INVESTMENT DEALERS ASSOCIATION OF CANADA

bulletin

ASSOCIATION CANADIENNE DES COURTIERS EN VALEURS MOBILIÈRES

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For distribution to relevant parties within your firm

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Proposed Changes to Thin Capitalization Rules

The federal government issued a News Release May 9 on varying tax measures set out in the Federal 2000 Budget in connection with the thin capitalization rules. The Budget had previously announced that the allowable limit of interest-deductible borrowings by the subsidiaries of non-resident companies would be lowered to a 2 to 1 leverage ratio from the existing 3 to 1 ratio, and that debt guaranteed by the non--resident parent would be included in the leverage calculation.

The News Release states that the decision to include debt guaranteed by the non-resident parent in the thin capitalization rule calculation will be deferred. While the Release is silent on the extent of the deferred period, Finance officials have indicated that the measure will be deferred until the government has completed extensive discussions and consultation with affected parties and industry associations such as the IDA; has developed at least one or more proposals for the treatment of guaranteed debt; and has had industry feed-back on any proposals brought forward. We have been assured by Finance officials that industry concerns will be given serious consideration and that consensus on an approach will be sought.

The policy issues involving reform of the thin capitalization rules are complex, as Finance intends to determine that portion of debt guaranteed by the parent non-resident firm deemed related party debt. Finance officials have indicated that, if a practical distinction can be made between related party debt and guaranteed debt, then appropriate transition and grandfathering mechanisms would be put in place to avoid disruption to the markets and the financial sector. These transition and grandfathering arrangements would be subject to consultation.

Finance is well aware of our concerns regarding the negative consequences of the Budget proposal on debt guarantees for debt markets, the near-bank financial sector and subsidiary operations of non--resident companies described in our March 31, 2000 submission. Finance officials have indicated that a balanced approach needs to be developed that would both meet the basic policy objective and avoid adverse consequences for domestic debt markets and preserve the competitiveness of the near-bank financial sector. They also indicated that the announcement of any new rule on guaranteed debt would, by necessity, contain appropriate transitional rules. In addition, grandfathering provisions would apply to debt incurred in accordance with current business practices prior to such an announcement.

If Member firms have questions or comments in connection with the clarification of the proposed changes to the thin capitalization rules, they should contact Ian Russell, Senior Vice-President, Capital Markets, Investment Dealers Association of Canada, by telephone (416) 865-3036, by facsimile (416) 364-9263 or by e-mail: irussell@ida.ca.

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