Let's Get Interest Deductibility Right: Kill the Beast

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Among my fondest tax memories are the government's various attempts to limit the deductibility of interest expense in Canada, and how each attempt was met with stiff resistance, and overturned. These attempts included the doomed 1981 federal budget proposal to limit interest expense to the amount of interest earned; the proposed changes related to corporate distributions, after the 1987 *Bronfman Trust* case; the 2003 ("reasonable expectation of profit") proposals following the *Ludco* case; and the proposed 2007 measure to deny interest deductibility on money borrowed to acquire shares of foreign affiliates (FAs). The latter proposal was followed by the appointment of the Advisory Panel on Canada's System of International Taxation, whose 2008 report recommended the repeal of the 2007 measure to deny the deductibility of double-dipped interest expense with respect to FAs. That report's recommendations gave rise to the complex FA dumping rules and expanded thin capitalization rules.

The 2020 federal budget was expected to launch the latest assault on the deductibility of interest—a limitation of net interest expense based on 30 percent of EBITDA (earnings before interest, taxes, depreciation, and amortization). Because of the COVID-19 pandemic, the 2020 budget never arrived, but this has not stalled global campaigns for and against interest deductibility reform.

Last election, both the Liberal and the NDP platforms included limits on corporate interest deductibility. Although each proposal belied the complexity of what it offered, the parliamentary budget officer estimates that these measures, if implemented, could raise $12 to $21 billion over the next decade. One cannot justify these proposals on the grounds that Canadian corporations are not paying tax: in 2019, corporate income taxes accounted for 15.2 percent of federal tax revenue as compared with 13.9 percent a decade ago, despite the fact that headline corporate income tax rates declined during this period. The rationale for the proposals seems to be that other countries are limiting the deductibility of interest expense. The United Kingdom has already enacted a limitation of 30 percent of EBITDA, and the United States recently released 575 pages of final regulations on its own business interest limitations, spawned by the country's 2017 tax reform.

I have come to believe that in the wake of the pandemic, Canada should move to prohibit the deduction of interest expense by all corporations, commercial trusts, partnerships, and other intermediaries, subject only to an appropriate exception for moneylenders and businesses whose profits are, of necessity, a function of borrowed money. This prohibition should be combined with consequential amendments that treat intercorporate debt the same as intercorporate equity. These changes would be somewhat radical, but they would, in my view, be appropriate measures to protect Canada's corporate tax base at a time when tax revenues are most needed by government.

Obviously, this proposal will be even more unpopular than a limit of 30 percent of EBITDA. But a blanket prohibition would apply evenly across relevant corporate sectors. It would be simpler to apply than the EBITDA limit, and it would avoid legislative complications such as the need to deal with carryovers of unused interest and intercompany interest. The proposal would also promote the elimination of ineffective tax policies and bad tax-planning behaviours that have resulted from rules that permit the deduction of interest expense.

Many holders of corporate debt are tax-exempt entities or non-residents. Deductible interest, when paid to these holders, gives rise to significant revenue leakage, even in the absence of aggressive tax planning. Elimination of the interest deduction would create the opportunity to significantly reduce headline corporate income tax rates and to permit faster writeoffs of depreciable property. For prudently financed corporations, this opportunity could mean that effective corporate income tax rates in Canada could be set as low as, or lower than, those currently prevailing in competing jurisdictions such as the United Kingdom and the United States.

As a former head of tax for two Canadian-based multinationals, I am baffled by the debate over interest deductibility, a debate that continues even as businesses ask for lower rates and faster writeoffs. Interest deductibility is at the heart of many tax-planning efforts. The topic is intertwined with fundamental questions: Why does Canada allow an interest deduction against exempt earnings? Why does the law effectively allow the conversion of large corporations into private income trusts when the corporations in question are owned by tax-exempt entities? Why is there ostensibly a 25 percent withholding tax on interest that is surrendered under treaties or in arm's-length situations? Why do corporations get a deduction for interest expense in the first place?

It was not until 1971 that Canadian corporations gained the ability to deduct interest on money borrowed to acquire shares in other corporations; the deduction was justified on the grounds that it would help Canadian corporations compete against foreign corporations that were able to claim such a deduction. Today, many of Canada's traditional large corporations have been acquired by foreign multinationals or tax-exempt pools of capital, such as pension funds and private equity investors. When these investors acquire a business, they are able to use the interest deduction to shift profits and thereby erode the corporate income tax base, which gives them a competitive advantage over taxable Canadian corporations. This lack of a level playing field was considered in a 2016 consultation in which the interested parties, not surprisingly, preferred to receive the status quo tax treatment rather than to face any restrictions; no legislative action has been taken to date.

Recent articles (see, for example, the *Financial Times* debate between Victor Fleischer and Jonathan Blake, and the articles by Jack Mintz and Allan Lanthier and Jack Mintz) lay out the usual competitiveness arguments for and against interest deductibility. I am not persuaded by these arguments. Canada is a diverse and open economy with bountiful resources and a well-educated workforce. If interest deductibility were so critical to Canada's competitiveness, our generous interest deductibility rules would put Canada at the top of the World Economic Forum competitiveness league tables, but we are not there. Tax competitiveness would be more effectively increased by sustainable, low corporate income tax rates, and accelerated depreciation. Now more than ever, as the government borrows $343 billion in a single year to finance rent and groceries for Canadians, the arguments for allowing interest deductibility appear weak.

