), paras. 4 and 7.

These changes include: a change from interest-bearing to interest-free or *vice versa*; a change in repayment schedule or maturity date; a change in principal amount; the addition, alteration or elimination of a premium payable upon retirement; a change in the debtor; or the conversion of a fixed interest bond to a bond in respect of which interest is payable only to the extent that the debtor has made a profit or *vice versa*.

The CCRA administrative position has been criticized on the basis that it appeared to emphasize the economic interest of the creditor rather than the legal relationship between the debtor and the creditor. It has been argued that since a debt is a legal contract between the debtor and creditor, the determination of whether amendments to the terms of a debt result in the creation of a new debt should be made by reference to the legal principles of novation and rescission.

Footnote r

See, for example, Brian J. Arnold and David A. Ward, "Dispositions — A Critique of Revenue Canada's Interpretation" (1980), vol. 28, no. 5 *Canadian Tax Journal* 559-84 and J. Scott Wilkie, "Non-Resident Witholding Tax: Corporate Obligations," *Report of Proceedings of Forty-Sixth Tax Conference*, 1994 Tax Conference (Toronto: Canadian Tax Foundation, 1995), 17:1-65.

In response to these criticisms, the CCRA revised its administrative position in 1998, stating as follows:

... if a debt obligation is renegotiated otherwise than as provided for in its original terms, the determination of whether a change in its terms is a substitution of a debt obligation for another *should be made in accordance with the law of the relevant jurisdiction.* ...

[In provinces other than Quebec], a rescission of a debt obligation will be implied when the parties have effected such an alteration of its terms as to substitute a new obligation in its place, which is entirely inconsistent with the old, or, if not entirely inconsistent with it, inconsistent with it to an extent that goes to the very root of it. In such a case, it is appropriate to view the original obligation as having been disposed of for income tax purposes.

[emphasis added]

Footnote r

Income Tax Technical News No. 14 (December 9, 1998). See also *Income Tax Technical News* No. 15 (December 18, 1998), where, in the context of whether the conversion of certain currencies to Euro resulted in the disposition of the former obligation and the creation of a new obligation, the CCRA stated the determination should be made by applying the law of novation or rescission.

General Electric

Notwithstanding the CCRA's apparent acceptance of the legal doctrines of novation and recission, the reasoning of the Federal Court of Appeal in *General Electric* is reminiscent of the pre-1998 CCRA position.

In *General Electric*, the Court considered the exigibility of withholding tax on interest payments made on certain promissory notes which were issued by the taxpayer to parties which were related to the taxpayer at the time of issuance of such notes. The terms of the notes initially complied with the subparagraph 212(1)(*b*)(vii) requirements, except that the taypayer and the noteholders did not deal at arm's length. After a number of years, the parties entered into a series of agreements which had the effect of increasing the interest rate to gross-up for the exigible withholding tax, reducing the principal amount by the amount of the withholding tax that the Canadian borrower was required to pay to the Minister on assessment for withholdings it had failed to make, and extending the maturity date for one year. In addition, the shares of the taxpayer were acquired by General Electric with the result that the taxpayer and the noteholders dealt at arm's length from and after that point in time. When the Minister assessed for failure to withhold, the taxpayer appealed, arguing that withholding tax was not exigible, by virtue of subparagraph 212(1)(*b*)(vii), because the interest was paid to an arm's length party and the original terms of the notes otherwise met the requirements of subparagraph 212(1)(*b*)(vii). The Minister argued that the amendments to the original notes resulted in a rescission of the original obligations and the creation of new obligations that did not meet the requirements of the subparagraph 212(1)(*b*)(vii) because their terms were less than five years.

At trial, the Federal Court dismissed the taxpayer's appeal, finding that the original promissory notes were so materially altered that they resulted in completely new obligations for the purposes of subparagraph 212(1)(*b*)(vii). Interestingly, the trial judge did not cite any authorities for his conclusion and, in fact, found the authorities on the doctrine of novation "to be of little value in the determination".

On appeal to the Federal Court of Appeal, the taxpayer argued that the only way an existing legal obligation could be superceded so as to acquire a new issue date, for the purposes of subparagraph 212(1)(*b*)(vii), was by means of a novation. In addressing this argument, the Federal Court of Appeal held that whether or not a new obligation had been created was a question of fact, but, because the term "novation" is not used in subsection 212(1), a novation, as it is understood in the common law of contract, is not required before there can be a new obligation for the purposes of that provision.

The Court then turned to the question of whether the transactions created a new obligation rather than a modification of the existing obligation. The Court took guidance from previous jurisprudence

Footnote r
Wiebe v. The Queen, 87 DTC 5068 (FCA).

in which it was held that fundamental changes to a stock option agreement, which substantially affected the basic elements of the agreement, were inconsistent with the continuing existence of the agreement. On this point, the Court of Appeal concluded as follows:

... when it can be said that substantial changes have been made to the fundamental terms of an obligation which materially alter the terms of that obligation, then a new obligation is created within the meaning of subparagraph 212(1)(*b*)(vii).

Footnote r
Supra at note 2, para. 16.

In the case of debt instruments such as the promissory notes in question, the Court held that the fundamental terms were as follows: the identity of the debtor, the principal amount of the note, the interest rate and the maturity date. Interestingly, these factors are much like those contained in the former CCRA administrative position as being so fundamental to the holder's economic interest in the property that a change in any of them will almost invariably constitute a disposition of such property. In the circumstances before the Court, all but one of these fundamental elements had been changed, and the Court found that new promissory notes had been created. As a result, the appeal was denied.

The decision of the Federal Court of Appeal appears to have moved away from a strict legal approach to the determination of whether an amendment to an existing debt obligation has the effect of creating a new obligation. Instead, the determination will now rest on an analysis of whether there has been a change to the "fundamental terms" of such debt obligation. It remains to be seen whether the above reasoning will survive an appeal to the Supreme Court of Canada.

Footnote r
It is our understanding that the taxpayer has applied to the Supreme Court of Canada for leave to appeal. At the time of publication, this application had not yet been heard by the Court.

— C. Michael Ryer and Anu Nijhawan, Bennett Jones LLP, Calgary