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Canadian Stripped Coupon Interest

Stripping Coupons, Filling Gaps: Proposed Amendments to Canadian Withholding Tax on Interest

Until recently in Canada, there was little reason to believe that application of withholding tax to interest payments on an interest-bearing debt would depend on whether the coupon had been stripped. That has changed with the Proposals, which, as noted, are a response to Lehigh Cement.

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If the whole is greater than the sum of its parts, it is also true at times that the parts, separated from each other, can become more complex than the whole. This appears to be increasingly so in Canada with respect to withholding tax on interest. Two recent developments bear on the circumstances in which Canadian nonresident withholding tax will apply to interest payments when the right to receive interest on a debt has been separated or “stripped” from the right to receive principal. On November 4, 2010, the Supreme Court of Canada denied leave to appeal in *The Queen v. Lehigh Cement Limited.*, so the Federal Court of Appeal (FCA) decision stands.[1] In that decision, an interest coupon stripping transaction that was intended to access an exemption from withholding tax on interest was found not to be subject to Canada's general anti-avoidance rule (GAAR). On March 16, 2011, the Canadian Department of Finance responded to the FCA decision with proposed amendments ("Proposals") that will subject otherwise exempt outbound interest payments to Canadian withholding tax in certain circumstances where the interest coupon has been stripped from the underlying debt instrument or loan.[2]

Background—Canadian Withholding Tax on Interest

The recent changes to withholding tax on stripped interest are best understood against the background of the existing Canadian withholding tax regime. Under Part XIII of the Income Tax Act (Canada) (ITA), certain amounts, including interest, that are paid or credited by a Canadian resident [3] to a nonresident of Canada are subject to a 25% tax. Although the primary liability for Part XIII tax is that of the nonresident payee, the Canadian-resident payor of an amount that is subject to Part XIII tax is required to withhold and remit the tax on behalf of the nonresident. In addition, an agent of either the payor or the payee may be required to withhold and remit Part XIII tax that was not withheld and remitted by the payor. The 25% rate is subject to reduction by treaty.

ITA paragraph 212(1)(b) imposes Part XIII tax not only on amounts paid or credited as, or in satisfaction, of interest; it also applies to amounts paid or credited “on account or in lieu of” interest. For example, if a borrower defaults on a loan, payments to its creditors by a guarantor in respect of accrued and unpaid interest on the guaranteed debt are considered by Canadian tax authorities to be made “in lieu” of interest. [4] Also, certain amounts are deemed to be interest under the ITA. For instance, if a nonresident person assigns or transfers to a Canadian resident a debt obligation issued by a Canadian resident person, the accrued but unpaid interest on the obligation may be deemed to have been paid as interest by the transferee to the transferor. [5] Further, when a borrower under a securities loan pays to the securities lender amounts equivalent to dividends or interest paid on the loaned securities, these substitute payments may be deemed to be interest. [6] Guarantee fees in respect of the indebtedness of a person resident in Canada, along with loan standby fees, are also deemed to be payments of interest. [7]

Under current law, after 2007, the provision that imposes withholding tax on amounts paid or credited as, on account or in lieu of, or in satisfaction of interest has treated three categories of interest differently for Part XIII tax purposes:

- “Fully exempt interest” is, as the name suggests, generally exempt from Part XIII tax. [8]
- “Participating debt interest” is subject to Part XIII tax regardless of whether the nonresident recipient deals with the payor at arm's length.
- Interest that is neither “fully exempt interest” nor “participating debt interest” is subject to Part XIII tax unless it is paid or credited to a person with whom the debtor deals at arm's length. [9]

The first category, “fully exempt interest,” very generally consists of interest that is paid or payable on, *inter alia:*

- Debt obligations issued by the Canadian federal government, a provincial or municipal government, certain governmental and quasi-governmental entities, and certain tax-exempt organizations.
- Mortgages in respect of real property located outside of Canada, except where the interest on the mortgage is deductible in computing income in Canada.
- Debt obligations issued by certain international organizations.

“Participating debt interest” is interest all or any portion of which is (1) contingent or dependent on the use of or production from property in Canada; or (2) computed by reference to revenue, profit, cash flow, commodity price, or any other similar criterion, or by reference to dividends paid or payable to shareholders of any class

of shares of the capital stock of any corporation.

