PERSPECTIVES ON TAX LAW & POLICY

Editor: Jeffrey Trossman Volume 2, Number 1, March 2021

Editor's Note

Jeffrey Trossman, Blake Cassels & Graydon LLP

The contributors to this issue of *Perspectives* present their views on the deduction of interest costs by corporations. Is now the time for new limits on companies' ability to deduct interest expense? Isn't interest just a normal, legitimate business expense, like rent? Corporate income tax is supposed to be charged on net profit (revenues minus expenses). Interest is a real expense, so shouldn't every dollar of interest costs be subtracted when net profit is being calculated?

Governments are concerned that interest charges can be used by large multinational enterprises to shift income to low-tax countries. Historically, as most tax experts know, profit shifting within multinational corporate groups has been quite easy to achieve. The multinational group could establish a lightly taxed financing vehicle (for example, in Luxembourg) that lends to other group companies that are doing business in higher-tax countries (for example, in France). Alternatively, the group could simply arrange for disproportionately large amounts of overall group debt to be incurred by group companies that are doing business in higher-tax countries. In both cases, the interest deduction in the higher-taxed entity reduces its taxable income, giving rise to tax savings that benefit the multinational enterprise while eroding the tax base of (and government revenues collected by) the higher-tax country's tax authority. This reduction of the tax base in higher-tax countries is commonly referred to as "base erosion."

In recent years, the concern about base erosion has led the United States, the United Kingdom, and the European Union to restrict the corporate interest deduction to a fixed percentage (typically 30 percent) of earnings, as recommended by the Organisation for Economic Co-operation and Development (OECD) in 2015. This means that if a company has, say, $100 million of annual earnings before interest, taxes, depreciation, and amortization (also known as EBITDA), it can deduct a maximum of $30 million of interest in the year. If the company's interest costs are actually (for example) $50 million, the $20 million in excess of the fixed percentage is not deductible. Corporate tax will be levied on taxable income of $70 million, when net profit is only $50 million. Policy makers justified the measure by saying that it would combat base erosion and profit shifting (BEPS) by large multinationals.

The governing Liberals, in their 2019 election platform, promised to introduce this kind of rule in Canada, maintaining that it would equip the government to "crack down" on tax loopholes being exploited by large companies. In April 2020, Jack Mintz, one of Canada's leading experts on tax policy (and a contributor to this issue of *Perspectives*), co-authored an economic study of the Liberals' proposal, concluding that the measure would increase taxes on business at the worst possible time, and should be abandoned.

A completely opposite and quite radical view emerged some months later, in this newsletter's September 2020 issue, as Michael O'Connor, a former senior tax executive, proposed a blanket prohibition against the deductibility of corporate interest expense. Under O'Connor's regime, a company with $100 million of EBITDA would be allowed to deduct precisely none of its interest costs; corporate tax would be imposed, albeit at reduced rates, on the full $100 million, even if net profit, after deducting interest costs, were, say, $50 million. Michael's wicked sense of humour notwithstanding, his startling proposal was deadly serious.

Reaction to his article was swift. In November, none other than Canadian tax legend Brian Arnold described the idea as "revolutionary," adding that O'Connor's proposal, while it poses serious design issues (which Arnold outlines in his account), is worthy of serious discussion and study. Other

In This Issue

CTF FCF CANADIAN TAX FOUNDATION FONDATION CANADIENNE DE FISCALITÉ

respondents were less nuanced, reacting with a flurry of critical e-mails and social media posts, challenging Michael to debate his radical idea in a public forum.

We are holding that debate in this issue of *Perspectives*.

I encourage readers to apply the informed perspectives they encounter in these pages not only to Michael's specific idea but also to the ongoing policy discussion about earnings-based restrictions on interest, and the design of the tax system more generally. ■

Interest, Interest, Interest, Interest. Why So Much Interest?

Angelo Nikolakakis, EY Law, LLP

The OECD, in its report on BEPS, recommended that net interest expense be capped at 30 percent of earnings. Several countries, including the United States, have implemented such a measure, and the governing Liberals' 2019 election platform included a similar proposal.

Michael O'Connor, in the September issue of this publication, made a more radical proposal, suggesting that the interest expense deduction be eliminated for all corporations other than financial institutions, and that the fisc use the savings to lower headline corporate tax rates. O'Connor asserts that the corporate interest deduction subsidizes foreign investors by allowing them to erode the Canadian corporate tax base in a way that domestic investors do not. He says that tax-exempt pension funds can similarly erode the base through interest charges to controlled corporations, giving them an unfair advantage. O'Connor also says that the elimination of the corporate interest deduction would bring tax neutrality to the funding of corporations by eliminating the bias toward debt financing. His accompanying proposal—to provide tax-free treatment for certain corporate recipients of interest—would make it unnecessary, he says, for Canadian multinationals to set up offshore financing structures. Finally, he says that the proposal would greatly simplify Canadian tax law, eliminating the need for a host of complex base-protection rules.

Since the publication of his article in September of 2020, O'Connor and I have engaged in a frank, friendly debate. He has failed to persuade me that his proposal has merit, and I have failed to persuade him of the error of his ways.

The prevention of undue base erosion is a valid legislative objective, but it is better achieved through targeted rules. Although simplification is a valid objective, it should not be sought at the expense of coherence. Interest is a legitimate business expense. Like other expenses, it should be deductible in computing corporate profit, as it generally is in other countries. Anti-avoidance rules have a role in the tax system, but concerns about tax avoidance should not drive the system's basic architecture. The deduction for corporate interest expense is not a subsidy or tax expenditure; it is a basic building block of a coherent tax system. O'Connor's proposal would distort corporations' calculation of profit by disallowing one kind of legitimate business expense while other, similar expenses, like rent and royalties, are—anomalously—allowed.

General Considerations

Before addressing O'Connor's specific arguments, let's consider some general points. Governments use tax revenues to invest in programs and services—including infrastructure, education, and health care—that contribute to productivity. Centralized governmental management of such programs is probably more efficient than their individual and uncoordinated management by actors in the private sector. It is reasonable to expect those who benefit from these services, including non-resident investors, to contribute to their costs. That is one reason why we impose a corporate income tax (CIT)—so that non-resident investors in corporations contribute to the cost of the publicly funded programs and services that contribute to the generation of corporate profit.

One of the key features of the Canadian tax system is integration—the principle that income should bear roughly the same amount of tax whether it is earned directly or through a corporation. Another key feature is progressivity: that is, higher marginal tax rates for higher levels of income.

If an individual carries on a business directly or through a partnership, no CIT applies; the individual is taxed at the individual's particular rate, under our system of progressive taxation. In contrast, if "Granny" is the shareholder of a corporation, her effective share of the CIT may exceed the rate that she would pay if she had earned the same share of income either through a business (that is, directly) or through a flowthrough vehicle, such as a partnership. This compromises progressivity.

But why shouldn't Granny first contribute (at a rate commensurate with the direct and indirect benefits she has received) to the cost of publicly funded programs and services that helped generate her share of corporate income, and only then benefit from progressivity? Interestingly, this is not what happens when Granny holds corporate bonds rather than shares. The corporation deducts interest on the bonds, and Granny is taxed at her applicable marginal tax rate; unlike what happens when Granny is a shareholder, progressivity is not compromised. By holding bonds, Granny could be said to be getting a free ride when it comes to helping with publicly funded costs that have contributed to the generation of her share of corporate profits, because she gets the full benefit of progressivity, provided that the corporation can deduct the bond interest. But this is not the full story.

When Granny buys a corporate bond, she is providing capital that the corporation can use to generate profit. Granny's bond income can properly be viewed as income from *capital* (not income from *business*). Under accepted principles of international taxation, income from capital should be taxed only where the capital owner resides; income from a business, in contrast, is taxed where the business activities are conducted. According to this logic, Granny the bondholder, in the domestic context, ought not to be required to contribute, as an equity holder should, to the publicly funded costs of generating business income. In that sense, Granny the bondholder is not getting a free ride, and neither is a non-resident bondholder.

Neutrality in Corporate Finance?

O'Connor argues that his proposal would "bring tax neutrality to the funding of corporations" by eliminating the current bias toward debt financing. After the last financial crisis, many observed that the deduction for corporate interest expense created a bias toward debt (rather than equity) financing: interest produces a corporate tax shield, whereas a return on equity (dividends) does not. At times of economic stress, corporate cash flow dries up, lenders demand repayment, and cash-poor businesses default, with many forced into insolvency. In this way, excessive leverage—that is, "too much" debt—can contribute to economic instability.

This bias in favour of debt financing is the inevitable result of allowing interest deductions; but that does not mean that interest should not be deductible. Consider an analogy: when drivers are given a choice between two bridges, one with tolls and one without, they naturally favour the toll-free route. In the same way, the corporate interest deduction naturally tilts corporations' preferences toward debt financing.

But there are two ways to neutralize that tilt: impose tolls on both bridges, or on neither. Both approaches will produce tax-neutral traffic flows. But these alternatives are not entirely neutral. If tolls are imposed on both bridges, this will reduce overall traffic volume; it may raise short-term revenues, but it could also reduce productivity as fewer people cross the bridges at all. By analogy, corporations' inability to deduct either interest expense or dividends may produce neutrality, but it will also tend to increase the cost of capital and thus impede financing and productivity more generally.

My toll bridge example leads me to recall that classic scene from *Monty Python and the Holy Grail*, when the Black Knight stands before a bridge, determined to bar King Arthur's crossing. Prohibiting the deduction of interest expense, as I see it, is a cause worthy of the Black Knight, and those familiar with this film will recall how the confrontation ends for that character, defeated and disarmed (in every sense) as King Arthur canters across the bridge.

Rather than imposing more tolls on bridges, the tax system should seek not to interfere unduly with passage from one side to the other. Tax rules should foster, not inhibit, the funding of productive activities. A prohibition against the deduction of interest expense, while it may achieve debt-equity neutrality, will create an unjustifiable obstacle to raising capital, especially in the cross-border context.

Tax-Indifferent Investors (Non-Residents and Tax-Exempts)

O'Connor states that his proposal would "remove the ability of [tax-indifferent investors] to acquire corporations and strip out" taxable income by taking advantage of their status as tax-exempt or foreign.

