The Joint Committee on Taxation of
The Canadian Bar Association
and
The Canadian Institute of Chartered Accountants

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Dear Sirs:

Re: Convertible Debentures

As discussed in our conference call of April 7, 2010, there is currently uncertainty regarding the potential application of Part XIII withholding tax to convertible debentures issued by Canadian resident issuers. In particular, as a result of the amendments to the *Income Tax Act* (Canada) as amended (the "Act") effective January 1, 2008, it is unclear whether the "conversion premium", and possibly the regular periodic interest payments, could be subject to withholding tax under paragraph 212(1)(b) of the Act.

We understand from our call that the Canada Revenue Agency ("CRA") has no obvious tax policy concerns with convertible debentures that would cause CRA to seek to apply withholding tax broadly in this context. You have requested a detailed submission outlining positions that could be taken to address this issue. The Joint Committee welcomes the opportunity to work with the CRA to resolve this matter. This letter will therefore set out the technical tax uncertainty currently facing issuers (and potential investors) of convertible debentures, and will suggest two alternative positions which could alleviate this issue.

A. Conversion Premiums and Withholding Tax

The first part of this submission sets out a general discussion of the issue and the technical provisions of the Act that are relevant to this analysis.

(i) Subsection 214(7)

The uncertainty respecting convertible debentures and withholding tax arises as a result of the potential application of subsection 214(7). In particular, subsection 214(7) provides that, where a debt obligation issued by a Canadian resident issuer is assigned or transferred (including on conversion)[1] by a non-resident holder to a Canadian resident, the amount by which the price for which the obligation was assigned or transferred exceeds the price for which the obligation was issued is deemed to be a payment of interest on the obligation. In the context of a convertible debenture, the premium realized on conversion or sale of the debenture (a "Conversion Premium") would constitute such an excess. Consequently, pursuant to subsection 214(7), a non-resident holder which transfers a convertible debenture to a Canadian resident for an amount in excess of the issue price will be deemed to receive an amount of interest equal to the Conversion Premium. Subsection 214(7) does not apply to "excluded obligations", as discussed below.

(ii) Participating Debt Interest

If the deemed interest is considered to be "participating debt interest" as defined in subsection 212(3), the Conversion Premium will be subject to withholding tax under Part XIII. Participating debt interest is defined to mean interest that is:

> *"paid or payable on an obligation, …all or any portion of which interest is contingent or dependent on the use of or production from property in Canada or is 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 a corporation."*

The question therefore arises whether the Conversion Premium, which is determined with reference to the share price of the issuer, could be considered to be participating debt interest. The current definition is virtually identical to the wording of the post-amble to former subparagraph 212(1)(b)(vii) (the "Post-amble"); accordingly, CRA's prior positions respecting the Post-amble may be relevant to this analysis. It was CRA's administrative position that the Post-amble did not apply to index-linked interest payments so long as the particular stock index chosen was not influenced by the inclusion in the index of the shares of the issuing corporation, corporations related to the issuing corporation, or a corporation whose primary business was substantially similar to that of the issuing corporation.[2] Such an influence, stated CRA, could lead to a conclusion that changes in the index represented a "similar criterion" (to revenue, profit, cash flow or commodity price) for the computation of interest. In addition, CRA has taken the position that interest payments which fluctuate on the basis of a formula that attempts to measure whether the issuer's stock price out-performs or under-performs the short term money market index would be offside the Post-amble.[3] CRA's position was that interest

[1] Subsection 214(14) provides that a redemption or cancellation of a debt obligation is considered to be an assignment for the purposes of section 214; as a result, a conversion of debt into shares is considered to be an assignment for this purpose.

[2] CRA document No. 2000-0046375, November 22, 2000, and CRA document No. 2001-0096655, October 9, 2001. See also CRA document No. 2000-0011015, May 16, 2000.

[3] CRA document No. 9915455, July 21, 1999.

computed in this manner would be *"computed by reference to revenue, profit, cash flow, commodity price or any other similar criterion"*.

