canadian tax journal / revue fiscale canadienne (2007) vol. 55, no 3, 629-54

Policy Forum: Seeking a More Coherent Approach to Interest Deductibility

Allan R. Lanthier and Jack M. Mintz*

ABSTRACT

The Canadian federal budget of March 19, 2007 proposed to deny deductions for interest on funds borrowed by Canadian taxpayers to invest in foreign affiliates. On May 14, 2007, the finance minister announced a much narrower measure that would limit the denial to situations where a Canadian borrowing is part of certain cross-border financing structures—so-called double-dips. In this article, the authors comment on the economic impact of outbound investment, as well as technical issues and problems that can be expected to arise under the government's proposal.

The authors argue that any limitation on interest deductibility should be considered in the context of a broader initiative that seeks to achieve greater neutrality between businesses, and at internationally competitive tax rates. A comprehensive domestic thin capitalization rule is recommended as an alternative to the government's proposal, to limit excessive debt leveraging in Canada in respect of both inbound and outbound investment, and also to address Canadian debt dumping by foreign investors and leveraged buyouts of Canadian businesses. Businesses maintaining reasonable levels of debt financing in Canada would not be penalized. The authors also argue that high Canadian corporate income tax rates attract debt to Canada and discourage Canadian domestic investment, and that any proposal to restrict interest deductibility should be linked with significant reductions in Canada's corporate tax rates.

KEYWORDS: ECONOMIC IMPACT ■ FOREIGN AFFILIATES ■ INTEREST DEDUCTIBILITY ■ INTERNATIONAL TAXATION ■ THIN CAPITALIZATION

CONTENTS

* Allan Lanthier is a retired senior partner of Ernst & Young LLP, Montreal. Jack Mintz is of the J.L. Rotman School of Management, University of Toronto, and a visiting professor at New York University Law School. Both were members of the Technical Committee on Business Taxation that reported to the minister of finance on business tax reform in 1997.

INTRODUCTION

The Canadian federal budget of March 19, 2007 proposed to deny deductions for interest on funds borrowed by Canadian taxpayers to invest in foreign affiliates ("the budget proposal").[1] On May 14, 2007, under significant pressure and criticism from the business and tax communities, Finance Minister Jim Flaherty announced a much narrower measure that would limit the interest expense denial to situations where the Canadian borrowing was part of certain tax-efficient financing structures ("the revised proposal").[2]

While both proposals were based in part on the principle that expenses incurred should be matched with income that is subject to Canadian tax, the measures raise a host of issues that require careful consideration. A business tax system should not be a barrier to Canadians growing international businesses that benefit the Canadian economy. However, neither should taxes encourage businesses to invest elsewhere and not at home.

In our view, the government should seek a more coherent approach to address its policy concerns. We believe that a business that is not excessively leveraged, with debt

1 Canada, Department of Finance, 2007 Budget, Budget Plan, March 19, 2007, 420. A "foreign affiliate" of a taxpayer resident in Canada is defined in subsection 95(1) of the Income Tax Act to mean a non-resident corporation in which the Canadian taxpayer has an "equity percentage" (as defined) of not less than 1 percent, provided that the total of the equity percentages of the Canadian taxpayer, and of each person related to the taxpayer, is not less than 10 percent: Income Tax Act, RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act").

2 Canada, Department of Finance, "Canada's New Government Improves Tax Fairness with Anti-Tax-Haven Initiative," *News Release* 2007-041, May 14, 2007, and accompanying Backgrounder.

levels within a typical range reflecting commercial realities, should not be penalized, even if some portion of the debt is used to finance international activities, however structured. We also believe that the revised proposal is too narrowly focused, and that the issue of interest deductibility should be cast within a set of tax policies directed at both inbound and outbound investment. The growing incidence of takeovers and leveraged buyouts of Canadian businesses by private equity pools and tax-exempt entities has been well documented, as has Canadian debt dumping by foreign investors. In addition to the implications for Canada's revenue base, these developments raise concerns about potential corporate inefficiency, to the extent that some investors have tax advantages over others.

Significant tax reform measures, such as those proposed in the budget, should reflect a balance between the competitiveness of Canadian businesses and tax fairness. Canada continues to have one of the highest corporate income tax rates in the world, at 34 percent currently, with scheduled reductions to 30.5 percent by 2011. The OECD average is 28 percent and falling, with announcements of corporate tax rate reductions in, for example, Germany, the United Kingdom, and Denmark. Canada also has the 11th highest marginal effective tax rate on domestic capital investments among 80 countries.[3] High corporate income tax rates discourage domestic investments and attract debt to Canada as businesses shift interest expense from low-tax to high-tax jurisdictions. However, the 2007 budget takes no further action to address our high corporate income tax rate.