But is such a measure necessary? In fact, numerous base-protection regimes already exist in current law, including

- the "thin capitalization" rules, which limit the ability of foreign investors to strip out taxable income;
- the "specified investment flowthrough" (SIFT) regime, which imposes an entity-level tax—at rates similar to the CIT—on the Canadian business income of publicly traded trusts and partnerships;
- the "foreign affiliate dumping" rules, which impede the ability of Canadian subsidiaries of foreign multinationals to incur interest expense to acquire foreign corporations that produce exempt dividends; and
- the "stapled security" rules, under which interest payable by public companies on debt that is "stapled" to equity is non-deductible.

These targeted regimes already limit earnings stripping in specific contexts.

I acknowledge that no similar regime prevents tax-exempt pension funds from stripping the income of controlled corporations by substituting debt for equity and deducting the interest on the debt, thereby eroding the tax base. But this is not the full story.

Tax-Exempts and the Deferral Benefit

Pension funds' income is ultimately taxed in the hands of pensioners when it is paid out to them. When the pension fund's income consists of dividends, the pensioner does not benefit from the usual integration provisions—namely, the dividend tax credit. Some will argue that this failure to integrate is the price the pensioner pays for the deferral benefit associated with earning income through a tax-exempt pension fund. But that argument is spurious, in my view.

The deferral benefit is a matter of broader social and economic policy. It creates incentives for and thereby supports savings, producing economy-wide efficiency and productivity benefits. Deferral should not be undermined by the double taxation of corporate income: doing so is inconsistent with the social and economic policy objectives that justify deferral in the first place. Furthermore, system-wide deferral benefits (and the public cost thereof) arise only to the extent of system-wide deferral. That is, they arise only to the extent, and for the duration, of actual accumulation. To the extent that pension funds use current income to pay out current benefits, no actual accumulation occurs and thus there exists no system-wide deferral benefit or cost; in this case, it becomes even more difficult to justify non-integration and the resulting double taxation.

This double taxation creates a bias in favour of debt financing rather than equity financing. If eliminating that bias is an objective, then the dividend tax credit should flow through pension plans.

Non-Resident Investors

For a non-resident investor that wholly owns a Canadian corporation, debt financing is perfectly substitutable for equity financing. In recognition of this fact, most countries, including Canada, have thin capitalization rules. Canada's rules in this regard, however, are particularly arbitrary. The rules impose a mechanical maximum debt-to-equity ratio. No attempt is made to consider whether the Canadian subsidiary is bearing more or less than its appropriate share of the multinational group's worldwide third-party debt.

A better-designed rule would block interest deductibility only where a disproportionate amount of group debt is being pushed into Canada. Indeed, under BEPS action 4 and some countries' rules, global group-wide third-party debt is used to adjust the cap of the amount of debt that can be pushed into the domestic jurisdiction before interest deductibility is denied. However, few countries use this kind of cap (or anything similar) under rules that allow a deduction for notional interest on equity, sometimes known as an "allowance for corporate equity" (ACE) or, more generally, "fat capitalization" rules. (For background on ACE, see the 2016 study by Boadway and Tremblay.)

In the cross-border context, asymmetry must be acknowledged as a pervasive issue. A deduction in one country without an inclusion in another country, or a deduction in one country that is at a higher effective tax rate than the inclusion in the other country, gives rise to numerous concerns and considerations. Some cannot resist crying foul in this regard, but asymmetry is a complicated issue.

With asymmetry, the dynamic is in some respects no different from our example, set out above, of Granny holding corporate bonds. If the rate imposed on Granny in her country of residence is lower than the rate at which the underlying corporate interest expense is deductible, then you might say, "So be it"—assuming you believe that income from capital should be taxed in the residence country.

But you may argue that some CIT should be imposed so that the bondholder contributes to the publicly funded costs that enabled the corporation to generate income in the first place. In that case, you will find excessive leverage—or even any leverage—to be problematic, particularly if this is more prevalent in the cross-border context than in the domestic context. Such an imbalance can have an impact on capital export neutrality and capital import neutrality, and thus on the efficiency of global capital allocation and productivity.

That said, competitiveness is also a very important, if in some ways unprincipled, consideration in the cross-border context. As I argued in 2007, Canada needs to compete for foreign capital, and if its tax rules are too onerous, capital will tend to gravitate to friendlier jurisdictions. Canada's multinationals also need to be competitive with their foreign counterparts.

Why Prohibit the Deduction of Interest Expense and Not of Other Expenses?

Why should corporate interest expense not be deductible while other expenses, such as rent and royalties, are deductible? Rent is similar to interest; both are charges for the use of capital that belongs to someone else. Royalties that result in a sharing of profit may resemble dividends in some ways, though not in all ways.

Income for tax purposes should be determined in a coherent manner. All revenues should be accounted for, and all bona fide expenses should be deductible. Dividends are fundamentally different from expenses. They are paid out of what remains for the owners after the expenses have been paid, and normally they are not legally enforceable. The deduction of all dividends would relegate the CIT to a mere withholding function, impeding its ability to force a contribution toward publicly funded costs that contribute to generating the income in the first place. That is not to say, however, that greater consideration shouldn't be given to the development of ACE regimes favoured by many economists.

There is also a paradox involved in denying the deductibility of corporate interest expense on the grounds that doing so would have a salutary effect on economic and financial stability. As a lawyer, I find that argument unconvincing. Unlike dividends, interest payments are legally enforceable. Thus, if interest expense is not deductible—or even if it is restricted to 30 percent of earnings before interest, taxes, depreciation, and amortization (EBITDA)—a corporation that has \$100 of revenues and \$90 of interest expense would be rendered insolvent by a tax rate above 10 percent. Such conditions would impair, rather than foster, economic and financial stability. This may explain why dividends are taxed differently from royalties. The latter, being legally enforceable, are normally deducted in calculating profit—that is, taken off the "top line." The former, in contrast, are declared at the board of directors' discretion and, subject to solvency limits in corporate law, taken out of retained earnings.

Some will say that in a world where corporate interest expense is non-deductible, corporations will simply adjust and take on less debt, so that the example of corporate insolvency that I posit above will be unlikely. In reality, the choice between debt and equity financing is driven by a combination of tax and legal considerations. Some businesses will be better positioned than others to raise capital by borrowing rather than issuing equity, without regard to tax considerations. In many businesses, especially those involved in resource extraction, revenues are inherently unpredictable, which increases the chance that non-deductible interest expense could lead to insolvencies. Denying the deduction of corporate interest expense could make the tax system seek to extract money from a corporation that has none, violating the "ability to pay" principle. This is why we have special "insolvency" deductions under the debt-forgiveness rules; perhaps similar concessions, giving rise to new complexities, would be required under the regime proposed by O'Connor.

The creditworthiness of borrowers unable to deduct interest expense would tend to be reduced under O'Connor's regime, especially if revenues are volatile. Borrowing costs would probably increase, as lenders seek compensation for this new risk. This effect might be mitigated by rules that seek to complement non-deductibility with integration to the holder. But if the current regime results in a bias toward debt financing despite our imperfect integration for dividends, why would an extension of the integration regime to corporate debt not result in an increased cost of capital?

To summarize, there is good reason to believe that, under O'Connor's proposal, insolvency risk would rise, leading to a higher cost of capital for businesses. Even if insolvency risk did not rise significantly, equity holders' after-tax returns would be reduced, because they would effectively bear the tax burden associated with corporate income used to service its debt, in the absence of perfect integration (and perfect integration is unrealistic). Overall, the O'Connor proposal would likely make it more expensive for corporations to raise capital.

Inappropriate Distinctions, Complexities, and Unanswered Questions

Finally, O'Connor's proposal includes some unjustifiable distinctions and raises many unanswered questions. Under the regime he proposes, interest expense would not be deductible by corporations (except by moneylenders), but it would be deductible by individuals. This would ensure, according to O'Connor, that only Canadian residents would benefit from the interest deduction.

But this anomaly is difficult to justify. Interest expense, whether incurred by an individual or a corporation, is a cost of earning income. Private companies, unable to deduct corporate interest expense, would undoubtedly seek to shift the expense to the companies' individual owners. It is possible that the resulting personal tax savings for individuals (taxed at relatively high tax rates) would more than offset the purported fiscal benefits of denying the corporate interest deduction.

How would partnerships and trusts be treated? What about partnerships that combine individuals and corporations? What about Canadian-controlled private corporations (CCPCs) that pay the special tax on investment income? Such companies are effectively treated as extensions of individuals, which is why the special tax applies. Why should they not be permitted to deduct interest expense in direct investment scenarios where the individual is permitted to do so? If CCPCs can deduct interest expense, part of the "benefit" of the resulting tax shield goes to non-residents, contrary to O'Connor's assertions. Rules added to stream the benefit to resident owners would undoubtedly be complex.

How will the necessary distinction between normal corporate borrowers and moneylenders work in practice? Will interest paid by moneylenders also benefit from a dividend tax credit, or will it benefit only to the extent that the interest is sourced from non-deductible corporate interest income? Without complex tracking rules, there may be overintegration or underintegration.

What about foreign lenders? Will they get a dividend tax credit or the equivalent from Canada (as they would under an "advance corporation tax") or from their home countries (as they would for an "indirect foreign tax credit")? Not likely. Thus, systemic double taxation will result, which will increase the cost of capital.

Another feature of O'Connor's proposed regime is that interest income from foreign subsidiaries would be exempt in Canada at the corporate level. However, that exemption is likely to lead to an increase in foreign taxation under other countries' rules. For example, other countries may deny a deduction for interest paid to a foreign (here, Canadian) corporation where the corresponding interest income is not subject to tax in Canada. The overall effect would be an effective surrender or "treasury transfer" of the Canadian tax base to other countries, which is hardly conducive to maximizing Canadian wealth and well-being.