These positions suggest that a concern could arise with the Post-amble in situations where the issuer's share price influences the calculation of interest payable. If this logic is applied to subsection 212(3), it is conceivable that CRA could assert that the Conversion Premium may be treated as participating debt interest.

In addition, it is standard for convertible debentures to include anti-dilution provisions that are intended to preserve a holder's rights to receive the appropriate number of shares on conversion in the event of certain significant transactions. For example, an adjustment to the conversion price or conversion ratio is often required if an extraordinary dividend is paid on the issuer's shares. Such a provision does not permit the holder to participate in the dividend through increased interest payments; instead, it increases the number of shares received if and when a conversion takes place (to compensate for the implied decrease in share price as a result of the extraordinary distribution of the issuer's property). Notwithstanding the purpose of these types of provisions, a concern arises that the Conversion Premium may be considered to be computed, albeit indirectly, by reference to dividends paid or payable to shareholders.

(iii) Excluded Obligation

Subsection 214(7) does not apply to an "excluded obligation" as defined in subsection 214(8). Paragraph 214(8)(c) provides that an excluded obligation means a debenture:

> *(c) that is not an indexed debt obligation and that was issued for an amount not less than 97% of the principal amount thereof, and the yield from which, expressed in terms of an annual rate on the amount for which the obligation was issued ... does not exceed 4/3 of the interest stipulated to be payable on the obligation, expressed in terms of an annual rate ...*

There is uncertainty whether a convertible debenture will satisfy this definition, particularly whether the "principal amount"[4] and the "yield" in respect of a convertible debenture must include the Conversion Premium.

(iv) Periodic Interest

Subsection 212(3) provides that "participating debt interest" means interest that is *"paid or payable on an obligation, <u>all or any portion of which interest</u> is contingent or dependent..."*. There is also concern that the regular periodic interest payments made on a convertible debenture could be subject to Canadian withholding tax simply because the possible future Conversion Premium that may be received on an assignment or conversion of the debenture could be considered to be participating debt interest.

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[4] We understand from our call that CRA is generally satisfied, based on the recent caselaw (discussed below), that the "principal amount" should not include the Conversion Premium.

(v) The 5/25 Rule

The uncertainty respecting the application of withholding tax to convertible debentures did not generally arise prior to January 1, 2008, the date on which Canada eliminated withholding tax on payments of interest to arm's length non-residents.

In practice, prior to January 1, 2008, most convertible debentures were structured to comply with the withholding tax exemption contained in subparagraph 212(1)(b)(vii) (the "5/25 Rule")[5]. When the 5/25 Rule was applicable, the periodic interest payments on a debenture were exempt from withholding tax. Furthermore, if the debenture satisfied the requirements of the 5/25 Rule, the debenture was an excluded obligation pursuant to paragraph 214(8)(a) and subsection 214(7) did not apply; accordingly, the Conversion Premium was not deemed to be interest. Such a convertible debenture was therefore fully exempt from withholding tax, both in respect of the regular interest and the Conversion Premium; of particular import to the present analysis, the existence of a Conversion Premium in no way influenced the application of the 5/25 Rule, the application of the Post-amble or the taxation of the periodic interest payments.

Conversely, when the 5/25 Rule did not apply (for example, convertible debentures with a term of less than five years), both the regular interest and the Conversion Premium would have been subject to withholding tax; however, the imposition of withholding tax was not in any way dependent on an analysis of whether the Conversion Premium fluctuated with share price - withholding tax was applicable simply because the Conversion Premium was deemed to be interest under subsection 214(7).

In either case noted above, the potential for a Conversion Premium to arise had absolutely no bearing on whether withholding tax would be exigible in respect of a convertible debenture. Accordingly, the present issue is a new one, and not one that is necessarily informed by previous CRA statements respecting the Post-amble.