The revised proposal does not adequately address the policy objectives that we believe the Canadian government should pursue: ensuring that tax policies are efficient and fair while protecting the Canadian revenue base that is used to fund public services. Given the deterrent effect of the corporate tax rate on domestic investment, as well as the complementarities between foreign and domestic investment, the revised proposal will do nothing to improve Canadian competitiveness. In addition, as discussed further below, the revised proposal targets interest expense on Canadian borrowing if the borrowing is linked to an interaffiliate interest deduction, and does not address the use of excess cash for these types of tax-efficient financing structures. The proposed measure creates inequities between taxpayers, presents opportunities for avoiding its application, and has limited potential to protect the Canadian revenue base. A more effective proposal could be developed to address these types of structures, whether financed with debt or excess cash, but this would run the risk of impairing the ability of Canadian-based businesses to expand their global activities.

Accordingly, and as an alternative to a narrow measure such as the revised proposal, which addresses interest deductibility only in the context of certain foreign

3 See Jack M. Mintz, *The 2007 Tax Competitiveness Report: A Call for Comprehensive Tax Reform*, C.D. Howe Institute Commentary no. 254 (Toronto: C.D. Howe Institute, September 2007); and Canada, Department of Finance, *Tax Expenditures and Evaluations* (Ottawa: Department of Finance, 2006).

affiliate investments, we suggest that the government develop a more holistic approach. The proposal we put forward in this article is for a comprehensive domestic thin capitalization rule, based on total indebtedness, whether arm's-length or non-arm's-length, of a Canadian corporate group, measured against total net Canadian domestic assets of the group. There is a need to recognize that companies with reasonable levels of debt financing in Canada should not be unduly penalized if they seek to expand globally. At the same time, we believe that our suggested approach would provide better protection of the Canadian revenue base than the revised proposal. We also believe that tax policy initiatives in this area should be reviewed in light of Canada's uncompetitive corporate tax structure, and that restrictions on interest deductibility should be combined with substantial reductions in corporate tax rates beyond those currently planned.

Our proposal is intended to limit excessive debt leveraging in Canada, in respect of both inbound and outbound investment, without unduly compromising the international competitiveness of the Canadian economy. This is one possible approach. Others should also be considered, and we suggest that the tax policy issues are sufficiently complex and important that a consultative document should be issued to the public for review before reform proceeds.

BACKGROUND

The Budget Proposal

Citing a mismatch between interest deductibility on funds borrowed for investment in foreign affiliates and deductions available to Canadian corporate taxpayers for dividends received out of "exempt surplus"[4] of such affiliates, the federal budget of March 19, 2007 proposed to deny deductions for interest expense (and other borrowing costs) on funds borrowed by a taxpayer to invest, directly or indirectly, in shares or indebtedness of a foreign affiliate of the taxpayer, or of a person or partnership that does not deal at arm's length with the taxpayer. The budget proposed the use of the tracing method for determining the amount of the impugned interest. In other words, if proceeds from borrowed funds could be traced, directly or indirectly, to investments in foreign affiliates, the interest expense would be subject to disallowance; on the other hand, if the proceeds were traceable to investment in Canadian domestic assets, the rule would not apply.

Interest expense that was denied would be added to a "disallowed interest pool," and would be deductible only if the Canadian taxpayer realized income from the foreign affiliate that was subject to Canadian tax.[5] No deductions would be given in

4 Exempt surplus, in general terms, includes active business income earned by a foreign affiliate in a country with which Canada has entered into a comprehensive tax treaty, provided that the affiliate is also resident in a tax treaty country.

5 Namely, dividends received by the Canadian taxpayer from "taxable surplus" of the foreign affiliate, net of any deductions in respect of foreign taxes applicable to such dividends; income attributed to the Canadian taxpayer as "foreign accrual property income" (FAPI), again net of any

respect of dividends received by a Canadian taxpayer out of exempt surplus of a foreign affiliate,[6] or in respect of underlying foreign tax applicable to the earnings out of which exempt or taxable surplus dividends are paid.