For non-government debt, the most commonly encountered types of interest payments will be neither “fully exempt interest” nor “participating debt interest.” For this third, residual category, the availability of an exemption from Canadian withholding tax under the ITA will turn on whether the nonresident person to whom the interest is paid or credited deals “at arm's length” with the resident obligor. There are two ways for persons to be considered not dealing at arm's length with each another for ITA purposes. First, persons that are “related” for ITA purposes are deemed not to deal at arm's length.[10] A series of complex rules applies to determine whether two corporations are related; they depend on the jurisprudential concept of *de jure* (very generally, voting) control.[11] Thus, for example, two corporations are related—and, therefore, deemed not to deal at arm's length—if one controls the other or if, under certain circumstances, the two corporations are commonly controlled. Second, whether two unrelated persons deal at arm's length at a particular time is determined based on the relevant facts concerning the relationship. Canadian courts have generally considered a common mind directing the bargaining of both parties, the parties acting in concert without separate interests, or the existence of *de facto* control, as indicative of (factual) non-arm's-length status.

If it is determined that the interest payor and payee are not dealing at arm's length (and the interest is not “fully exempt interest”), the interest will not be exempt from withholding tax under the ITA. However, a bilateral income tax treaty may still reduce or eliminate the Canadian withholding tax that otherwise would be imposed. Article XI(1) of the Canada-U.S. tax treaty ("Treaty") generally exempts Canadian-source interest payments to a U.S. resident from Canadian withholding tax (and vice versa), without regard to whether the payor and payee are unrelated or deal at arm's length.[12] Like the ITA, the Treaty does not exempt from source-country taxation certain participating interest payments.[13]

Stripped Coupons—Recent Developments

Like many other forms of property, a conventional, interest-bearing debt can be conceived of as conferring on its holder a bundle of rights, including two primary components: (1) the right to interest or “coupon” payments [14] and (2) the right to repayment of the principal at maturity. Unbundling these rights occurs frequently. In the bond markets, for instance, investment dealers and other financial institutions may separate (strip) a conventional bond into its constituent parts—entitlement to separate future interest payments, and a residual representing entitlement to payment at maturity of the principal amount—each of which may then be sold and held separately.

For the size of its capital markets, Canada has a well-developed market in stripped bonds.[15] While the majority of this market is in (primarily provincial) government obligations,[16] it extends to obligations of Canadian corporations. In certain instances, the debt issuer will sponsor or participate in the stripping of its own debt, but more frequently coupon stripping is undertaken by financial institutions in the secondary market without involvement or perhaps knowledge of the debt issuer. Coupon stripping is typically a response to imbalances in supply and demand in the debt market—as demand for debt with appropriate credit quality and a certain duration outstrips supply, the aggregate resale price of stripped coupons and residual may exceed the trading price of the underlying debt in amounts sufficient to cover costs and provide an intermediary with a spread for purchasing and stripping corporate debt.

Until recently in Canada, there was little reason to believe (subject to potential application of GAAR) that application of withholding tax to interest payments on an interest-bearing debt would depend on whether the coupon had been stripped. That has changed with the Proposals, which, as noted, are a response to *Lehigh Cement.*

Lehigh Cement

In *Lehigh Cement*, the Canada Revenue Agency (CRA) unsuccessfully sought to use GAAR to deny application of an exemption from Canadian withholding tax to a stripped interest payment. Lehigh was a Canadian resident corporation that was a member of a multinational corporate group, the parent company of which was a German corporation, Heidelberger Zement ("HZ Group"). In 1986, Lehigh borrowed $140 million under a term facility from a group of Canadian banks, which then sold the term loan to a nonresident member of the HZ Group. In 1997, the term loan was restated in the form of a note ("Note") that expressly permitted separate holding of the rights to receive principal and interest. The terms of the Note were amended to include a "gross-up" from Lehigh should Canadian withholding tax apply. Soon thereafter, the nonresident member of the HZ Group then holding the Note sold the right to receive interest payments to a Belgian bank ("BBL"). A member of the HZ group continued to hold the right to be paid the principal at maturity.