A further source of complexity arises from the fact that a prohibition against corporate interest deductibility would impair the ability of Canadian corporate groups to take self-help measures to achieve tax consolidation. Current administrative policies that allow loss-consolidation transactions rely heavily on the deductibility of interest expense. Preservation of these policies would necessitate special exceptions to the O'Connor proposal—resulting in yet more complexity. It is well known that previous attempts to implement broader statutory tax consolidation, as exists in other countries, have been stymied by provincial opposition.

As for the social effects of O'Connor's proposal (the gender impact, for example), I have difficulty seeing the benefits. Those who have trouble raising borrowed capital would likely have even greater difficulty raising equity capital, or debt capital, in O'Connor's alternative universe.

Conclusion

The wholesale denial of the deductibility of corporate interest expense is a bad idea. The only apparent benefit of such a prohibition would be some simplification of the tax system. Even that is likely illusory, because the implementation of such a regime would result in new complexities.

Rational and measured refinements and targeted interest deductibility rules are justifiable. But it does not make sense either to throw out the baby with the bath water or to throw Granny under the bus. From an "economic substance" perspective, Granny the bondholder is not the same as Granny the shareholder. A shareholder has more downside risk and all the upside; a bondholder has less downside risk and none of the upside. I firmly believe that tax policy should not be grounded in legal fictions. But the distinction between an owner and a creditor is hardly fictitious. The distinction is grounded in economic reality, just like the distinctions between an owner and an employee and a customer.

Canada should not abandon longstanding principles that are grounded in economic reality and accepted globally, and that allow corporations to deduct interest as a cost of doing business. Indeed, O'Connor's proposal amounts to the abandonment of the corporate *income* tax as such, in favour of an alternative tax on corporate earnings before interest and taxes (EBIT). It is a very radical proposal. ■

Interest Deductibility Remix

Michael O'Connor

Last summer, I was asked to contribute to this newsletter an article on post-pandemic directions in tax policy. I racked my brain for the most consequential idea I could think of. I considered various alternatives, including executive compensation, defunding the CRA, and simplifying tax dispute resolution. I concluded that none of these was a game changer.

Then I noticed the recent fuss about interest deductibility. I reviewed the Liberal and NDP proposals (inspired by the OECD BEPS action 4 proposals) to limit deductions of corporate interest expense to 30 percent of earnings before interest, taxes, depreciation, and amortization (EBITDA). I concluded that Canada should go further and legislate a blanket prohibition against interest deductions by most corporations.

I did not fully anticipate the maelstrom of reaction I would get from friends and foes alike. Some agreed that my proposal would reduce the use of deductible interest for tax-avoidance purposes, especially for interest paid to non-residents and tax-exempts. Others railed against my idea and plied me with the usual arguments—including concerns about "competitiveness" and double taxation—for maintaining the status quo. Brian Arnold, in the November 2020 Arnold Report for the Canadian Tax Foundation, said that my proposal was worthy of study, but that the corporate interest deduction was "too deeply entrenched to be abandoned."

Having considered these reactions to my proposal, pro and con, I remain steadfast in my startling realization that the ease with which a corporate interest deduction may be claimed is the root cause of (1) many international tax-avoidance schemes, (2) most of the complexity in our corporate tax system, and (3) most bad corporate tax behaviour. I am not the wisest person when it comes to the intricacies of interest deductibility. But I have overseen more interest deductions than most. My views are thus informed by practical experience and untethered by any constituency.

My Proposal

The key elements of my proposal are as follows:

1) The corporate interest deduction should be repealed, with an exception for moneylenders.
2) Headline corporate tax rates should be reduced substantially.
3) The treatment of recipients of intercompany interest should be similar to the treatment of recipients of intercompany dividends.
4) As Allan Lanthier and Jack Mintz suggested in 2007, the government should initiate a nationwide, evidence-based consultation on interest deductibility that would enable stakeholders to state their positions on, and to test the arguments for and against, proposals in this area, including proposals like mine. The government should complete this consultation before proceeding with any changes to corporate interest deductibility, to be sure we get it right.

The consultation is a key part of my recommendation. We need to understand how much corporate debt exists and how much is held by various groups, including non-residents, tax-exempts, registered plans, and individuals. Are there systemic issues beyond taxation that affect the ability to borrow—in particular, issues related to gender or challenges faced by BIPOC (Black, Indigenous, and people of colour) communities in which borrowing may be more of a challenge and in which, therefore, the ability to realize the subsidy of the corporate interest deduction may be unavailable? Does corporate interest deductibility favour the wealthy and contribute to income inequality? Is the issue confined to related-party interest, or is it broader? Answers to these questions are required to accurately size the issue, to understand how much is at stake, and to direct appropriate action at the correct issue.

I believe that my proposal will be found to be appropriate. I stand by my proposal; it is not a meme. It would be more effective in curbing tax avoidance than the OECD's pillar 2 blueprint, which effectively calls for a global minimum tax and would, in my view, be particularly detrimental to the competitiveness of Canada as a cellar-dwelling country in the G7. My proposal would be superior to the patchwork of complex restrictions in current law, and to the 30 percent restriction proposed by the OECD.

Beauty or Beast?

I do believe that the current system, which Jack Mintz describes, elsewhere in this issue, as "beautiful," is pretty good. (I will resist calling it the house that Jack built, but that might not be too far from the truth.)

In fact, the past 25 years have seen greater collaboration between countries, an increase in globally consistent reporting requirements, and a proliferation of anti-avoidance measures across the globe. My analysis of publicly available data shows that statutory corporate income tax rates have fallen, on average, 32 percent in 10 major jurisdictions (the G7 plus Australia, India, and China) since the "harmful tax competition" rhetoric began in the 1990s.

If, in 1995, someone had said that 25 years from now corporate tax rates will have dropped by 32 percent, they would have been locked up or sent to the OECD to make it all happen. As rates declined during this period, multinationals faced enhanced governmental efforts on various related fronts—the policing of transfer pricing, "crackdowns" on tax avoidance, new legislative tools such as general anti-avoidance rules (GAARs), and, yes, widespread attempts to limit interest deductions, which were a key part of these efforts. My proposal is to do that again—eliminate the corporate interest deduction, and further reduce rates. This can be done on a revenue-neutral basis by properly calibrating the rate reduction. It is worth noting that over the last decade in Canada, as headline rates have declined, the CRA's annual financial reports indicate that corporate tax revenue as a share of total tax revenue has increased, despite rhetoric suggesting otherwise.

That said, our current rules, while they provide a complex web of overlapping anti-tax-avoidance regimes (such as our crude thin capitalization rules, foreign affiliate dumping rules, and transfer-pricing regimes), leave Canada's corporate tax base susceptible to significant base erosion, usually by way of interest deductions. None of the existing regimes prevents tax-exempt owners of taxable companies from stripping out earnings with interest. My proposal would put a stop to that.

I will now address some of the criticisms levelled against my proposal.

Cost of Capital and Competitiveness

One of the key arguments against my proposal is that it will increase the after-tax cost of capital to Canadians and make Canada a less attractive place to invest. This ignores my proposal for a significant corporate tax rate reduction. Jack Mintz dismisses the rate reduction not by arguing that it is a bad idea but, rather, by simply asserting that it won't happen because post-pandemic governments will be fiscally stretched.

In fact, businesses' cost of capital should be unaffected under my proposal. My math suggests that a combined federal-provincial corporate tax rate of around 16 percent (down from the current 25 percent) would completely offset any impact on return on equity to a reasonably profitable and traditionally capitalized corporation.

Also remember that, currently, the benefit of the corporate interest deduction goes to the equity holders. This is perverse, given the goal of removing bias and distortions to economic or financing decisions; tax policy should have a neutral role in decisions on capital structure unless a sound policy reason exists to favour one decision over the other. A historical review of the origins of the corporate interest deduction shows that little or no thought was put into the decision to allow a deduction for interest expense. Angelo Nikolakakis argues that the equity holder should not bear the tax burden of a denial. But consider this: if there were a withholding tax on cross-border interest, the corporation would, realistically, be required to gross up any payment, in which case the equity holders would effectively bear the burden of that tax. Under my proposal, the adverse effect of the interest deduction prohibition would be offset by lower corporate tax rates.

The policy rationale for the corporate interest deduction (as Alvin C. Warren explained decades ago, in a seminal *Yale Law Journal* article that questioned the deduction) is predicated on a narrow "proprietor's" view of corporate finance. And I would propose, accordingly, that where you stand on this issue depends on whether you take a "proprietor's view" of interest expense or an "enterpriser's view." Proprietors hold the equity; they view interest as a cost of doing business. To an enterpriser, the optimal method of capitalizing a corporation is a question of financial economics. It is widely accepted that the cost of a firm's capital is U-shaped; the optimal mix of debt and equity arises where the marginal cost of these two sources is equal. This optimal debt-equity mix minimizes the weighted average cost of capital (WACC). The enterpriser strives to achieve this optimal mix of debt and equity, thereby minimizing the firm's WACC.

The corporate tax deduction distorts this crucial financing decision; the tax shield afforded by interest obviously biases management toward debt. This leads to excessive leverage, which can boost equity outcomes but at the cost of increased risk. This theory is proved in practice: it is widely understood that enterprise value is derived by discounting unlevered cash flows (that is, EBIT).

My proposal would eliminate the distortion created by the corporate interest deduction. Contrary to others' critiques, this would tend to lower businesses' overall cost of capital by giving them an incentive to achieve the optimal debt-equity mix. It would also reduce the proliferation of corporate insolvencies during recessions, because businesses would on average be less highly leveraged.

Other Countries' Policies

Some have argued that Canada should not adopt my recommendation because other countries allow a corporate interest deduction. Nikolakakis states that interest "should be deductible in computing corporate profit, as it generally is in other countries." We should be careful about comparing Canada's rules with other jurisdictions' rules, unless we understand the contexts in which these other rules operate.