The budget proposed no grandfathering, and only a limited transition period. It was proposed that, in the case of debt incurred on or after the budget date (other than pursuant to an agreement in writing entered into before that date), the rule would apply after 2007. For existing borrowings, the rule would apply after 2008 in the case of related-party debt, and after 2009 in the case of funds borrowed from third parties.[7]

In support of the proposed denial, the budget documents note that the deductibility of interest expense on money borrowed for investment in foreign affiliates was raised as an issue of concern by the auditor general in both 1992 and 2002, and refer in particular to the *Report of the Technical Committee on Business Taxation* ("the report of the technical committee"), issued by the Department of Finance in April 1998.[8] The mechanics of the budget proposal drew heavily from the report of the technical committee, but with some significant differences. For example, the technical committee recommended that indebtedness incurred or committed to under existing rules be exempted from any new regime, or be eligible for a generous transition period. The committee also suggested a de minimis exemption for new debt, to prevent small startup businesses from being penalized, and to address the administrative and compliance burden on small and medium-sized business. Finally, the committee's report set out analyses of other possible alternatives to address the issue of interest deductibility in the context of Canada's exemption regime.[9]

---

deductions in respect of foreign taxes; net taxable capital gains from dispositions of shares of the foreign affiliate; and interest income received by the taxpayer on indebtedness of the foreign affiliate. The deduction in respect of FAPI was curious because it would have encouraged taxpayers with a balance in the disallowed interest pool to transfer excess passive assets to foreign affiliates in tax havens.

6 In fact, under the budget proposal, the balance in the disallowed interest pool would be reduced by the amount of any dividends received out of exempt surplus. This rule, if implemented, could have served as a disincentive for exempt surplus dividends to be paid to the Canadian taxpayer and reinvested in Canadian domestic assets, or distributed as dividends to the Canadian taxpayer's shareholders. The pool was also to be reduced by, inter alia, the amount of deductions in respect of foreign tax applicable to dividends received out of taxable surplus and to FAPI.

7 In either case, the rule would apply after the expiry of the current term of the debt if that date was earlier.

8 Canada, *Report of the Technical Committee on Business Taxation* (Ottawa: Department of Finance, April 1998). The technical committee was appointed by the federal minister of finance in March 1996, to review taxes paid by Canadian business, with the constraint that any recommendations for reform would leave government revenues unchanged. The committee reported to the minister in December 1997 and recommended a number of measures to broaden the tax base and lower corporate income tax rates to more competitive levels. Many of the recommendations have been adopted, including some reductions in corporate tax rates.

9 Including the possible addition of a "high-tax requirement" for active business income of a foreign affiliate to qualify as exempt surplus.

The Revised Proposal

The budget proposal met with strong opposition from the Canadian business and tax communities, which took the position that the measure would significantly impair the international competitiveness of Canadian business. Less than two months later, the finance minister presented a revised proposal, a much narrower measure limiting the denial of interest deductibility to situations where the Canadian borrowing is part of certain types of tax-efficient financing structures—so-called double-dip.

Under the revised proposal, deductions for interest expense (and other borrowing costs) of a Canadian corporation will be denied in respect of funds borrowed to invest, directly or indirectly, in shares or indebtedness of a foreign affiliate of the taxpayer, or of a person or partnership that does not deal at arm's length with the taxpayer, only to the extent of the corporation's "double-dip income" (as defined) for the particular taxation year. In other words, interest expense may be denied to the Canadian corporation to the extent that the Canadian borrowing forms part of a series of transactions or events that results in a second interest deduction in another country.

The new measure (like the original budget proposal) would use the tracing method to determine the amount of interest expense potentially subject to denial.[10] Double-dip income is defined, in general terms, to mean interaffiliate interest received or receivable by a foreign affiliate of the Canadian taxpayer that is recharacterized[11] as active business income to the recipient under the Income Tax Act. The interaffiliate interest income must relate to a "specified debt," defined as a debt owing to the foreign affiliate that arose as part of a series of transactions or events that included, and can reasonably be considered to have been funded by, the proceeds of interest-bearing indebtedness of the Canadian corporation that was used to make a foreign affiliate investment. Double-dip income is then reduced by the amount of foreign income taxes[12] that can reasonably be considered to have been paid in respect of the interest income of the foreign affiliate.

Interest expense that is subject to the revised proposal is permanently denied, and is not eligible for any type of carryforward relief. The new measure proposes no grandfathering for existing debt and will apply to interest paid or payable by a Canadian corporation in respect of a period that begins after 2011.

ECONOMIC IMPACT OF OUTBOUND INVESTMENT AND THE ROLE OF INTEREST DEDUCTIBILITY

The integration of production internationally has had a significant impact on the productivity and efficiency of Canadian businesses. The outward flow of investment

10 Interest expense potentially subject to denial is reduced by interest income received or receivable by the Canadian corporation on indebtedness of a foreign affiliate.