During the tax years at issue, the relevant exemption from Canadian withholding tax for arm's-length debt was narrower than the arm's-length interest exemption described above.[17] However, the most relevant aspect of the exemption at issue in *Lehigh Cement* was the requirement that the interest payor and payee deal at arm's length. Prior to 1997, when a nonresident member of the HZ Group held the right to interest (and principal), the arm's-length condition was not met. Therefore, during those years Lehigh duly withheld and remitted Part XIII tax to the Canadian government when it made interest payments on the Note. However, once the interest coupon was sold to an arm's-length party (BBL), Lehigh began to treat the interest payments as exempt from withholding tax.

The CRA sought to deny that the interest payments to BBL on the Note were exempt from Canadian withholding tax. The ground for the CRA's challenge was not that the technical requirements of the relevant exemption (ITA former subparagraph 212(1)(b)(vii)) had not been met, but rather that the tax benefit should be denied under GAAR. Under this statutory rule, a tax benefit arising from a primarily tax-motivated transaction may be denied if allowing the tax benefit would result in a misuse or abuse of the ITA (individual provisions or read as a whole). Lehigh conceded that the sale of the right to interest payments to BBL was an "avoidance transaction" entered into to obtain a "tax benefit" (exemption from Part XIII tax), so that the only issue was whether there was a "misuse or abuse" of the statutory withholding tax exemption in ITA subparagraph 212(1)(b)(vii).

According to principles established in the leading case on the application of GAAR,[18] there would be a "misuse or abuse" in this circumstance if allowing Lehigh the benefit of the exemption in subparagraph 212(1)(b)(vii) would be inconsistent with the object, spirit, or purpose of that provision. At trial, Justice Mogan found that the purpose of the provision was to lower the borrowing costs of Canadian corporations by increasing their access to international capital markets, and that the sale to an arm's-length party of the right to receive interest on debt already owing to a non-arm's-length party was inconsistent with the legislative purpose so

construed, since no new capital was accessed from a non-Canadian lender. On this ground, the Tax Court of Canada applied GAAR to require that Canadian tax be withheld on the arm's-length interest payments. [19]

The FCA reversed the lower court decision, essentially because it found that the Canadian government had failed to discharge its evidentiary burden of establishing that what Lehigh, the HZ Group, and BBL had done would frustrate a clear purpose of subparagraph 212(1)(b)(vii). The FCA disagreed that Parliament's intent in drafting subparagraph 212(1)(b)(vii) was that the exemption should apply only to interest payments on debt where the indebtedness had originated in a borrowing from international capital markets. The court found insufficient evidence of such an intent in either the legislative history [20] or the text of subparagraph 212(1)(b)(vii), which required the arm's-length test to be met between the payor and payee of interest rather than the payor and payee of principal.

In the course of its reasoning concerning GAAR, the FCA observed:

> [T]hat an exemption may be claimed in an unforeseen or novel manner, as may have occurred in this case, does not necessarily mean that the claim is a misuse of the exemption. It follows that the Crown cannot discharge the burden of establishing that a transaction results in the misuse of an exemption merely by asserting that the transaction was not foreseen or that it exploits a previously unnoticed legislative gap.

If the use of interest stripping on non-arm's-length debt to obtain the benefit of an exemption for arm's-length interest indeed constituted the exploitation of a "previously unnoticed legislative gap," as the Crown asserted in *Lehigh*, subsequent developments indicate that the Canadian government has both taken notice and moved to fill that gap.

Draft Legislative Proposals

The March 16, 2011, Proposals are specifically targeted at the application of Canadian withholding tax to stripped coupon payments. [21] The Proposals would affect only the residual category of interest payments described above (i.e., those that are neither "fully exempt interest" nor "participating debt interest"). Fully exempt interest—for instance, interest paid on Canadian government bonds—remains exempt from Canadian withholding tax when stripped, regardless of who holds the residual. This is significant since the majority of the market for stripped Canadian debt is for government debt. [22]

Participating debt interest remains subject to Canadian withholding tax regardless of whether it is stripped. Under current law, interest other than fully exempt interest or participating debt interest is subject to Part XIII tax only if it is paid or payable to a nonresident person with whom the resident payor does not deal at arm's length. The Proposals would also make this interest subject to Part XIII tax if it is "paid or payable ... in respect of a debt or other obligation to pay an amount to a person with whom the payer is not dealing at arm's length." [23] For example, where the right to interest on a debt owing by a Canadian resident borrower to a non-arm's-length lender has been stripped and transferred to an arm's-length nonresident holder, interest payments would be subject to Part XIII tax notwithstanding that the payor and payee of the interest deal at arm's length, because the interest would be paid or payable "in respect of a debt ... [owing to] a person with whom the payer

is not dealing at arm's length.”

