*Intelligence* MEMOS

From: Jack Mintz

To: Canadians Concerned about Investment

Date: February 4, 2020

Re: **The Little-noticed Tax Deductibility Attack on Corporations**

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An intriguing Liberal party platform promise to limit corporate interest deductibility seems set to return as we get closer to this spring's federal budget.

Even though making corporations pay more tax is politically popular, they account for the lion's share of investment and jobs in the country. The proposal could haunt the minority government if the 2007 backlash that forced finance minister Jim Flaherty to withdraw his similarly intended proposal is any example.

Specifically, the Liberals promised to limit companies from deducting interest from their taxable income to no more than 30 percent of their earnings before deduction of interest, taxes, depreciation and amortization (EBITDA). There would be a $250,000 limitation to net interest expenses to exempt most small businesses, but many companies would be hit.

Overall, the Parliamentary Budget Office predicted the proposal would net $5 billion in the next four years (an estimate as shaky as a fiddler on a roof.)

To put it in Donald Trump's terms, this is "yuge."

Canada's current rule limits foreign companies, branches and trusts from deducting "thinly capitalized" interest paid to related non-residents, and it raises little money. Thin capitalization arises when debt exceeds 1.5 times the debtor's equity held by related non-residents with at least 25 percent ownership in the Canadian entity. Not only will that company pay more corporate income tax, but the re-characterized income is treated as dividend and subject to a withholding tax up to 25 percent. The thin-cap rule is meant to protect Canada's corporate tax base from the tax avoidance erosion from foreign parents levering up their Canadian business with debt. But most companies easily arrange affairs to avoid a disallowance of interest deductions.

The new earnings-based interest limitation proposal is expansive. It is much broader, applying to all companies – domestic or foreign – operating in Canada. This is pretty sophisticated stuff for an election campaign, which is why it got so little attention. The idea has been percolating at the Department of Finance for at least two decades.

To understand how it works, consider the following example. Suppose a company's EBITDA is $1 million, depreciation costs are $300,000 and debt interest costs are $400,000. Subtracting these costs from earnings, the company earns a tidy pre-tax profit of $300,000, which, if taxed at the rate of 25 percent, leaves $225,000 for shareholders.

Now if the interest limitation is applied, only $300,000 in interest costs would be deductible (30 percent of $1 million in EBITDA.) The company has $400,000 in taxable profits (which is more than its accounting profit of $300,000) and will pay $100,000 in corporate tax, leaving shareholders with $200,000 in after-tax profits. The effective corporate tax rate zooms up from 25 percent to 33 percent; a considerable hike.

There are several problems with this proposal. Financial companies are highly leveraged. So, too, are utility companies and real estate. And the earning-based interest limitation rule can hit companies even if they are not highly leveraged.

The new earnings-based interest limitation rule also discriminates against startup (e.g., technology firms) and cyclical industries (e.g., resource companies) when earnings are low. Overall, companies will be still hit with taxes when they can least afford them.

Less well-known is that the earnings-based interest limitation rule can favour industries with highly depreciable assets. By investing in short-lived assets, companies create much more EBITDA room to soak up disallowed interest deductions. In some early work published in Germany's ECONPol, I showed that the US interest limitation rule actually reduces the effective tax rate on machinery (for other assets the effective tax rate rises as expected.) Given Canada already has accelerated depreciation that is more favourable to machinery investments, this is just another kick in the groin to those businesses reliant on structures and inventories investment like trade and construction.

The interest limitation proposal will be harmful to our already weak investment performance. Canada's non-residential business investment is almost a tenth less than in the first quarter of 2014. There might be good reasons to broaden the tax base. However, this sort of rule should only be part of a comprehensive reform that would lower corporate rates further, not just be another tax grab.

*Jack M. Mintz is the President's Fellow at the University of Calgary's School of Public Policy. He is also a Senior Fellow at the C.D. Howe Institute.*

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