11 In accordance with paragraph 95(2)(a) of the Act.

12 Grossed up by the "relevant tax factor," defined in subsection 95(1) of the Act.

might be viewed as a loss of capital to the Canadian economy; however, the financial returns arising from outbound investments add income to the economy. Evidence has suggested that global Canadian businesses perform better than domestic businesses in terms of both profitability and productivity. Foreign direct investment provides a means to establish production facilities in foreign markets that can contribute to greater exports from Canada. Foreign investment can also contribute to greater acquisition of technology and skills that can add to the efficiency of domestic production.[13] On the other hand, foreign direct investment might be viewed as leading to a loss of production and employment to Canada when assets are moved offshore.[14] Most Canadian studies have suggested that foreign direct investment is complementary to Canadian production.

While a strong case can be made that foreign direct investment by Canadian-based multinationals is beneficial, this does not justify tax policies that favour foreign investment over domestic investment. One issue is simply a question of revenue, since public goods and services provided in Canada must be funded from taxes. Given a certain level of taxes to be raised, what objective should be used in devising the best tax structure to minimize the harm that taxes inevitably inflict on an economy?

Neutrality is a good benchmark for business tax policies since it results in similar tax burdens across business activities, thereby leading to a more efficient allocation of resources in the economy. However, at the international level, neutrality is achieved by considering not just Canadian tax policy, but also taxes set by other governments and beyond Canada's control.

If the focus is on the allocation of capital by Canadian-based multinationals, similar effective tax rates on domestic and foreign activities are warranted, so that the tax system does not interfere with business choices to locate investment—a principle known as capital export neutrality. From a global perspective, the total effective tax rate should be considered, which would include both foreign and Canadian taxes levied on foreign-source income earned by Canadian multinationals. The taxation of income with a credit for foreign taxes with respect to dividends from taxable surplus is consistent with global neutrality, as is the exemption of dividends from exempt surplus, but only to the extent that the underlying income has borne foreign tax equivalent to Canadian rates. How interest deductibility relates to neutrality is discussed further below.

---

13 See Steven Globerman, "The Public and Private Interests in Outward Direct Investment," in Steven Globerman, ed., *Canadian-Based Multinationals*, Industry Canada Research Series, vol. 4 (Calgary: University of Calgary Press, 1994), 1-31; and Walid Hejazi and A. Edward Safarian, *Modelling Links Between Canadian Trade and Foreign Direct Investment*, Industry Canada Research Publications, Perspectives on North American Free Trade Paper no. 2 (Ottawa: Industry Canada, April 1999).

14 See Walid Hejazi and Peter Pauly, *Foreign Direct Investment and Domestic Capital Formation*, Industry Canada Research Publications, Working Paper no. 36 (Ottawa: Industry Canada, April 2002).

It is also important to consider other notions of neutrality with respect to capital allocation decisions at the international level. National ownership neutrality is achieved if businesses with different owners face similar tax burdens.[15] If businesses are taxed at differential rates, then capital will be misallocated accordingly. This is particularly relevant to the benefits received from outbound investment, since the economic return on foreign investments could contribute to higher incomes earned by Canadian residents. This condition for neutrality is related to the notion of international competitiveness in that Canadian multinationals should not face tax burdens that make them uncompetitive, or be given special tax advantages relative to the rest of the world.

It is impossible to achieve complete and simultaneous neutrality, in terms of both capital export neutrality and national ownership neutrality, when tax systems differ from country to country. For example, an effective tax rate on outbound investment equal to the domestic tax rate could impair international competitiveness if other countries tax their multinationals at lower rates. Therefore, in order to accommodate both capital export neutrality and national ownership neutrality, the most neutral policy for Canada is to establish effective tax rates on domestic investments as similar as possible to those of its international trading partners.

Keeping in mind these notions of neutrality, a deduction provided for interest and other borrowing costs in Canada should theoretically be apportioned across domestic and international activities, to increase the tax base at home and reduce the tax base in other countries for income earned abroad.[16] However, even if a relatively simple approach could be developed for apportioning these expenses, several difficulties arise that could impair neutrality. Companies can be put at a disadvantage in respect of their foreign investments when it is more costly to raise debt in a foreign jurisdiction than in Canada. Allocating interest to untaxed foreign income could therefore result in a higher effective tax rate on foreign investment compared to domestic investment because of a denial of interest deductions in Canada. Further, if a formula based on the share of domestic to foreign assets is used to allocate interest, companies using debt financing for domestic investments also face a higher cost of capital, since a portion of the interest expense incurred will be allocated to untaxed foreign-source income.[17] The use of such a formula can impair not only capital export

15 This is also referred to as capital import neutrality in the context of inbound investment.

16 For a review of apportionment, see Joann Marten-Weiner, *Company Tax Reform in the European Union* (New York: Springer, 2006).