B. CRA's Responses to Date

In May, 2009 CRA issued a technical interpretation (the "2009 Technical")[6] respecting convertible debentures. CRA took the position that, in the context of a "traditional convertible debenture", the Conversion Premium realized on conversion by the original holder for common shares of the issuer would not be subject to withholding tax. This position was based on the view that, on conversion, there would be no excess amount under subsection 214(7); in particular, the "price for which the obligation was assigned" on the conversion would be considered to be equal to the face amount of the debenture (as that is the price determined under the terms and conditions of the debenture). However, the 2009 Technical was limited to this narrow class of "traditional convertible debentures" held by the original holders, and did not address the withholding tax consequences of a transfer of such a debenture.

The 2009 Technical was followed by the issuance of Technical News #41 in December 2009 (the "Technical News"). The Technical News was issued in response to certain questions posed to

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[5] In particular, convertible debentures were specifically contemplated in clause 212(1)(b)(vii)(E).

[6] CRA document No. 2009-0320231C6, May 1, 2009.

CRA at the November 2008 Annual Tax Conference; it is unclear if the Technical News reflects CRA's position in December 2009, or simply the responses actually given at the 2008 Conference. In any event, the Technical News briefly considers whether: (i) a convertible debenture may constitute an excluded obligation pursuant to paragraph 214(8)(c); (ii) the Conversion Premium may constitute "participating debt interest"; and (iii) the regular periodic interest payments may also be considered to be participating debt interest. CRA did not provide definitive answers, but rather invited submissions from the practitioner community.

As a result, Canadian corporations and trusts wishing to raise capital through the issuance of convertible debentures to non-resident investors face significant uncertainty.

C. Potential Solutions

A convertible debenture is a common and accepted security that has been used by issuers to raise funds in the capital markets for many decades. In light of the fact that CRA has no evident policy concerns with convertible debentures, we believe that it is important for CRA to provide certainty respecting the treatment of convertible debentures, and that any guidance should apply to the broadest possible range of situations that could arise in practice.

(i) Interpret Participating Debt Interest to Exclude Standard Convertible Debentures

The definition of participating debt interest in subsection 212(3) must be interpreted in a manner that reflects the underlying policy of the provision. In relation to a "standard convertible debenture", [7] we believe (for the reasons set out below) that such an interpretation will lead to the conclusion that a Conversion Premium is not participating debt interest. If the Conversion Premium (and the anti-dilution provisions) discussed below do not invoke the definition of participating debt interest, no withholding tax issues should arise in respect of convertible debentures held by arm's length investors. The first solution, therefore, would be for CRA to confirm that in the case of a "standard convertible debenture", the definition of participating debt interest is simply not applicable to Conversion Premiums or periodic interest payments. Any position taken would apply equally to all holders, and not only to original holders as set out in the May Technical.

Most Canadian issuers of convertible debentures issue a fairly typical form of convertible debenture. Such a debenture generally has a right of the holder to convert the debenture into a fixed number of common shares or units of the issuer; however, the regular periodic interest payments thereunder are generally not participating, and the debenture is not structured to distribute profits in the guise of interest payments. A standard convertible debenture is similar to the traditional convertible debenture described in the May Technical, although not quite as narrow. The nine factors indicative of a traditional convertible debenture, as discussed in the May Technical, are set out in Schedule "A" hereto. However, many convertible debentures do not satisfy all of these nine criteria. It is suggested that a "standard convertible debenture" should also contemplate the following additional variations (which are intended to supplement and broaden those criteria set out in Schedule "A"):

- the debenture may be secured, and may not be subordinated;

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[7] We use "standard" instead of "traditional" in this submission to include the other features of a convertible debenture, discussed below, that we believe are necessary to accommodate common (and non-controversial) offerings.