As noted above, the Department of Finance said that the amendments regarding stripped interest were introduced in response to the FCA decision in *Lehigh Cement.* In materials accompanying the draft legislation, the Department stated that the purpose of the exemption from Part XIII tax for arm's-length interest payments is “to give Canadians improved access to international capital markets and to lower their borrowing costs.” [24] On this basis, it said that “the sale by a non-arm's length non-resident of the interest portion of a loan to a non-resident that deals at arm's length with the payer in order to avoid withholding tax is not consistent with these objectives, since the debt is still held by a non-arm's length party and the borrowing cost for the resident of Canada is unchanged.” [25]

The Proposals have the potential to affect nonresident, arm's-length holders of stripped coupons who may have acquired their coupons based on the interest being exempt from Canadian withholding tax, so it is important to know when the Proposals would take effect. As a general rule, the proposed amendment to paragraph 212(1)(b) would apply to interest that is paid or payable after March 15, 2011. Thus, once enacted, the amendment would apply retroactively. There is an exception for interest paid (1) in respect of a debt or obligation incurred by the interest payor before March 16, 2011, and (2) to a recipient that acquired the entitlement to the interest under a written agreement or arrangement that the recipient entered into before that date. In other words, interest paid on a stripped coupon to a nonresident who held the coupon entitlement on March 16, 2011, generally would be grandfathered. [26]

Impact on U.S. Holders

If the Proposals are enacted without change, they will have a more limited impact on stripped coupon holders in the United States than in other jurisdictions. The treaty with the United States is the only one of Canada's tax treaties that provides for a full exemption from withholding tax on interest. Accordingly, if the Proposals are enacted, where a Canadian resident obligor pays or credits stripped interest to an arm's-length U.S. resident who is entitled to benefits under the Treaty, Canadian withholding tax should not apply even if the interest is paid “in respect” of an obligation to pay principal to a non-arm's-length person. [27]

Capital Markets Implications

As the FCA stated in *Lehigh Cement*, stripping interest coupons from bonds is a common occurrence in debt markets. Indeed, Canadian income tax law has long recognized the practice. ITA subsection 240(2), which was enacted in 1966, provides that coupons that do not form part of, or are capable of being detached from, a debt obligation must be stamped as withholding tax exempt or withholding tax exigible. The FCA cited this provision in *Lehigh* in declining to apply GAAR, noting that in enacting this provision in the specific context of nonresident withholding tax, Parliament had expressly contemplated stripping entitlement to interest from an underlying debt obligation.

While subsection 240(2) was introduced in the context of coupons that were physically clipped or detached from bonds held in physical form, the underlying premise of the statutory provision—that a nonresident purchasing a stripped coupon owing by a Canadian corporate issuer should be able to determine whether the

interest would be subject to or exempt from Canadian withholding tax—remains valid in the current market for stripped coupons. Prior to 2008, this would involve determining, by reference to either any nonresident tax disclosure in respect of the corporate debt or its underlying terms, that the debt qualified for the exemption from withholding tax under ITA former subparagraph 212(1)(b)(vii). Post-2007, a nonresident purchaser of coupons dealing at arm's length with the issuer could determine that the purchased coupons were exempt from Canadian withholding tax provided that no portion of the interest under the debt was participating debt interest.

The post-2007 simplification of the Canadian withholding tax regime is important to Canadian borrowers' access to and the liquidity of cross-border debt markets. The concept underlying ITA subsection 240(2) and subsequent commercial practice, that a nonresident purchaser of coupons of a Canadian corporate debt should be able to determine whether that coupon is exempt from or subject to withholding tax, is important to nonresident participation in and liquidity of the market for stripped bonds of Canadian issuers.