My experience is that for decades, the governments of Canada's major trading partners have introduced significant practical obstacles to pushing debt into entities. The UK antihybrid rules effectively blocked the ability of foreigners to hold hybrid preferred shares in that country's subsidiaries for tax-planning purposes. The United States has effectively made cross-border financing into that country more difficult and less effective, with its interest deductibility rules, base erosion and anti-abuse tax (BEAT) rules, and anti-hybrid rules. Australia has aggressively applied its part IVA (general anti-avoidance rule) to any attempts to recapitalize Australian subsidiaries with debt. In France, as far back as 1988, the government imposed an interest restriction known as the "Amendement Charasse"—a rule, still in force today, that prevents debt "pushdowns." Until 2019, France blocked interest expense deductions through complex thin capitalization rules, a general 25 percent non-deductibility rebate, the "Amendement Carrez," and anti-hybrid rules, in addition to the "Amendement Charasse." Some of these rules were replaced in 2019 by an OECD-inspired rule that generally limits the deduction of net financial expenses to 30 percent of EBITDA. Several times in recent memory, France has moved to limit the ability of foreign multinationals to push debt into French subsidiaries, and today there are many rules directed at interest deductibility, including, but not limited to, related-party debt. In practice, these rules rarely come up, because the French government generally takes a dim view of takeovers of French companies.

My proposal is consistent with this international trend toward blocking corporate interest deductions and thereby protecting the tax base. Have these other countries' measures made them less competitive? I suspect not. In any event, assertions about Canada becoming less competitive need to account for the fact that other countries have a long history of blocking corporate interest deductions.

What About Other Expenses?

Some have asked: Why stop at interest expense? What about rents and royalties? I believe that these kinds of expenses are fundamentally different from interest. Interest expense arises from the corporation's choice of how to finance its business. It is unrelated to any primary factors of production. You do not increase production by increasing the debt-to-equity ratio. That is why the statutory interest-deduction rule is worded the way it is: taxpayers get an interest deduction only for the cost of funds used in, or to acquire, factors of production. Leasing and debt substitutes should be taken into account in any new system, but I do not believe that the financing element of leases factors into current thin capitalization or other interest-based limitations, which suggests that, in the context of tax policy, leasing and debt substitutes have always been distinguished, in the main.

Nikolakakis's example of a business with highly levered earnings is extreme; such a business (assuming that it is not a financial intermediary) is probably already insolvent. That said, the example highlights the legitimate question of whether my own proposal should be directed only at related-party debt; my own view is that the prohibition, like the OECD's 30 percent rule, should apply to all interest, but this point should be considered in the context of a broad consultation.

It may even be appropriate to take a wider view of corporate taxation and reshape the system according to a stakeholder view, whereby the tax is based on the share of EBIT allocable to each investor group, debtholder, and shareholder. I fear that we have been there before, however, with income trusts; and this would require us to reimagine corporate taxation entirely. We have learned, too—along with our trading partners that have imposed similar restrictions—that even a 30 percent limitation, as simple as that sounds, is a slippery slope; it will not give Canada the "first mover" advantage, and I suspect that it won't be long before we all get to the 100 percent limitation.

Participation Exemption

My proposal also involves treating intercompany interest the same as dividends. In light of the OECD pillar 2 proposal, we need to skate to where the puck is going (as a famous Canadian once said), and the few Canadian multinationals that still exist should anticipate that channelling debt (let alone double-dip structures) into other countries will become increasingly difficult. Accordingly, we need to reconsider Canada's inter-affiliate payment rules, and, despite the costs to the government of COVID-19, we need a way to avoid an increase in corporate tax rates or a reversal of the lower rates achieved over the past 25 years.

The ability to use offshore intermediaries to avoid tax in other jurisdictions is clearly coming to an end. My proposal dispenses with the need for special-purpose financing vehicles in tax havens.

My proposal to eliminate corporate interest deductions, reduce headline rates, and extend the participation exemption will preserve a competitive advantage for Canadian multinationals for years to come. This will especially be the case if other countries cling to their complex rules on the deductibility of corporate interest expense, only to have the tax benefit to multinationals ground down arbitrarily within these complex webs of rules, thus leaving multinationals effectively exposed to persistently higher tax rates.

Private Companies

For private companies, corporate and individual tax integration is more relevant. My proposal might well (as Brian Arnold predicts) result in a shift of interest deductions from companies to shareholders, especially given the persistently high marginal personal tax rates. This obvious reaction should be taken into account by policy makers, but it is not a persuasive argument against my proposal.

* * *

I do not think that my proposal throws "Granny" under the bus. The difference in risk profiles between bonds and shares is not a convincing basis for granting a corporate interest deduction. I see things differently, where Granny is concerned: I believe that Granny has been throwing Canadians under the bus, and it is now time for us to grab hold of the wheel and steady the car. Let me reiterate, too, that while I believe my proposal is appropriate, we should delay acting until an evidence-based consultation lights our path forward in a compelling way. Let's not fall for the beauty of our own system only to find that a better one is waiting for us just around the corner.

One final thought: while I do not agree that many of the positions advocated by others in this issue of *Perspectives* will solve the challenges that Canada faces, I am very pleased to see that people are now talking about the rationale for interest deductibility and laying out their arguments on either side of the debate. ■

The O'Connor Idea

Brian Ernewein

In this article, I map out key legislative design changes that would be required to implement the proposal put forward by Michael O'Connor in his September 2020 contribution to this newsletter. His proposal, herein referred to as the O'Connor idea (OI), was to eliminate the deductibility of interest expense for most firms.

General Observations

I begin with some preliminary observations on O'Connor's central proposition.

As a member of Finance Canada's Tax Policy Branch for over 35 years (until my retirement last fall), I've been directly involved with a number of major proposals to limit interest deductibility, including all but the first of the measures listed by O'Connor in the initial paragraph of his September article. Notwithstanding my involvement in these initiatives (and my lack of success in helping to get three of the four measures to stick), I don't share the view that it would be sensible to impose—on a system that seeks to tax income—a blanket prohibition against the deductibility of one of the major expenditures that firms incur in the income-earning process.

O'Connor's proposal is clearly at least "somewhat radical," as he suggests, but this is not to say that it hasn't been raised before. The comprehensive business income tax (CBIT), for example, which was one of the prototypes considered in the 1992 US Treasury study (*Taxing Business Income Once*), would generally make both interest and dividends non-deductible and non-taxable.

O'Connor's suggestion that the revenues raised from limiting the recognition of interest should be used to accelerate further the writeoff of capital property reminded me also of the "cash flow tax," an idea described by Mervyn A. King, back in 1987, as follows:

> The tax base can be measured as the difference between the receipts from sales of goods and services and the purchases of all real goods and services required in the production process, including purchases of capital goods. At the same time the tax base would disallow any deduction for the financing of the investment. Hence there would be no deductibility of either interest payments or dividends. The major departures from the present system would be the granting of immediate expensing (100% first-year depreciation allowances) to all forms of investment (but given this there would be no need for an investment tax credit), and interest payments would no longer qualify as a deduction for the purposes of the corporate income tax.

Perhaps there is some basis for reforming the Canadian CIT into something akin to a cash flow tax, but I don't see that case being made in O'Connor's article.

Key Arguments

Set out below, in italics, are what seem to me the major arguments in support of the OI, followed by my comments. I am not addressing the assertion that "interest expense is not really a part of the determination of profit." I question that assertion, but I leave it to others to address.

- *There are some problems with interest deductibility—for example, in relation to borrowings used to generate exempt income, and in cases involving non-residents and tax-exempts*. Perhaps so, but this would seem a reason to address those problems, rather than to take a scorched-earth approach and completely eliminate interest deductibility. The problems that O'Connor identifies seem, for the most part, limited to situations where firms' holders of equity and debt are the same or are in a position to collaborate. A better course than the OI would be to focus on addressing those situations (with the caveat that if the Canadian government moves ahead with the OECD BEPS measure, it would reduce the case for other, more targeted actions). One area, in particular, that seems deserving of re-examination is the need for some constraint on the ability of domestic tax-exempts to choose their debt-equity mix in commercial enterprises they control—although the extent to which such investors actually use their own funds to provide the debt-financing component should be considered in assessing the importance of any changes in this area.

- *Attempts to surgically address the issues with interest deductibility have not been successful.* True, but it is unclear how the odds of success would be improved by eliminating interest deductibility and thus taking on all of those issues, and many more, at once. (I acknowledge that the across-the-board limits contemplated in the OECD BEPS proposal can be viewed as taking on all issues at once, but the magnitude of the change matters.)
- *Adoption by Canada of the OECD BEPS proposal to limit interest deductibility cannot be justified on the basis that corporate Canada hasn't been paying sufficient CIT of late.* If we accept the premise that corporate Canada has been paying sufficient CIT, there is even less justification for a complete prohibition against interest deductibility.
- *Eliminating interest deductibility would allow Canadian CIT rates to be reduced to the levels of the CIT rates in competitor countries (or permit faster writeoffs of property), thus improving Canada's competitive position overall.* For the rare firm that exemplifies the general tradeoff argued here, I question what benefit is to be gained by paying X percent on Y as opposed to, say, 3⁄4 of X percent on 4⁄3 of Y. More generally, it is unclear how lowering tax rates to match our competitors—which would be achieved by the raising of taxes through an expanded tax base not replicated in our competitors' tax systems—would improve Canada's overall competitive position. Similar comments apply, mutatis mutandis, to the tradeoff between interest deductibility and faster writeoffs—with the additional point that the pace of depreciation is only a timing matter, whereas non-deductible interest would give rise to a permanent difference in the computation of income.
- *"The pandemic presents Canada with a great opportunity to redraw the tax treatment between corporate debt and equity."* I question whether this rather fragile time is in fact a propitious moment for such a major shakeup of the CIT system as O'Connor proposes. In any case, it still begs the fundamental question of whether such a change would be to the good.

Implementation

As I considered the question of how to implement the OI, my initial plan was to list all provisions of the Income Tax Act (ITA) that would require modification if the OI were implemented, and to describe the required changes. I soon abandoned this approach, recognizing that even the list of provisions would likely exceed my allotted word count for this article. Instead of providing such a list, I provide below a more generalized description of changes that would require consideration.

The primary change, of course, would be to turn off the basic interest deduction rule in the ITA (paragraphs 20(1)(c) and (d)). I presume that other financing expenses would also be subject to the new prohibition. I tend toward the same conclusion for guarantee fees, although some would argue, perhaps, that these should be left untouched.