- the issuer may be a public or private corporation, a trust or a partnership;
- the debenture may be denominated in Canadian dollars or in a foreign currency;
- the debenture is convertible at the holder's option at any time or only at certain times (there may be an initial non-conversion period and/or other non-conversion periods);
- the terms of the debenture specifically provide either a fixed conversion price or fixed conversion ratio, but these would be subject to adjustment in accordance with standard anti-dilution provisions;
- the debenture may be issued with an initial discount;
- the rate of interest may be fixed or floating (i.e. based on a published commercial interest rate, for example, Canadian BA rate or LIBOR), but will not be participating.[8] The rate of interest will be determined by market factors and will reflect a commercial rate of interest in the context of the convertible debenture;
- at maturity, the debenture is repayable at its face amount, plus accrued and unpaid interest. In some circumstances, the issuer may have the option of satisfying the redemption price through the issuance of equity, which is typically valued for this purpose at a small (e.g. 5%) discount to market price; and
- the debenture may be redeemable by the issuer prior to maturity, or on the occurrence of certain events (such as a change of control), at a redemption price based on a fixed percentage of face value (e.g. 100% or 102%), plus accrued and unpaid interest.

In the context of a standard convertible debenture, we believe that both periodic (non-participating) interest payments and the Conversion Premium should not, from a policy perspective, be subject to Canadian withholding tax. As discussed above, prior to the January 1, 2008 amendments to the Act, most convertible debentures were exempt from withholding tax, and it seems counter-intuitive that a broadening of the interest withholding tax exemption would cause amounts which were previously tax free to become subject to Canadian tax.

A textual, contextual and purposive interpretation of the term "participating debt interest" should also lead to the determination that the Conversion Premium is not participating debt interest. The wording of the term is virtually identical to that of the Post-amble; while the language of the Post-amble is quite broad, its interpretation has properly been restricted to its policy by CRA. This policy has been described by CRA as preventing *"the parties from mischaracterizing a payment as exempt interest when it is really a distribution of earnings"*.[9]

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[8] In some cases, the issuer may satisfy its interest payment obligation by issuing sufficient equity to a trustee which sells the equity in the market for cash. The cash is then used to satisfy the interest payment. The amount of interest payable is not dependent on the proceeds realized on the sale into the market.

[9] Income Tax Technical News #11.

For example, an interest rate that fluctuates with a basket of commodities could be considered to technically fall within the wording of the Post-amble; however, so long as such interest rate was not a proxy for the income, profit etc. of the debtor, CRA has determined that the Post-amble did not apply.[10] Similarly, an interest rate that fluctuates inversely with EBITDA may be considered to fall within the wording of the Post-amble. Such interest rate was determined by CRA not to satisfy the Post-amble because the interest rate is a proxy for credit-worthiness, not a surrogate for a distribution of profit.[11] CRA has stated that *"in cases of uncertainty, it should be the underlying economic substance of a payment, and not the method of measurement per se, that determines whether or not it is interest for purposes of the paragraph 212(1)(b) exceptions"*.[12] Accordingly, the words of the Post-amble have been previously interpreted and applied to reflect the underlying policy.

A similar approach to the definition of participating debt interest should lead to the conclusion that a Conversion Premium in respect of a standard convertible debenture is not participating debt interest.[13] It is readily apparent that a standard convertible debenture does not involve a distribution of earnings. Although an investor's return from a convertible debenture may reflect the earnings of the issuer (to the extent that these earnings inform its share price[14]), this correlation is no different than the economic appreciation that may arise on any right to acquire to those shares, or on the direct ownership of those shares themselves. This appreciation in value may reflect those underlying earnings, but does not create a right to any distributions. The realization of a gain from the increase in an issuer's share price is not subject to withholding tax in any other context, at least until a distribution of underlying earnings is actually made by the issuer, and should not be subject to withholding tax in this situation simply because it is tied to a convertible debenture.

As noted above, we believe that CRA's prior inclination to apply the Post-amble to situations involving the issuer's own shares should not act as an impediment to this approach. The technical interpretations discussed above under "Participating Debt Interest", which found that interest which fluctuated based on the issuer's share price was caught by the Post-amble, dealt with a very different situation. In particular, these technical interpretations concerned regular periodic interest payments which <u>themselves</u> were tied to the issuer's share performance; arguably, these debts could be considered as an attempt by the issuer to distribute its cash flow or profit on a tax-deductible basis.