The Proposals represent a marked departure from the approach apparent since the introduction of subsection 240(2) in 1966. They would impose withholding tax on interest paid to an arm's-length nonresident when the residual is held by a person with whom the payor does not deal at arm's length. In *Lehigh*, BBL was aware that the residual continued to be held by a member of the HZ Group and negotiated a specific gross-up to protect BBL from any risk of Canadian withholding tax.

In contrast, a purchaser of coupons in the stripped bond market typically would not know or have the means to determine who held the residual at the time of purchase or payment of the coupon. Many bonds exist only in book-entry form, so book-entry strip bonds (representing the right to either interest or principal) would generally exist only in electronic form within ledgers maintained by a securities depository. Holders of these strip bonds see their positions only on periodic statements from their investment dealer, bank, or trust company. In Canada, stripped components of different book-entry-held debt instruments can then be packaged together and sold in book-entry form as strip bond package securities. [28]

In this situation, the holder of a stripped coupon will often be unaware of and may well be unable to determine the identity of the holder of the right to the corresponding principal payment. Therefore, unless the coupon holder is a U.S. resident who is entitled to the benefits of the Treaty, [29] a nonresident holder of a stripped coupon who deals at arm's length with the Canadian resident issuer generally would be unable to determine whether the purchased coupon is exempt from or subject to Canadian withholding tax. Were the residual held by a person with whom the borrower does not deal at arm's length, the Proposals would impose Canadian withholding tax, although the person primarily liable for the tax (the nonresident interest recipient) may have no knowledge of such tax liability.

This is not to say that acquisition of the residual by a person who does not deal at arm's length with the issuer of the bond would be a typical or expected transaction. The issuer group might acquire the residual, for example, to reduce the duration of its outstanding debt obligation, but these circumstances may be relatively unusual. However, based on the Proposals, as noted above, a nonresident purchaser of coupons stripped from debt of a Canadian corporate issuer may be unable to determine whether the purchased coupon will be exempt from or subject to Canadian withholding tax (and any such determination would be subject to

subsequent transactions in the residual). This is a marked change from the regime in place for the preceding 45 years and touches on a more general principle of tax policy—that a potential taxpayer entering into a commercial transaction should be able to determine whether he is subject to tax in respect of the transaction.

This change in approach may have different effects on existing investors in coupons stripped from Canadian corporate debt and investors under future coupon-stripping transactions. Nonresidents holding these coupons prior to March 16, 2011, are generally grandfathered from the Proposals and may continue to hold and collect coupon payments from arm's-length Canadian corporate borrowers free from Canadian withholding tax regardless of who holds the residual. Subsequent purchasers of such coupons are not grandfathered, however, which may affect the liquidity and pricing of the secondary market for these coupons.

Even if the debt obligation contains a “gross-up” clause in respect of Canadian withholding tax, it is unclear whether the clause would protect a subsequent nonresident purchaser. As noted, typically the corporate issuer does not participate in the coupon-stripping transaction. If a corporate bond is issued with a gross-up clause, stripped in the secondary market, and the residual acquired by a non-arm's-length person, resulting in the application of withholding tax to a post-March 15, 2011, nonresident coupon purchaser, depending on the specific terms of the gross-up clause, the issuer having issued an (unstripped) bond exempt from withholding tax may be able to successfully argue that as no withholding tax would have applied but for the coupon strip, liability for withholding tax arises only by virtue of the stripping transaction to which the issuer was not a party and the gross-up clause should not be interpreted to apply in favor of the nonresident coupon holder.

If the gross-up clause applies in these circumstances, application of a gross-up typically entitles the issuer to repay the debt at par, undermining the protection from reinvestment rate risk that is generally a key investment rationale for a purchaser of future coupons, particularly in the current interest rate environment, with older stripped bonds carrying above-market interest rates and the components of the stripped bond trading in aggregate at perhaps a significant premium to par. Thus, while a pre-March 16, 2011, coupon holder is grandfathered, the Proposals may raise potential issues affecting the secondary market (aside from Canadian resident or U.S. Treaty eligible purchasers).