Debt substitutes would need to be addressed. For example, leases of personal property reflect an embedded interest charge: should this charge now be isolated and denied deduction? What about the time-value element of real property rents? Given the rationale for the OI, perhaps the answer depends on whether the lessor is a tax-exempt or a non-resident. The time value of money can also be a feature of conditional sales: if, for example, a foreign vendor sells a new machine to a Canadian firm, with payment required only at the end of a five-year period (and no stated interest), can the firm claim depreciation in respect of the entire cost of the machine, including the embedded interest that would not be deductible if separately paid? Or should some part of the deferred payment be treated as non-deductible interest (assuming that existing rules, such as sections 16 and 68, do not otherwise apply to treat a portion of the payments as interest)?

The ITA contains many provisions that seek to identify an interest component, or to adjust the timing of recognition of interest, in debt instruments or debt substitutes. In general, rules that elaborate on what constitutes interest for tax purposes would seem to remain relevant—the change, in such cases, would relate to the *consequence* of being characterized as interest (that is, taxable/deductible now; explicitly non-taxable and non-deductible under the OI).

Rules that prescribe or adjust the timing for the recognition of interest income or expense may no longer be relevant—at least for "ordinary" firms. The same is true for rules that recharacterize dividends as interest, or vice versa (or provide a similar result). In this context, I agree with O'Connor that the OI should prompt a review of the suite of (what I believe he meant to refer to as "commendable") preferred share provisions introduced in the 1970s and 1980s to address after-tax financing structures. My preliminary view is that these provisions might no longer be required in relation to recipient firms, for which both dividends and interest would become "nothings." But these provisions would remain applicable to financial institutions and to any other firms not subject to the proposed prohibition on deducting interest expense.

The OI suggests that interest received by affected firms should be treated as the equivalent of dividends. On the basis of this direction, I would suggest that the outcomes discussed below are appropriate.

For Corporate Recipients

Such interest received from a domestic payer should qualify for a deduction analogous to the intercorporate dividend deduction. It also seems appropriate that the same treatment would apply in respect of foreign-source portfolio interest.

With respect to interest received by Canadian firms from their foreign affiliates, I see legitimate arguments for both deductibility and non-deductibility. The deduction that the exempt surplus system provides for distributions (in the form of dividends) is predicated on the dividends generally being a distribution of after-foreign-tax foreign profits. Interest paid by a foreign affiliate, in contrast, is more likely to be a foreign-deductible (that is, pre-foreign-tax) foreign-source payment. Even if the Canadian government agreed to exempt such receipts, I suspect that foreign governments would consider moving to eliminate the apparent opportunity for tax arbitrage. They would not, I wager, be as concerned with our deliberate and self-inflicted creation of double taxation whereby interest paid by Canadians to non-residents is non-deductible to the Canadian payer while remaining taxable to the foreign lender. If Canada provided exempt treatment and foreign governments did *not* react, an incentive might be created for cash-rich Canadian firms to invest (by way of loan, the interest on which would be deductible in other countries but not here) in foreign operations over domestic ones.

It is interesting to consider how far the equivalence of interest and dividends would extend. For example, with respect to the current dividend stop-loss rules, should non-taxable interest received on a debt instrument grind any loss on a subsequent disposition of the debt? To take another example—going further to analogize the underlying debt instrument as equity—should the concept of paid-up capital, applicable to corporations resident in Canada, also be made relevant to debt instruments?

O'Connor appears to contemplate that dividend equivalency would extend to non-resident withholding taxes; in other words, the cross-border payment of interest would be deemed to be a dividend for withholding tax purposes to the extent that it is not deductible by virtue of the new prohibition. I considered whether the renegotiation of tax treaties, including the Canada-US treaty, might be necessary to achieve this outcome. If so, history suggests that this renegotiation would necessarily be a long-term undertaking. Perhaps this renegotiation would be unnecessary (putting aside any US policy challenge) if the legislation makes it sufficiently clear that such interest is "income that is subjected to the same taxation treatment as income from shares under the laws of" Canada, because this would seem to qualify the payment as a "dividend" under the Canada-US treaty.

For Individual Recipients

The OI would preserve the right of individuals to deduct interest expense incurred on borrowings used for income-earning purposes, and I infer that the interest income of individuals would also remain taxable under the OI. It would be necessary to determine whether interest receipts constitute ordinary income or, following the dividend-equivalency model, should be subject to the dividend gross-up and tax credit regime applicable to individuals; I assume that the latter approach is intended.

If interest continues to be taxable (whether as ordinary income or as dividends) when it is received by individuals but not when it is received by corporations, there arises an obvious incentive to place interest-earning investments in corporate solution. It seems appropriate that interest income earned by private corporations should continue to be taxed under part I or part IV.

It is not clear to me what in the current system would prevent a public corporation (that is not an excepted financial institution) from raising capital from individuals with the express intention of investing in long-term interest-bearing instruments. The interest income earned on those instruments would be exempt from corporate tax under the new participation exemption. In the absence of any new anti-deferral or other anti-avoidance rules (both inevitably complex), an opportunity would seem to arise for significant deferral of personal tax on that income.

With respect to the expense side, allowing individuals but not most other entities to deduct interest expense seems likely to create pressures and distortions. It seems reasonable to expect that individuals will increasingly take on personal debt to support the business carried on in their private company or other entity (or, perhaps, to eliminate the separate entity altogether). For small, "one-person" firms, for which the lender may in any case have sought a personal guarantee of the entity's loan, a personal borrowing may not fundamentally change the overall commercial profile of the loan arrangement. For somewhat larger entities, particularly where several (or more) individual shareholders are involved, pushing the debt up to the shareholders may be difficult to orchestrate and harder to maintain over time. I do not identify a particular legislative response that would either aid or suppress attempts by taxpayers to seek the "least bad" outcome in this context, but it seems that the shifting of interest deductions to individuals would suppress the revenue-raising effects of the prohibition against corporate interest deduction.

* * *

While at first blush the OI might appear to achieve simplification, the implementation of such a profound change would pose numerous challenges and might give rise to complex new rules. ■

"Should 5 Percent Appear Too Small, Be Thankful I Don't Take It All"

—"Taxman," the Beatles

John Tobin and Josh Morry, Torys LLP

We appreciated the provocative, tongue-in-cheek panaceas that Michael O'Connor, in the September 2020 issue of this newsletter, proposed for the broader tax issues facing Canada—challenges that will only be more difficult to resolve following the pandemic, when the government needs more tax revenue. Imagine the sound of O'Connor's soft tenor voice along Elgin Street, singing "Losing My [Interest] Deduction," his simple love song to the abolition of interest deductibility for most Canadian businesses. Then imagine that he follows that up with his recent YouTube phenomenon, "If I Just Applied the GAAR," and maybe throws in, for good measure, a musical cure for transfer pricing, with "My Heart Aches for Formulary Apportionment." Tax returns will simplify, assessments will amplify, and collections will multiply. It surely will be the best of all possible worlds.

What could possibly go wrong? Denying the deduction of an interest expense may sound simple. But make no mistake: even if implemented with a general corporate rate decrease, it is nothing other than a tax on businesses that rely on borrowing. The Liberal and NDP election platforms recognized that their own proposals to limit corporate interest deductions to 30 percent of EBITDA (earnings before interest, taxes, depreciation, and amortization) would raise an estimated $12 billion to $21 billion in the next decade. (These proposals would exclude net interest expense less than $250,000, in order to reduce the impact of the proposed change on small business.) O'Connor, by suggesting that his more extensive changes would protect the "tax base at a time when tax revenues are most needed by government," implicitly recognizes that his changes will lead to tax increases, though he also suggests that the introduction of the interest denial could be accompanied by reductions in headline tax rates on a "revenue-neutral basis."

Interest Is an Ordinary Business Expense

Where we fundamentally differ from O'Connor is in our view that interest is part of the determination of profit. He views interest as a distribution of profit, not as a cost of doing business. The owner of a business that borrows from a bank to buy an extra machine does not have more profit until the machine produces enough revenue to cover the costs associated with its acquisition and operation, including the cost of interest. The bank that makes the loan would hardly be considered to be sharing in the owner's profit. For the owner of a business, loans rank ahead of distributions of profit, and when the loans are secured, they may rank ahead of ordinary creditors, including the CRA and labour. Allowing businesses to deduct interest expense when determining profit is consistent with commercial principles and is predictable and fair.

History of the Interest Deduction

O'Connor argues that Canada permits the deduction of interest expense because of legislative inertia. In reality, interest expense has long been viewed as an important cost of doing business. Almost all industrialized countries that levy an income tax (which includes most countries in the world) allow for the deduction of reasonable costs associated with earning revenue.

Generally speaking, reasonable interest expense incurred to gain or produce income has been deductible in computing income for tax purposes since 1923. Even in 1917, it was the position of Canada's finance minister, Sir Thomas White, that

> [w]ithout doubt, interest upon bonds is a fixed charge and net profits are only ascertained after deducting interest upon underlying charges, all interest payments, operating expenses and overhead—in other words, the net profits, according to a properly drawn balance sheet. [Bryan Pontifex, *Canadian Income Tax: The Income War Tax Act, 1917, With Explanations by the Minister of Finance and Instructions of Finance Department* (Toronto: Carswell, 1918).]

When interest deductibility was first codified in the Income War Tax Act in 1923, then Finance Minister William Fielding argued that the amendments "do not introduce much that is new." Rather, according to Fielding, they were "really intended to clarify the existing law." An important point is that the finance minister proceeded to justify the deduction of interest as "a proper charge against the business" that "should be deducted before the income is declared" (Canada, House of Commons, *Debates*, June 27, 1923, 4492-94).

Brian Arnold's 1992 article in the *Canadian Tax Journal*, "Is Interest a Capital Expense?" addressed the question of whether interest is a capital expenditure that requires a specific carve-out in section 20 for it to be deductible, or whether it is deductible in computing profit under section 9. Nonetheless, for a period of almost 100 years, interest has resembled any other deductible business expense and has been deductible in computing income from business.