Prior to January 1, 2008, the underlying policy of the Post-amble was never properly analyzed in the context of convertible debentures, because such analysis was never required. Nothing turned on whether the Conversion Premium fell within the wording or the policy of the Post-amble. If the

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[10] See, for example, CRA document No. 2000-0046375, November 22, 2000, CRA document No. 2000-0057253, 2001, CRA document No. 2001-0096655, October 9, 2001, CRA document No. 2006-0208001R3, 2006.

[11] See, for example, CRA document No. 2003-0047713, 2003, and CRA document No. 2005-0165121R3, 2005.

[12] *Supra*, footnote 9.

[13] In fact, CRA has already adopted the purposive approach in the context of subsection 212(3). For example, it has taken the administrative position that an interest rate which fluctuates inversely with EBITDA of the debtor does not constitute participating debt interest for the purpose of subsection 212(3). See CRA document No. 2008-0301391E5, May 29, 2009.

[14] In many cases, an issuer's share price from time to time could reflect factors other than earnings, profits or cash flow, including the possibility of future earnings, general market or industry performance, prevailing business conditions, foreign currency fluctuations, etc.

present analysis is unencumbered by these previous CRA positions, it should be reasonably straightforward to conclude that the realization of a Conversion Premium should not be assimilated to the distribution of underlying profits. In fact, if the Conversion Premium does create such a concern, convertible debentures should not previously have obtained the benefit of the 5/25 Rule; in light of former clause 212(1)(b)(vii)(E) (which specifically permits convertible debentures to comply with the 5/25 Rule), this was clearly not the intention of Parliament.

It should be noted that the January 1, 2008 amendments to the Act retained the concept of the 5/25 Rule in paragraph 214(8)(a). In particular, a debenture which satisfies the 5/25 Rule (as it previously existed) will be considered an excluded obligation pursuant to paragraph 214(8)(a).[15] However, there does not appear to be any coherent policy rationale for distinguishing between the tax treatment of a Conversion Premium in relation to a convertible debenture that satisfies the 5/25 Rule and one that does not.

Finally, the anti-dilution provisions of a standard convertible debenture should not be considered to cause the Conversion Premium to constitute participating debt interest. Clearly, these provisions are not intended to effect a distribution of profits by the issuer to the debenture holder; these provisions are included solely for commercial reasons to protect against the dilution of the Conversion Premium through unusual distributions to existing equity holders.

This letter does not address a convertible debenture with an exchange ratio that fluctuates or is adjusted in a manner that attempts to track realized profits. Neither does this letter address a convertible debenture having an interest rate which itself fluctuates with the issuer's profits, earnings or cash flow.

Having regard to the foregoing, we believe that CRA could readily and rightly conclude that a Conversion Premium in respect of a standard convertible debenture should not be considered to be participating debt interest because the underlying policy concerns are not apparent in this context.

(ii) Apply Paragraph 214(8)(c) to a Standard Convertible Debenture

As noted above, subsection 214(7) does not apply to an excluded obligation, including one described in paragraph 214(8)(c). If CRA were to confirm that a standard convertible debenture is an excluded obligation pursuant to paragraph 214(8)(c), the withholding tax concern in respect of most (but not all) convertible debentures would be alleviated.[16]

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[15] The Technical Notes do not clarify why paragraph 214(8)(a) retains the concept of the 5/25 Rule: *"As drafted, the amendment to subsection 214(8) refers to "subparagraph 212(1)(b)(iii) or (vii) as they applied to the 2007 taxation year". This approach has been taken in order to preserve the effect of the subsection for the immediate future without unduly complicating it, pending a more comprehensive examination of the rules in section 214 in the light of the changes to paragraph 212(1)(b)."*