Prospective nonresident investors in post-March 15, 2011, coupon strips have the choice of purchasing on the premise that the residual is unlikely to be held or acquired by a person with whom the issuer does not deal at arm's length, or not purchasing if the withholding tax exemption cannot be assured. The Canadian corporate stripped bond market could take steps to provide assurance that unexpected withholding tax would not be imposed—for example, requiring representations from prospective purchasers of the residual that they act at arm's length with the issuer as a condition of purchase. Ultimately, the market will determine whether theoretical uncertainty as to the withholding exemption has an effect on the market and whether the market can adopt private measures to restore that certainty.

Scope of the Proposals

The Proposals are a response to the FCA decision in *Lehigh* and directed at coupon-stripping transactions. The wording of the Proposals themselves is not so clearly limited. They impose Canadian withholding tax on interest “paid *in respect of* a debt or other obligation owing to a person with whom the payer does not deal at

arm's length" (emphasis added). Interest paid on a stripped coupon where the residual is held by a person with whom the payor does not deal at arm's length, as in *Lehigh*, is an example of the application of the proposed wording. However, Justice Dickson, writing for the majority of the Supreme Court of Canada, has noted:

> The words "in respect of" are, in my opinion, words of the widest possible scope. They import such meanings as "in relation to" or "in association with." The phrase "in respect of" is probably the widest of any expression intended to convey some connection between two related subject matters.[30]

Given the breadth with which Canadian courts have interpreted "in respect of," its use in the Proposals raises the question of whether, outside the context of coupon stripping, nonresidents (in particular, those who are not eligible for the benefits of the Treaty) must inquire as to any connection or relationship between interest paid to them and any other debt or other obligation that may be owing to a person with whom the payor does not deal at arm's length to determine whether interest paid to them is exempt from or subject to Canadian withholding tax.

The Backgrounder[31] and Explanatory Notes[32] accompanying the Proposals do not use such broad language, referring to "interest paid or payable on [rather than "in respect of"] a debt obligation owing by the payer to a nonresident [a limitation not expressed in the draft legislation] with whom the payer does not deal at arm's length." It is hoped that when draft legislation is brought before Parliament implementing the Proposals, the language will be more consistent with the Explanatory Notes and more clearly limited to the coupon-stripping transactions that are the expressed target. As discussed, the Proposals depart from the principle that a taxpayer should be able to determine whether the transactions that he undertakes are subject to tax—it would be unfortunate to extend that departure beyond coupon stripping to other cross-border interest payments.

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[1] Lehigh Cement Limited v. The Queen, 2010 DTC 5081 (FCA). See "Canadian Tax Court Overturned in GAAR Case," 21 JOIT 11 (August 2010) .

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[2] See "Canada Legislation Targets Withholding on 'Stripped' Interest," 22 JOIT 10 (June 2011) ; Pankratz, "2011 Canadian Budget and Other Tax Proposals," 22 JOIT 50 (June 2011) .

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[3] In certain circumstances, Part XIII tax may apply where the payor is a nonresident of Canada, such as for certain amounts that are deductible in computing the nonresident obligor's taxable income earned in Canada (see ITA subsection 212(13.2)). For instance, where a nonresident borrows from a non-Canadian lender and carries on business in Canada through a branch, if some or all of the nonresident's interest expense is deductible in computing its Canadian business income, interest payments by the nonresident borrower to the nonresident lender could be subject to Canadian withholding tax.

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[4] See, e.g., CRA Doc. No. 2007-0241391E5, *Withholding Tax on Payments Made by a Guarantor* (January 23,

2008).

5

ITA subsection 214(6).

6

Id. subsection 260(8).

7

Id. subsection 214(15).

8

Certain types of "fully exempt interest," however, are not exempt from Part XIII tax if they are also "participating debt interest."

9

ITA para. 212(1)(b).

10

Id. para. 251(1)(a).

11

The rules are in ITA subsection 251(2) (and related provisions). "De jure" control in Canadian tax law generally means the right of control residing in the ownership of the shares that carry the majority of the voting rights that can be exercised to elect the majority of directors to a corporation's board of directors. Buckerfield's Ltd. et al. v. M.N.R., 64 DTC 5301 (Ex. Ct.).