Current law continues to permit taxpayers to deduct reasonable amounts of interest expense incurred to gain or produce income. Although the rules have introduced exceptions and limitations (for example, the after-tax financing rules, the foreign affiliate dumping rules, and the thin capitalization rules), this regime is longstanding, predictable, and fair. Interest is viewed as a cost of doing business, which is consistent with a normal understanding of how to measure business income.

Uncertainty and Unfairness

O'Connor's proposed change is radical. There would be winners and losers under the new regime, and it is difficult to predict whether the economic behaviour driven by the change would enhance Canada's competitive advantage or harm it. Two aspects of the proposal, in particular, would add uncertainty and bring unintended consequences.

The first is that O'Connor's proposal is not a universal denial of interest. He proposes a carve-out, such that the prohibition would not apply to "moneylenders and businesses whose profits are, of necessity, a function of borrowed money." It would be a complex task to determine which activities fall within these amorphous categories of business. Most credit providers are either in the business-to-business chain or in the business-to-consumer chain. Without a robust definition of O'Connor's carve-out—which, in our view, even O'Connor himself will find difficult to produce—Parliament will run the risk of reducing the availability of credit within Canada by substantially increasing the tax burden on businesses that provide such credit.

The second problematic aspect of O'Connor's proposal is that many transactions involve elements that are not generally thought of as being interest at law but are akin to interest or have an embedded interest component. It will be difficult to determine which business expenses that involve a time-value/interest component should be denied, and which should be allowed. Examples include rent, sharia-compliant financial products, repurchase agreements (repos), futures, options and forwards, discounts, and premiums. Even similar arrangements, such as early payment discounts on receivables, would result in an equivalent to interest payment. Under O'Connor's proposal, it will be necessary to draw this distinction between the allowed and the disallowed, which either will create additional uncertainty or, as is likely, will default to purpose tests or to reliance on the general anti-avoidance rule, in order to distinguish taxpayers who are entering into equivalent-to-interest transactions for bona fide business purposes from taxpayers who are seeking to abuse the legislation.

Taxing income before interest is not equivalent to taxing "net income." As Angelo Nikolakakis notes in this newsletter's lead article, if tax is applied to earnings before interest and taxes (EBIT), a company may face a tax bill that is larger than its available cash. Taxing on a basis other than net income may therefore create distortions. Canada has a history of implementing, and later rejecting, non-income taxes designed to address perceived BEPS concerns. While many of these taxes did not endeavour to be revenue-neutral, they were eventually removed because "business taxes" that are not tied to net income (measured after ordinary business expenses including interest) distort the market. In the November 2020 Arnold Report, commenting on O'Connor's proposal, Brian Arnold referenced the 1997 *Report of the Technical Committee on Business Taxation*. That report observed that Canada had responded to the erosion of its tax base by imposing other taxes, including capital taxes that impeded "prospects for job creation" (page 1.4). Arnold also referenced George Zodrow's 2008 Policy Forum article in the *Canadian Tax Journal*, "Corporate Income Taxation in Canada," which observed that foreign direct investment into Canada and international capital are "quite mobile and significantly affected by tax factors." Canada has since discarded those taxes (including, for example, the tax on capital) as being unfair in that they were not tied to income or profit and did not promote competitiveness.

Undermining Existing Tax Policies

Denying the deductibility of interest expense also signals that Parliament is opposed to borrowing to fund business activities. This signal will likely encourage businesses to underborrow. The ITA denies a number of deductions in order to deter behaviours that Parliament deems improper or excessive. Fines and penalties are non-deductible, even though courts have held them to be ordinary business expenses. Meals and entertainment expenses are generally limited to a 50 percent deduction. These express limitations signal to taxpayers that certain activities will not be underwritten by the tax system. Lumping interest into the category of non-deductible expenses suggests that incurring interest is undesirable and possibly "bad."

Some of the reasons that O'Connor cites for eliminating interest deductibility run counter to other incentives that Canada has adopted to promote economic activity. Parliament has consistently taken the position that a reduced (or nil) rate of tax on an interest receipt is not a justification for taxing the payer. For example, Canada has deliberately pursued zero rates of cross-border withholding on interest to promote the availability of low-cost credit to Canadian businesses. For many years, Canada imposed withholding tax on cross-border interest except where the so-called 5/25 exemption applied. No explicit rationale existed for the exemption, but it was commonly understood that this regime effectively prevented foreign lenders from competing with Canadian banks in the short-term lending market.

With the concurrence of the Canadian banks, the government deliberately changed the rules in 2007 in order to exempt all cross-border interest paid to arm's-length lenders. The rationale for this change was to support Canadian businesses by facilitating cheaper and easier access to credit. O'Connor's proposal would undermine this policy objective by subjecting cross-border interest to withholding tax as if it were a dividend. Parliament should not proceed with this change without re-evaluating the policy decision made in 2007, and we are aware of no reason to turn back the clock on that measure. The mere fact that Canada does not tax arm's-length non-residents on cross-border interest in no way justifies a full denial of interest.

Another example is that deductions are also permitted for expenses paid to other taxpayers with sufficient losses to offset the income inclusion. There is no outcry that a Canadian business using its properly available carryforwards, such that it is not subject to tax, somehow subverts the tax system if another business claims an expense on amounts properly paid to the loss business for goods and services.

Parliament has also adopted the thin capitalization rules to preclude earnings stripping to certain related non-residents, seeking to strike a balance between the need of a Canadian business (usually a subsidiary of a non-resident) to obtain capital, and the base erosion that results from allowing an excessive interest deduction. In this regard, Parliament's deliberate decision to limit the thin capitalization rules to cross-border loans from significant non-resident shareholders is an important signal regarding the amount of interest that will be considered reasonable to pay to certain related non-residents.

Not the Right Time

A cynic would argue that denying the interest expense deduction at this point in the economic cycle is politically expedient, given our low-interest-rate environment. The immediate impact on many businesses will be small. However, when interest rates eventually increase (and they will), the denial of interest deductibility has the potential to significantly increase tax revenues. This will not only disproportionately hurt businesses operating in capital-intensive industries, but also, potentially, further harm those businesses that were forced to borrow during the pandemic just when they are starting to get back on their feet. Given the pandemic's ongoing unpredictability, these borrowings may be significantly larger than anticipated.

A cynic might also argue that it is mean-spirited to deny an interest expense deduction to businesses that have had to borrow during the pandemic in order to survive. Businesses rely on predictability, and their current decisions, made during the pandemic, are based on a calculation of the cost of borrowing on an after-tax basis. To unexpectedly change the rules of the game midstream would, at the least, reduce these businesses' return on investment, and in some cases may jeopardize their survival. Under the existing rules, such borrowings would result in deductions and likely losses in the current year or two that would smooth out these businesses' tax liability as they pick up and become profitable again.

Put yourself in the shoes of a business owner who is struggling to adapt to the pandemic and who now faces the regime proposed by O'Connor. You will probably see this radical tax change as ill-timed. You will likely have to spend more to invest in professional and other help to determine the impact of the new rules on your business. You will likely have to consider changing your business's capitalization, or try renegotiating with lenders. You might also have to make changes in your business structure to separate financial businesses (which may be entitled to a deduction) from other businesses (which will not). If Canada needs to make tax changes now, we need to focus on making them simple (or specifically targeted), even if that means changing the headline corporate tax rate.

No One Else Is Doing It

Tax competitiveness is also measured comparatively. Other countries allow full interest deductibility, so if Canada were to act unilaterally by adopting O'Connor's proposal, the Canadian system would become comparatively unattractive for investment; businesses would face an additional expense when doing business in Canada. While some countries have changed their rules to limit interest deductibility to a maximum amount, these changes have been aimed at eliminating "excess" interest and reducing the incentives for businesses to "interest shop" internationally. For example, subject to certain exceptions, the OECD's 2015 BEPS action 4 proposes a fixed cap on interest deductibility tied to EBITDA, along with targeted rules to address specific policy concerns. However, in targeting *excessive* interest—that is, interest in excess of what is reasonably necessary to earn income (see, for example, page 50 of the OECD's Corporate Tax Statistics)—the OECD still recognizes that *reasonable* interest is a cost associated with earning revenue and should, accordingly, be deductible.

Conclusion

Back in 1996, in a paper titled "Why Tax Corporations?" Richard Bird identified many rationales for taxing corporations. Interestingly, he found no single rationale to be compelling, but he supported the taxation of corporations nonetheless, stating that "[a]lthough none of the possible rationales for taxing corporations is particularly strong, in total it is clear that we not only should but must impose some explicit taxes on corporations." He also observed, however, that such taxes should be properly designed to collect revenue "in ways that would improve economic well-being." Denying an interest deduction to businesses in computing their taxable income is the wrong policy at the wrong time. ■

Interest Deductibility: Beast or Beauty?

Jack M. Mintz, School of Public Policy, University of Calgary and EY Canada

It was fun to read Michael O'Connor's machinations in the September 2020 issue of this newsletter. His spirited view of the vagaries of interest deductibility raises important issues for tax policy design. Yet his proposal to abolish corporate interest deductibility altogether under the current income tax system is not only impractical but wrong. It would lead to unwelcome economic distortions and unfairness. Below, I will argue that interest deductibility is not a beast but a key part of the income tax's beauty.

To begin, we should remember that many business taxes are calculated without any deduction for interest. These include accounts-based value-added taxes (VATs), such as Japan's consumption tax, known as the JCT; resource taxes, including oil and gas levies in Alberta and mining profit taxes in Ontario; and gross margin taxes, such as Italy's regional production tax (known as IRAP), and special levies on financial companies in lieu of VAT. A key point is that these taxes are levied only at the business level and not on the owner or consumer. Each plays a specific role, such as taxing consumption or resource rents, or providing a revenue source for subnational governments in lieu of gross revenue, capital, or payroll taxes.

In principle, interest deductibility makes sense under the income tax, which is a major source of revenue and plays a critical role in the efficiency and fairness of the tax system. That is its beauty. Interest income is taxed in the hands of the holder of debt obligations; if the company borrows from an equity investor, interest expense should be deductible to avoid distortions and unfairness. In principle, one could disallow the deductibility of (net) interest, as of dividends, but that would require a major overhaul of the income tax. Similar points were made by Brian Arnold in his November 2020 instalment of the Arnold Report.