[16] Convertible debentures with an initial issue discount of greater than 3% would, however, continue to be subject to possible withholding tax on the discount and the Conversion Premium. This result seems to be anomalous. A "true" initial issue discount, on its own, would not be subject to withholding tax (assuming an arm's length holder) regardless of the amount, because the deemed interest is not participating. Similarly, paragraph 214(8)(c) will prevent the Conversion Premium on a standard convertible debenture having only a shallow discount or no discount from being subject to withholding tax. Accordingly, each feature (discount and Conversion Premium) on its own would not result in withholding tax; it seems strange then to conclude that by combining the features withholding tax should result. A

The requirements of paragraph 214(8)(c) are set out above; in general terms, the obligation must have been issued for an amount not less than 97% of its principal amount, and the yield from the obligation must not exceed 4/3 of the interest stipulated to be payable thereon. Accordingly, the determination of whether this paragraph applies depends on the interpretation of the terms "principal amount" and "yield" in this context.

The term "principal amount" was the focus of the Tax Court of Canada decision in *Tembec*[17]. This case considered the application of paragraph 20(1)(f) to a convertible debenture, and considered the meaning of the term "principal amount" for the purposes of paragraph 20(1)(f). The taxpayer in *Tembec* argued that, in light of the definition of principal amount in the Act (generally being the maximum amount payable on account of the obligation), the principal amount of a convertible debenture may vary over time and must be determined with reference to the value of the underlying shares issued upon conversion. In summary, the fundamental issue was whether the principal amount of a convertible debt could fluctuate for this purpose or whether, instead, it is determinable by reference to the amount owing on the date of issuance. The Tax Court in *Tembec* held that,

> *"to calculate the principal amount, the amount of the redemption agreed upon at the time the obligations are issued is essential. We must therefore look at the subscription agreement. In the agreement, there is no reference made to redemptions greater than the amounts loaned. What is contemplated is redemption equal to the amount loaned, whether the amount loaned is redeemed in cash or by conversion of shares."*[18]

Accordingly, the Court in *Tembec* determined that the principal amount of the convertible debenture did not fluctuate, and was equal to the face amount of the debenture, being the agreed upon price in the trust indenture. The fair market value of the shares at the time of conversion was therefore not relevant to this analysis. Based on the reasoning in *Tembec*, provided that a convertible debenture has an agreed upon redemption amount equal to face value (the ninth indicia in the May Technical), and is not issued with an original issue discount greater than 3%, the convertible debenture would be issued for an amount that is not less than 97% of its principal amount. Accordingly, the first component of paragraph 214(8)(c) is satisfied.

The *Tembec* decision did not consider the meaning of the term "yield", and this term is not defined in the Act. It is therefore unclear if the Conversion Premium should be included in the computation of yield. If it were, most convertible debt obligations with even modest appreciation would fail to satisfy paragraph 214(8)(c).

We believe that yield should contemplate only the return which is determinable at the time of issuance of the debt obligation, reflecting the stated interest rate and the initial issue discount, if any. In contrast, if the Conversion Premium were relevant to the calculation of yield, a number of

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discount could arise for marketing reasons on an offering or in situations where a convertible debenture is issued on a reorganization or exchange of securities. Because of this technical issue, it seems that the first solution could have a broader application.

[17] *Tembec Inc. v. R.*, 2008 DTC 3232 (TCC), 2009 DTC 5877 (FCA).

[18] *Tembec,* TCC decision at para. 40.

fundamental concerns would result: one could not determine at the time of issue whether the debenture was an excluded obligation (thereby making the application of withholding tax to periodic interest payments impossible to determine), and different holders of the same obligation could have different Canadian tax consequences. For example, the same debenture would be considered to be an excluded obligation in respect of one holder which transfers its debenture for an amount equal to the stated principal amount (ie, with no Conversion Premium), but it may not be an excluded obligation in respect of a different holder which transfers its debenture at a different time for a higher amount (ie, with a Conversion Premium that causes the yield to exceed 4/3 of the interest rate). Similarly, the determination would also change depending on the cost of the debenture to the holder; holders which acquire the same debenture at different costs could have different yields, even if the debentures are then converted or assigned for the same price. As a practical matter, the scheme for applying withholding tax in these situations would be unworkable (particularly for a Canadian resident purchaser) if the determination were dependant on factors that were individual to particular holders (when such factors are not easily determinable, unlike residency); Canadian resident purchasers acquiring convertible debentures on the secondary market from non-resident holders would have no way of determining the yield realized by the particular non-resident transferor, and would be unable to determine if tax should be withheld.