12

As discussed below, to date, the Treaty is Canada's only bilateral tax treaty that zero rates withholding tax on interest. To qualify for this rate, a U.S. interest recipient would have to be a Treaty resident and beneficial owner of the interest, and qualify for benefits under the limitation-on-benefits Article (XXIXA) .

13

However, the category of excluded payments in Article XI(6) of the Treaty is somewhat narrower than the definition of "participating debt interest" in the ITA, so the Treaty may exempt certain amounts that would otherwise be taxable by Canada as participating debt interest.

14

"Coupon" refers to some bearer bonds having actual coupons attached to them, which holders remove and redeem to receive interest. This is less common today as more records are kept electronically and more debt instruments are held in book-entry form. "Coupon" is commonly now used to refer to the periodic interest component of a debt instrument and it is used in this sense in this article.

15

As of October 2009, there was over $7 trillion face value worth of stripped (zero-coupon) bonds outstanding in Canada. See report prepared by Alexandra Cohl of Scotia Capital Inc., "Strip Bonds" (November 13, 2009) ("2009 Scotia Capital Report"), http://grandwealth.ca/assets/Stripbonds2010.pdf.

16

Id.

17

Under ITA former subparagraph 212(1)(b)(vii), which applied prior to 2008, Part XIII tax did not apply to interest that was paid or payable by a Canadian resident *corporation* to a person with whom the corporation dealt at arm's length, if generally under the terms of the debt the borrower could not be obliged to pay more than 25% of the principal amount (or aggregate principal amount if several identical obligations made up a single debt issue) within five years from the date of issue.

18

Canada Trustco Mortgage Co. v. Canada, 2005 DTC 5523 (SCC). See Kingissepp, “Canadian Supreme Court Rules on General Anti-Avoidance Rule,” 17 JOIT 12 (May 2006) .

19

Lehigh Cement Limited v. The Queen, 2009 DTC 1148 (TCC).

20

The FCA noted that the only legislative history on which the Tax Court of Canada relied was one statement in a budget paper that the Dept. of Finance released in 1975 (when subparagraph 212(1)(b)(vii) was first proposed).

21

Shortly after the Proposals were released, the Conservative Party-led government was defeated in a no-confidence vote on March 25, 2011, triggering a general election on May 2, 2011. The Conservative Party won with enough seats to form a majority government. On May 19, 2011, at the IFA Canada 2011 International Tax Seminar (“2011 IFA Seminar”) a Dept. of Finance official affirmed the government's intent to enact the March 16, 2011, Proposals in due course, possibly in fall 2011. See Pankratz, *supra* note 2.

22

2009 Scotia Capital Report.

23

As discussed below, “*in respect of* a debt or obligation” in the proposed amendment makes its scope somewhat uncertain.

24

Dept. of Finance (Canada), "Backgrounder: Draft Legislative Proposals Relating to the Income Tax Act and Income Tax Regulations" (March 16, 2011), www.fin.gc.ca/n11/data/11-024_1-eng.asp.

25

Id.

26

The Dept. of Finance representative who briefly discussed the Proposals at the 2011 IFA Seminar did not address the coming-into-force provision, presumably because it is intended to be retained as originally proposed.

27

The Backgrounder, *supra* note 24, acknowledges that any imposition of withholding tax under the Proposals on amounts that otherwise would be withholding tax exempt under prior law is subject to application of Canada's tax treaties.

28

Canadian Depository for Securities Ltd., "CDS Services for Stripped Securities: An Overview for Traders and Investment Managers" (April 2005), www.cds.ca/cdsclearinghome.nsf/Downloads/-EN-Stripbond/$File/Stripbonds+200504v3.pdf?OpenElement.

29

As discussed above, for such a stripped coupon holder, exemption from Canadian withholding tax under the Treaty is not affected by any potential non-arm's-length relationship between the interest payor and the holder of the residual, i.e., the zero-coupon bond.

30

Nowegijick v. The Queen, [1983] 1 SCR 29 at 39.

31

See Backgrounder, *supra* note 24.

32

Dept. of Finance (Canada), "Explanatory Notes to Legislative Proposals Relating to Income Tax Act" (March 16, 2011), www.fin.gc.ca/drleg-apl/ita-lir-0211n-eng.asp.

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