Intelligence MEMOS

From: Allan Lanthier

To: The Department of Finance

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Re: **OTTAWA SHOULD FORGET ABOUT LIMITING INTEREST EXPENSE DEDUCTIBILITY**

The Liberals promised in the fall campaign to limit a corporation's deductible interest expense to 30 percent of earnings before interest, taxes, depreciation and amortization (EBITDA) if annual interest expense exceeds $250,000.

It would be a mistake to include this measure in the upcoming federal budget. The proposal duplicates existing restrictions and should be scrapped.

Some background: An international base erosion and profit shifting (BEPS) initiative began in 2013 at the OECD to address global tax avoidance by multinational enterprises (MNEs). Initially supported by the OECD and the G20, the so-called "Inclusive Framework" now includes 137 countries and aims to find consensus on radical new international tax rules by the end of 2020.

As an early part of the BEPS initiative, the OECD issued a report in 2015 focused on base erosion involving interest deductions. The report recommended that deductible interest be limited to 10-30 percent of EBITDA.

The OECD's concern is that money is mobile, and that MNEs can transfer debt to higher-tax countries, often via intra-group financing (otherwise known as "double-dips"). While the OECD acknowledges that there are various approaches to limit debt leveraging, it recommends the concept of interest expense to EBITDA.

Since 2015, most EU member countries have either retained or adopted this type of limitation, as have some countries outside the EU, including the United States. Canada has not, nor should it.

Canada already has two sets of rules that address excessive debt leveraging – the "thin capitalization" provisions that limit deductible interest for inbound investment by non-residents, and the "foreign affiliate dumping" (FAD) rules that apply to outbound investment in foreign affiliates by Canadian corporations that are controlled by non-residents.

First, thin capitalization. In 1972, Canada became one of the first countries to adopt such rules. In general terms, a 1.5 to 1 debt-equity ratio applies on loans to a Canadian corporation from non-resident shareholders who own at least 25 percent of the corporation's shares. Deductions are denied for interest paid on debt that exceeds this ratio, and the excess is taxed as a deemed dividend to the non-resident.

Then came the FAD rules, introduced in 2012 following an ill-fated attempt by Jim Flaherty to deny interest expense for investments in foreign affiliates. Under these rules, if a Canadian corporation is controlled by a non-resident and invests in a foreign affiliate, the full amount of the investment is often treated as a taxable dividend to the non-resident parent company.

The government could have denied interest expense on funds borrowed to invest in foreign affiliates, or deemed the amount of the investment to be a taxable dividend. Either approach would have prevented debt leveraging: it opted for the second.

The FAD rules therefore do not limit the deductibility of interest expense. They go much further, and prevent any foreign affiliate investment at all by a foreign-controlled corporation unless it has sufficient "paid-up capital" to avoid a taxable dividend.

Beyond those duplication issues, an earnings-based limitation would be harmful to businesses that are cyclical in nature, and to start-ups and scale-ups if earnings are low.

Special rules would be required for industry sectors that are typically more highly leveraged than others, such as utilities and real estate. And the legislative language would be horribly complex, particularly considering that Canadian corporate groups cannot file on a consolidated basis for tax purposes.

In short, the proposed limitation is misguided, unnecessary, and should be abandoned.

Allan Lanthier is a retired senior partner of a global accounting firm and has been an advisor to both the Department of Finance and the Canada Revenue Agency.

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