Accordingly, it is submitted that yield must be calculated at the time the obligation is issued, and only with regard to factors that may be determined with certainty at that time. In such case, a Conversion Premium would not be included in the calculation of yield. This point in time interpretation was endorsed by the Federal Court of Appeal in *Tembec,* where J.A. Noel, in analyzing the *Imperial Oil*[19] decision, stated,

> *"According to Justice LeBel, the deduction provided for by paragraph 20(1)(f) is limited to a "point-in-time expense", represented by the discount calculated at the time the obligation was issued. In saying this, he excludes any deductions that would reflect "the appreciation or depreciation of the principal amount over time" and "that can be ascertained only at the time of repayment" (idem). The effect of this reasoning is unequivocal: the deduction of financing costs provided for by paragraph 20(1)(f) is limited to the monetary discount granted when an obligation is issued".*[20]

Having regard to the similarities between paragraph 20(1)(f) and paragraph 214(8)(c), we believe that paragraph 214(8)(c) is also a "point-in-time" test. The following words in parentheses in subsection 214(8)(c) support this conclusion:

> *"(which annual rate shall, if the terms of the obligation or any agreement relating thereto conferred on the holder thereof a right to demand payment of the principal amount of the obligation or the amount outstanding as or on account of the principal amount thereof, as the case may be, before the maturity of the obligation, be calculated on the basis*

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[19] *Imperial Oil Ltd. v. R.,* 2006 D.T.C. 6639 (SCC).

[20] *Tembec,* FCA decision at para. 8.

of the yield that produces the highest annual rate obtainable either on the maturity of the obligation or conditional on the exercise of any such right)"

These words anticipate a future contingent event (repayment before maturity) and require yield to be calculated at the highest possible rate based on certain assumptions. If yield was meant to be computed on an ongoing basis, or with reference to actual facts determined subsequent to issue, these additional words would not be needed. Instead, this provision instructs us to make assumptions about future uncertain events for the specific purpose of allowing the determination to be made at the time of issuance. Accordingly, it is submitted that, on a textual basis, yield must be determinable at the time the obligation is issued. On this interpretation, a Conversion Premium cannot be a component in the calculation of yield since it cannot be known at the time of issuance whether (or what quantum of) any Conversion Premium will be realized.

The same words respecting yield are found in subsection 16(3) of the Act (and previously in subsection 16(2)). In accordance with that provision, holders of discounted obligations issued by certain persons (for example, tax-exempts) are required to include the discount in income in the year the obligation is acquired by the holder. Accordingly, in that context, the determination of yield must be made at the time of the issuance of the obligation, or the provision could not be applied properly.[21] Having regard to the similarity in wording, there is no reason to believe that yield is intended to have a different, or broader, meaning in paragraph 214(8)(c).[22]

Yield has been defined in the commercial context as follows:

> *"(noun) When used in relation to a redeemable security, means the effective rate of interest that will be returned on the purchase price if the payments of interest specified in the security are made up to and including the redemption date and the security is then redeemed at the specified value."*[23]

This definition also takes a prospective rather than retrospective view. Since a standard convertible debenture is generally redeemable by the issuer at face, this definition of yield leads to the conclusion that the yield in respect of a convertible debenture will equal the interest payable up to and

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[21] We also believe that the history of subsection 16(2) is informative. It was enacted in 1960 to counter the perceived abuse of provincial governments and other tax-exempts (which were not concerned with interest deductibility) issuing low-interest obligations with significant discounts; arguably, the discount was not taxable to the holder, but brought the effective yield to maturity to a market rate. Fifty years ago, perhaps before the advent of many sophisticated financial instruments, "yield" in this context seemed to be directed primarily at an interest rate calculation – that is, using the stated rate of interest, the discount and the time to maturity (each of which is known or assumed at the outset) to compute the effective yield of the obligation.