The question of whether to deduct interest is central to understanding the basic role of the corporate income tax (CIT). Under the personal income tax, capital gains are taxed only when realized, not on an accrual basis. One role of the CIT is to withhold income that is difficult to tax at the personal level. Under this withholding model, only reinvested profits would be subject to corporate income taxation; this model suggests that dividends, like interest, should be deducted from the corporate tax base.

However, this is not the model of our current tax system. Such an approach would substantially reduce the tax that non-residents pay to the Canadian treasury, and thereby undermine a second purpose of the CIT: ensuring that non-residents contribute to Canada's treasury. This purpose makes sense, given that the investments of non-resident corporate investors are made more profitable by Canadian expenditures on public services, such as infrastructure.

Seen in this light, O'Connor's proposal to make interest expense non-deductible for corporations is consistent with the aim of withholding income from foreign investors. Yet, given that Canada's capital markets are a small share of the world market, corporate bond interest paid to non-resident banks and other financial intermediaries would result in higher interest rates charged on loans to Canada. (Indeed, this was the rationale for the 2007 elimination of withholding tax on interest paid to arm's-length non-residents.)

Given our current income tax structure, the elimination of corporate interest deductibility without any other adjustments would create several harmful distortions. Consider, specifically, the following:

- Investors will prefer equity over bonds if personal tax relief is given only to capital gains and dividends, not to interest income. For this reason, proposals to eliminate the deduction of interest ought to be combined with adjustments to the personal income tax to treat interest income similarly to dividends—for example, by providing a tax credit. (See, for example, this 1992 recommendation from the US Treasury.) O'Connor proposes adjustments that would cause intercorporate interest to be treated the same as intercorporate dividends, but in order to mitigate double taxation, a further adjustment would be needed to provide equivalent-to-dividend treatment for individuals who receive interest on corporate debt.
- O'Connor proposes that banks and other financial institutions be exempted from the prohibition against interest deductibility, as they are from Canada's GST and many other VAT systems, which has resulted in a VAT exemption for financial services. Some countries impose a separate gross margin tax on financial institutions, although no input tax credit is provided to VAT-registered borrowers. Leaving aside the obvious political fallout, the exemption of one form of business activity from the general prohibition against interest deductibility would create distortions in the allocation of capital toward that activity. To compensate for the tax revenue lost by exempting domestic financial institutions, authorities might pursue a different form of tax on financial institutions. But the options available in this regard are not so easy to deploy.
- Limitations on interest deductions for debt issued to pension plans would be inconsistent with the objective of allowing Canadians to invest in tax-exempt savings plans in order to accelerate the accumulation of retirement savings. Although such limitations would put equity and debt held by pension plans on a level playing field (both subject to underlying corporate taxes), a different approach, consistent with retirement objectives, would be to provide a dividend tax credit to pension funds. Such a regime was once in place in the United Kingdom, though it was repealed in 1997. Canada has balked at giving pension funds an "implicit" dividend tax credit by prohibiting dividend rental arrangements with banks, on the grounds that this would create a distortion favouring pension plans'

ownership of Canadian corporations over taxable companies' ownership. At the same time, according to this argument, pension plans and sovereign wealth funds should pay tax on interest if they have at least a controlling interest in a company. Imposing a tax on interest earned by tax-exempt institutions is different from prohibiting interest deductions altogether.

- Subject to interest limitations in other countries, Canadian multinational companies would have the latitude to avoid Canada's restrictions by taking interest deductions abroad to fund Canadian operations, which would give them a significant advantage over smaller companies that do not have operations outside Canada. Although this would generate more government revenues, it would create an unlevel playing field among companies. O'Connor argues that it is more difficult to push interest deductions into other countries, especially with the recent adoption of earnings-stripping rules. But, as I have argued elsewhere, there remains scope for multinationals to shift deductions abroad.
- With no deductibility for corporate interest expense, companies facing economic downturns could be required to pay income tax even though they may not be earning any profits, leading to cash flow problems and potential insolvencies. Companies cannot simply forgo interest payments, which are fixed costs, regardless of the business cycle; and even without interest deductibility, companies would continue to borrow for economic reasons.
- With interest expense no longer deductible in Canada but still deductible in the rest of the world, the higher cost of funds for Canadian companies would hurt investment and competitiveness. O'Connor argues that this disparity could be offset by a corporate tax rate reduction. Governments, however, may not be interested in revenue-neutral corporate tax reform, given various budgetary demands, especially after the current COVID-19-induced recession.

The primary argument for limiting corporate interest deductibility is that the borrowing may be used to earn exempt income (such as dividends from foreign affiliates—although capital gains and some foreign dividends remitted to Canada are taxed). As O'Connor rightly points out, complex issues arise at the international level. A country could disallow interest deductibility in order to earn foreign-source income but thereby impair capital market efficiency at the international level. This issue received much attention in 2007, when then Finance Minister Jim Flaherty proposed to limit interest deductions traced to foreign investments. That proposal was later withdrawn.

Many governments around the world have adopted regimes—thin capitalization rules, allocation rules, or earnings-stripping rules—to limit interest deductions made by foreign subsidiaries. These limitations are designed to protect the corporate tax base, especially from base erosion through payments of interest to related persons. In recent years, such rules have been broadened to include domestic investments. This trend began in Europe, where thin capitalization rules that applied only to foreign-controlled companies began to be struck down by the European Court of Justice in 2002 on the basis that they were discriminatory and contrary to the freedom of establishment under EU law (see the Lankhorst-Hohorst case). In response, Germany and other European countries broadened their interest deductibility rules to apply to both domestic and foreign lenders.

In the 2017 Tax Cuts and Jobs Act, the United States adopted a similar rule, limiting interest deductions to no more than 30 percent of adjusted taxable income, which can be thought of as earnings before the deduction of interest, taxes, depreciation, and amortization (EBITDA). As of 2022, the limit changes to 30 percent of EBIT (earnings before interest and taxes) (rather than EBITDA). This rule, like the recent European thin capitalization measures, applies to both domestic and cross-border payments. The rule also applies to both related-party and arm's-length interest, though there are notable exceptions in this respect—for example, for real estate. (In response to the current recession, the earnings-stripping limit has been temporarily adjusted to 50 percent of EBITDA.) This base-broadening provision, among others, helped cover the cost of reducing the federal CIT rate from 35 percent to 21 percent.

Inspired by the OECD BEPS recommendations, Canada is now considering a similar rule. V. Balaji Venkatachalam and I evaluated this proposal (included in the 2019 election platform of the governing Liberals) in a recent study. The limit would not apply to companies with less than $250,000 in net interest expense or to smaller Canadian-controlled private corporations. Denied interest could be carried back for 3 years or forward for 20 years. We found that the measure was equivalent to a 0.9 percent increase in the corporate tax rate, and we concluded that the proposal in its current form is ill-advised, especially because it comes just as companies are piling on more debt owing to the economic fallout from the current COVID-19 crisis. This type of rule would need to be applied to corporate groups to make it effective. This poses a major design challenge, given that the Canadian tax system, unlike the systems in most other countries, has no existing system of group taxation.

Insufficient analysis has been devoted to the appropriateness of EBITDA-based earnings-stripping rules that have become a trend among OECD countries in recent years. In my view, Canada should not proceed in this direction, for a number of reasons.

First, earnings-stripping rules based on EBITDA are distortionary, favouring machinery-intensive investments. When companies invest in short-lived assets, they create more room to deduct interest expenses than they do with investments in long-lived or non-depreciable assets. For example, I have found that, with no carrying forward of unused interest deductions, the US EBITDA-based earnings-stripping rule results in a 16-point drop in the effective tax rate on marginal investments, because more interest deductions can be absorbed when additional depreciable investments are made. A more neutral approach is to base the earnings-stripping rule on EBIT, a measure that the United States will adopt in 2022 unless further changes are made to the law.

Second, the earnings-stripping rule is unsuitable to Canada's resource-based economy. Companies facing a downturn in earnings may pay taxes even if they are not particularly highly levered. In some countries with earnings-stripping rules, according to the OECD, carryforward or carryback provisions for unused interest deductions provide some relief. Better still, a safe harbour (for example, a limit on the net debt-to-equity ratio) would reduce both economic distortions and compliance costs. Companies that are not highly levered would be exempted from the rule's application when their earnings are low.

Third, given the cyclical nature of Canada's economy, the earnings-stripping rule is inferior to other interest limitation rules, such as thin capitalization. After all, if a safe harbour is used in accordance with the earnings-stripping rule, the safe harbour itself should be sufficient to limit interest deductions on a thin capitalization basis, anyway. For example, resource-based Australia's net interest limitation is applied to outbound and inbound investment according to the amount of maximum debt that is used to finance domestic investments (to qualify for the maximum, three tests must be met, including a safe harbour of debt that is 1.5 times equity).

Fourth, an interest limitation rule leads to the double taxation of interest for residents and non-resident investors. The rule should therefore be targeted to minimize distortions at the international level. It could in principle be applied to outbound investment, but, as Allan R. Lanthier and I noted in a 2007 *Canadian Tax Journal* article, doing so would require a thin capitalization rule that is applied more generally than is currently the case in Canada.

A movement to a comprehensive elimination of interest deductions, as Michael O'Connor recommends, or even to the US- or European-style earnings-stripping rule, is a step too far. It would undermine the beauty of the income tax as the main pillar of our Canadian tax system. ■

New Interest Deductibility Rules on the Horizon for Canada?

Marlene Cepparo and Michelle Thornton, KPMG LLP

It may come as a surprise to many businesses that the Canadian government may be considering a new regime to limit the deduction of corporate interest expense. Details of how this new regime might work are provided in a 2019 parliamentary budget officer (PBO) report. The regime described in this report limits the deduction to 30 percent of earnings before the deduction of interest, taxes, depreciation, and amortization (EBITDA). This measure is obviously less extreme than Michael O'Connor's proposal (discussed in other articles in this issue). But it would nonetheless represent a significant change for corporate taxpayers.