In my view, interest expense is not really a part of the determination of profit (shareholder profit, yes; but not overall profit). It is more akin to a priority distribution of that profit. Interest is generally a fixed return paid to creditors. It represents compensation for providing debt capital, instead of the shareholders' own equity, to operate the business. It is a cost that equity holders accept in order to finance business activities without diluting their equity interests. In the same way that residual returns to common shareholders represent the cost of common share capital, the fixed return on debt instruments represents the cost of that form of capital; and, together, the weighted average of each makes up the weighted average cost of capital (WACC). Fundamentally, interest is allowed as a deduction only because the law specifically allows it to be deducted, albeit with restrictions.

By allowing intermediaries an interest deduction (sometimes constrained by thin capitalization rules), the current law effectively subsidizes foreign investors. If interest deductibility were generally available only to individuals, as I propose, we could be certain that the tax benefit is appropriately targeted at Canadian taxpayers.

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What we should be doing now is what Jack Mintz and Allan Lanthier suggested in a 2007 Policy Forum article in the *Canadian Tax Journal*. They proposed that "a consultative document should be issued to the public for review before reform proceeds." Today, a nationwide consultation, framed in the current Canadian context with real data, would give interested Canadians a chance to test the arguments for and against interest deductibility and an opportunity to adjust their thinking in response to the fiscal hole created by the government's actions to address the COVID-19 pandemic. We should also examine the extent to which tax-exempt registered plans and non-residents contribute to the corporate tax gap.

The pandemic presents Canada with a great opportunity to redraw the tax treatment between corporate debt and equity and the use of interest expense in corporate tax planning, while preserving Canada's competitive advantage. The anticipated 30 percent limit is arbitrary, would not affect prudently capitalized companies, and would, of necessity, be riddled with complexity. It would create more inequities and would not fully address the core issue.

In my view, we would all be better off if the corporate interest deduction were simply eliminated. By allowing intermediaries a tax deduction for interest-bearing debt, we in effect subsidize, through the tax shield on interest, any number of foreign shareholders, beneficiaries, or partners. If interest deductibility were generally available only to individuals (not to trusts or non-Canadian partnerships), we would ensure that tax relief for interest expense is given only to Canadian taxpayers. Now that the United States, the United Kingdom, and other countries have enacted 30 percent limitations, Canada should go further by disallowing the deduction of interest by corporations. This should be coupled with an exemption for interest income on intercorporate debt, just as an exemption exists for intercorporate dividends from domestic corporations and FAs. Given Canada's lack of a consolidated tax system, would intercompany interest denied by a limitation of 30 percent of EBITDA be exempt from income tax in the hands of the recipient, or taxed only to the extent of 30 percent of EBITDA?

Abolition of the corporate interest deduction, unlike a 30 percent limit, could greatly simplify our corporate tax system. It could even allow for lower corporate income tax rates with no sacrifice of overall tax revenues. It could reduce tax controversies, including those related to transfer pricing, while simultaneously preserving fairness for small businesses. The new exemption for intercorporate interest would reinforce Canada's movement toward a true territorial system. It might even assist in providing a rationale for eliminating the heinous preferred share rules that target debt substitutes.

Although the elimination of corporate interest deductibility may seem far-fetched, I believe that it would neatly address many problems caused by the deduction. The measure would bring tax neutrality to the funding of corporations that have debt as opposed to equity. The proposal would not only solve the quandary of why Canada allows a deduction for interest expense against a tax-free source of income (dividends from other corporations or income from the exempt surplus of FAs), but also remove the ability of pension funds and foreign corporations to acquire corporations and strip out Canadian-source corporate income at lower tax rates that are made available by the funds' and corporations' tax-exempt status, or by their status as holders of debt exempt from withholding tax under domestic law or a treaty.

An added benefit of extending Canada's participation exemption to interest on intercompany debt is that it would enable Canadian corporations to debt-finance foreign operations directly rather than through offshore financing affiliates in purported tax havens, given that the interest would, subject to local thin capitalization or base erosion rules, be deductible, and the interest income could be received in Canada tax-free, mimicking the existing FA system's treatment of dividends. Being able to eliminate offshore finance companies from corporate structures of Canadian multinationals would resolve issues related to the residence of such companies, issues that have arisen from the pandemic-induced travel restrictions. Since debt that is eligible for a participation exemption in Canada would not require the sort of hybridity features targeted by the US anti-hybrid rules, this measure may even become an effective way to fund US groups. And, finally, the elimination of corporate interest deductibility would end double dipping. With interest rates at rock-bottom levels for the foreseeable future, what better time to effect this change than now?

In light of the tendency of various political parties to politicize corporate interest deductibility, more study and consultation on the matter should be undertaken immediately, with a view to eventually getting Canadians, including the business community, to buy in. In the end, given a choice between, on one hand, my proposal of no corporate income tax deduction for interest expense and, on the other hand, a possible limitation based on 30 percent of EBITDA, Canadians may find that the latter looks fairly reasonable. In light of the pandemic spending, however, we should open our minds to something more radical. Of course, if Canadian corporations are to face any restriction on interest deductibility, even with a tax rate reduction or accelerated depreciation, the extension of Canada's participation exemption to the intercompany debt of FAs, as a means of preserving Canada's "home ice advantage," will make any limitation easier to swallow.

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