[22] It also appears that subsection 214(10) could support an argument that amounts deemed to be interest pursuant to subsection 214(7) are generally intended to be those which accrue on a day-to-day basis over a period of time, such as interest and initial issue discount. This is evidenced by the fact that, under subsection 214(10), the proportion of tax refunded is determined by reference to the number of days in which the non-resident held the debenture in relation to the number of days the debenture was outstanding; such a scheme does not appropriately contemplate lump sum amounts that are subject to significant fluctuation, such as Conversion Premiums.

[23] Daphne A. Dukalow, *The Dictionary of Canadian Law*, 3rd ed., (Thomson Carswell, 2004) s.v. "yield".

including the redemption date, plus the amount by which the specified redemption value exceeds the issue price for the obligation. This definition of yield supports the argument that yield must be calculated at the time of issuance of the obligation, and does not include a Conversion Premium.

Many standard convertible debentures issued by Canadian issuers are denominated in US dollars, and perhaps other foreign currencies; accordingly it must be considered whether potential foreign exchange fluctuations would affect the application of paragraph 214(8)(c). Following *Tembec* and in light of subsection 261(2), it is clear that the principal amount of a foreign currency denominated convertible debenture is determined at the time of issuance, and does not fluctuate with the movement of the Canadian dollar. A similar interpretation is appropriate in the context of yield. Given that yield must be determined at the time of issuance of the obligation, foreign exchange fluctuations after issuance should be irrelevant. In addition, the court in *Imperial Oil* determined that paragraph 20(1)(f) did not contemplate foreign currency fluctuations, and accordingly, it is submitted that the similarly worded paragraph 214(8)(c) should not contemplate foreign currency fluctuations.

Based on the foregoing, a standard convertible debenture, other than one which is actually issued at a greater than 3% discount, should be an excluded obligation under paragraph 214(8)(c).

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As we have discussed, this matter is of significant importance to the tax community. The Joint Committee would like to thank you for your consideration of these issues, and we look forward to working with you to resolve these uncertainties. Please feel free to contact Mitchell Sherman or the undersigned to discuss this matter.

Yours truly,

D. Bruce Ball
Chair, Taxation Committee
Canadian Institute of Chartered Accountants

Elaine Marchand
Chair, Taxation Section
Canadian Bar Association

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SCHEDULE A

Nine Indicia of a Traditional Convertible Debenture as set out in the May Technical

(a) The debentures are an unsecured subordinate debt.

(b) The issuer is a public corporation.

(c) The debentures are issued for a fixed amount of money in Canadian dollars (for instance $1,000) that represents the face value of the debentures. The debentures are issued with no original discount.

(d) The debentures bear interest at a commercial fixed rate per year calculated on their face value. The interest on the debentures is paid by the issuer at least annually.

(e) The debentures are convertible at any time at the holders' option into the common shares of the issuer prior to maturity. Some debentures have an initial non-conversion period.

(f) The terms of the debentures specifically provide either a fixed conversion price (specifying the fixed price paid per common share to acquire the common shares through the conversion of each debenture) or a fixed conversion ratio (specifying the number of common shares that can be obtained for each debenture). The conversion ratio may be determined by dividing the conversion price into the face value of the debenture. In some cases, the security contract may provide for certain changes in the conversion price of conversion ratio over time.

(g) The conversion price exceeds the price at which the common shares of the issuer could have been purchased on the market at the time the debentures are issued (for example, with a 25% conversion premium).

(h) The debentures have a specified maturity date.

(i) At maturity, the debentures are redeemable by the issuer at a redemption price of 100% of the face value, plus accrued and unpaid interest.