The PBO report provides only a limited description of the potential measure. The proposed rules are generally consistent with the OECD's 2015 recommendations of "best practices" for rules to limit base erosion caused by interest deductions and other financial payments (published as part of action 4 of the OECD/G20 BEPS project). Several countries have already implemented EBITDA-based interest limitation rules, and Canada, if it prepares to go down the same path, will surely want to consider these countries' experiences. Below, we provide an overview of the regime described in the PBO report. We also canvass some aspects of EBITDA-based interest deduction limitations in the United States and the United Kingdom.

What Could the New Regime Look Like?

During the 2019 federal election campaign, the Liberal Party promised to "crack down on corporate tax loopholes that allow companies to excessively deduct debt to artificially reduce the tax they pay." The PBO analyzed the potential revenues that could be raised by introducing a general rule that limited a corporation's deductions of interest expense to no more than 30 percent of its EBITDA. Under the new rule, as under the existing rules for business losses, any non-deductible interest could be carried back (for 3 years) or carried forward (for 20 years). The PBO assumed that the proposed limitation would not apply to a corporation whose net interest expense is less than $250,000 or to a Canadian-controlled private corporation (CCPC) with less than $10 million in assets or less than $500,000 in active business income. Also, if the corporation is part of a "corporate group" and the group's worldwide ratio of total net third-party interest expense to EBITDA exceeds the 30 percent threshold, the limit on deductible interest would be increased to reflect that worldwide ratio.

Unlike some other jurisdictions, Canada does not provide for taxation at the consolidated group level. The PBO report does not address the fact that any changes to the rules would need to take into account the overall net interest expense of the Canadian corporate group before the interest limitation is applied to a particular corporation in the group, or before taking into account the worldwide group ratio. For example, assume that a Canadian corporate group has a group-wide net-interest-expense-to-EBITDA ratio of 30 percent, but one corporation within that group (Corporation A) has a ratio of 50 percent. If the 30 percent limitation applies to the Canadian group-wide ratio, none of the corporations should be subject to a denial of interest expense. However, if the rules are applied on an entity-by-entity basis, Corporation A's net interest expense in excess of 30 percent of its EBITDA could be denied, while other corporations within the group whose net-interest-expense-to-EBITDA ratios are below 30 percent could have unused interest capacity. This would seem to be an inappropriate result.

The proposed limitation analyzed in the PBO report would apply regardless of whether the interest is payable to a related party or to an arm's-length lender. In this respect, the proposed regime contrasts with existing thin capitalization rules, which apply only to debt to "specified" (which generally means "significant") non-resident shareholders. The report does not state whether the proposed rule would replace or supplement existing thin capitalization rules, but the policy objectives are generally the same for both regimes—namely, limiting the use of interest deductions to erode taxable income. We would suggest that if the new rule is introduced, the thin capitalization rules be simultaneously repealed. It would be unduly onerous for Canadian businesses to have to contend with two complex, overlapping regimes.

The PBO estimates that the measure could raise between $1 billion and $1.5 billion in revenue annually—though it cautions that this estimate has "high uncertainty." The estimates in the PBO report predate the ongoing pandemic and today's historically low interest rates, and they should be revisited. The estimated amount of incremental tax revenue is in fact quite modest, viewed in the context of overall federal tax revenues. One should keep in mind, of course, that the details of any rule that may be introduced by the government could differ from those set out in the PBO report.

It is unclear if or when such rules may be formally proposed, as the country struggles with the pandemic-induced recession. The measures are likely to be opposed by business. And it is uncertain whether the government, which did not table a budget in 2020, would include this kind of tax change in the 2021 budget, which is expected shortly after the publication of this newsletter. Nonetheless, the prime minister's 2021 supplementary mandate letter to the minister of finance asked her to continue to focus on the government's priorities as outlined in the 2019 election campaign platform.

Key Components of an EBITDA-Based Interest Limitation Regime

The OECD generally recommends that countries limit an entity's net interest deductions to a percentage of taxable EBITDA in order to prevent BEPS through the use of excessive interest deductions or financing to produce exempt or deferred income.

By comparing certain aspects of the OECD's recommendations with the potential Canadian measures and with similar rules in other jurisdictions, such as the United States and the United Kingdom, we may gain additional insight into potential Canadian changes.

Fixed-Ratio and Worldwide-Group-Ratio Methods

Generally speaking, the interest expense limitation rules assumed in the PBO report are consistent with the OECD recommendations. The OECD advocates fixed-ratio rules to limit an entity's deduction of net interest expense to a percentage of its taxable EBITDA or its taxable earnings before interest and taxes (EBIT). The OECD also recommends that countries may supplement the fixed-ratio rules with worldwide-group-ratio rules. Doing so will allow an entity to deduct interest expense in excess of the fixed-ratio limit, up to the worldwide group's ratio of net third-party interest to taxable EBITDA or EBIT, if the worldwide group ratio is higher than the fixed ratio.

In 2017, the United Kingdom introduced similar fixed-ratio and worldwide-group-ratio rules. These "corporate interest restriction" (CIR) rules generally limit the deduction of UK companies' net interest expenses to the lesser of 30 percent of the group's UK taxable EBITDA and the group's worldwide net external interest expense, under the fixed-ratio method. The group may be able to elect to deduct a higher amount, using the group-ratio method, if the group's worldwide net third-party interest expense is higher than 30 percent of the group's worldwide EBITDA (subject to relief being capped at the group's worldwide net third-party interest expense, if that amount is lower).

The United States introduced fixed-ratio rules, but not a group-ratio test. In the 2017 Tax Cuts and Jobs Act, the United States made significant changes to its interest expense rules under section 163(j) of the Internal Revenue Code. The US rules apply not only to interest paid to foreign related parties but also to interest paid or accrued to any party (related or unrelated, US or foreign). For taxable years beginning after December 31, 2017, a taxpayer cannot deduct business interest expenses to the extent that its net expense exceeds 30 percent of "adjusted taxable income" (essentially the same as EBITDA), subject to certain adjustments.

For taxation years beginning after 2022, the 30 percent ratio is based on the more restrictive EBIT rather than on EBITDA.

In the US pandemic relief legislation (the CARES Act), the 30 percent limit was temporarily changed to 50 percent for taxable years beginning in 2019 and 2020, although taxpayers may elect out of the increased limitation.

De Minimis Rule

The OECD's recommendations also include the option of a de minimis rule that is generally based on the net interest expense of the "local group" (that is, multiple entities in a country). The PBO report describes a de minimis net interest expense of $250,000. That is relatively low compared with the amount prescribed in the UK rules, which include a group de minimis net interest expense for UK tax purposes of £2 million for a 12-month period. The PBO report appears to apply a Canadian de minimis exception at the entity level, not the local group level (as implemented by the United Kingdom and recommended by the OECD), though further clarification may be needed in this regard. As noted above, any proposed legislation should carefully consider how to tailor these rules to reflect the fact that Canadian law, unlike the laws of other jurisdictions that have implemented similar rules, does not provide for the taxation of consolidated groups.

Exclusions, Carryforwards, and Carrybacks

The OECD also recommends optional exclusions (such as for interest on certain public-benefit projects) and carryforward or carryback rules for disallowed interest or unused interest capacity. These features are intended to reduce the impact of these limitation rules on entities or situations that pose less BEPS risk. The PBO report assumes that smaller CCPCs may be excluded, but it does not outline other exclusions that may be considered. Also, the PBO report, while stating that denied interest can be carried back and carried forward, does not include details on the treatment of unused interest capacity. The PBO report does not detail the many additional complexities that would have to be considered before these rules could be implemented—for example, how these carryforward and carryback rules would operate in the context of an acquisition of control.

In the United Kingdom, a taxpayer can elect to exclude from the CIR rules, in certain circumstances, qualifying interest expense on funds invested in long-term infrastructure that is for the public benefit. A deduction that is denied to a taxpayer under the CIR rules may be carried forward indefinitely. Any unused deduction room may be carried forward for five years.

The United States provides exclusions for certain qualifying small businesses and public utilities, and certain real property trades or businesses and farming businesses can elect out of the US rules (though they may then be required to use an alternative depreciation system). The US rules also provide that any business interest expense in excess of the limitation for a taxation year will not be deductible but may be carried forward indefinitely. The US limitation applies on a consolidated group basis, rather than separately to each member of a consolidated group.

OECD Comments on Thin Capitalization Rules

The PBO report does not provide details on the potential interaction of the proposed rules with Canada's existing thin capitalization rules. The OECD notes that, as a best practice, thin capitalization rules should not be included as a general interest limitation rule, because they may be relatively easy to manipulate through an increase in the level of equity. The OECD does say, however, that thin capitalization rules may still be effective as a supplemental rule.

The OECD reported that by 2019, 43 members of the OECD Inclusive Framework had thin capitalization frameworks in place and that 30 had earnings-stripping rules based on a ratio of interest to EBITDA.

Conclusion

Canada appears to have only started to consider the parameters of new interest limitation rules. The changes being considered are not entirely unexpected, however, given that an increasing number of jurisdictions across the globe have enacted EBITDA-based rules that limit the deduction of interest expense.

Canada must consider the impact that any changes may have on its ability to attract capital. The new rules' potentially negative effect on Canada's cyclical resource-based economy was recently highlighted by Jack M. Mintz and V. Balaji Venkatachalam. The PBO report offers some indications of what may be in store for Canada if the government moves forward with these rules. But certain aspects of the regime (such as the low de minimis threshold) should be compared with the regimes in other countries, and one should consider the complications that may arise from the fact that Canada's tax law does not provide for the taxation of consolidated groups. Many other issues would still have to be addressed, including the interaction of the new measures with the existing thin capitalization rules or exclusions—an interaction that could ultimately make Canada's system more complex.

If Canada decides to move forward with a new interest deductibility regime, one hopes for a robust public consultation process and sufficient time for businesses to comment on the new measures. Governments face significant deficits as a result of the pandemic. And yet, according to the PBO report, only a small amount of incremental tax revenue is likely to be gained from the proposed regime. Furthermore, the introduction of a new interest expense regime right now could risk upsetting the already fragile economic recovery. ■