17 The United States uses an allocation formula that requires domestic interest to be allocated to foreign earnings according to the share of foreign assets to domestic and foreign assets. If a US company pays less US tax than foreign tax on repatriations of income, the US interest allocation rules can increase the effective tax rate on both foreign and US investments. See Rosanne Altshuler and Jack M. Mintz, "U.S. Interest-Allocation Rules: Effects and Policy" (1995) vol. 2, no. 1 *International Tax and Public Finance* 7-35.

neutrality but also national ownership neutrality and competitiveness to the extent that Canadian businesses are taxed at higher rates than businesses based in countries that do not limit interest deductions for tax purposes.

On the other hand, denial of an interest deduction in respect of foreign investments could reduce differences in effective tax rates for domestic and foreign assets if foreign income is more lightly taxed than domestic income. With the current dividend exemption system, investments in foreign jurisdictions may be more lightly taxed than Canadian assets, particularly given Canada's high effective tax rate on capital investments.[18] Further, in some circumstances, including those targeted by the revised proposal, effective tax rates on foreign investments may be substantially lower than rates on domestic investments because of multiple deductions for interest arising from certain tax-efficient structures, providing a very favourable cost of capital.[19]

While denial of an interest deduction for investment in foreign assets may or may not improve capital export neutrality, it could harm national ownership neutrality, especially when other governments provide similar advantages.

Because of the uncertain allocative effects and the inevitable tradeoffs involved with revenue considerations, the application of a policy to deny interest deductibility is not clearcut. Given the mobility of financial capital, it is often difficult for governments in small open economies such as Canada's to take policy positions very different from those of other countries. A regime that is too restrictive could impose significant economic costs by making it more difficult for Canadian companies to operate globally. One that is too lax could encourage debt dumping into Canada, resulting in tax base erosion.[20]

Consistent with the report of the technical committee, we believe that the financing of foreign affiliates is a policy issue that merits analysis and debate. However, that report also noted that it can be legitimately argued that interest deductibility is a reasonable price for Canada to pay to allow Canadian multinationals to continue to expand and compete in the global marketplace. Taking a broader view of corporate tax policies, any limitation on interest deductions should be considered in the context of an overall approach that seeks to achieve greater neutrality among businesses, and at internationally competitive tax rates.

---

18 Mintz, supra note 3.

19 Jack Mintz, "Conduit Entities: Implications for Indirect Tax-Efficient Financing Structures for Real Investment" (2004) vol. 11, no. 4 *International Tax and Public Finance* 419-34.

20 Several studies have shown that debt financing of corporations is quite sensitive to differences between foreign and domestic corporate income tax rates. See, for example, Vijay Jog and Jianmin Tang, "Tax Reforms, Debt Shifting, and Tax Revenues: Multinational Corporations in Canada" (2001) vol. 8, no. 1 *International Tax and Public Finance* 5-25.

CANADIAN TAXATION OF FOREIGN AFFILIATE INVESTMENT

Canada's tax regime applicable to outbound foreign direct investment—like that of other developed countries—must address three fundamental elements:

- the deductibility of interest expense related to foreign affiliate investment, and what restrictions, if any, should apply;
- the application of the exemption method or the deferral method with credit, or a combination of these methods, to prevent double taxation of business income earned by foreign affiliates when received as dividends by the Canadian parent company; and
- the nature and scope of rules governing the taxation of passive income, in Canada referred to as foreign accrual property income (FAPI).

In seeking to achieve both fairness and competitiveness, tax policy choices must strike a delicate balance among these three elements. In support of competitiveness, changes that tighten the rules in one area may argue for no change, or for greater relief, in another. On the other hand, if all three elements are too permissive, fairness may be compromised.

Deductibility of Interest Expense Related to Foreign Affiliate Investment

Under current law, interest is deductible on funds borrowed to acquire or invest in foreign affiliates, whether the investor is a corporation or an individual, and whether the affiliate is in a treaty or a non-treaty country. The general restrictions in the Act must, of course, be satisfied; for example, the interest must be reasonable in amount and be incurred for the purpose of gaining or producing income.

Prior to tax reform in 1972, interest on funds borrowed by Canadian corporations to invest in Canadian and foreign subsidiaries was non-deductible. Since 1972, interest has been deductible by Canadian companies on funds borrowed to invest in both domestic companies and foreign affiliates. The 1972 change to allow interest deductibility was based on the rationale that this would put Canadian corporations on a more equal footing with foreign corporations in claiming interest deductions on funds borrowed to invest in other businesses. As noted in the report of the technical committee,

> [w]hile interest deductibility resulted in a significant reduction in the Canadian tax revenue base, it also resulted in a significant decrease in the after-tax cost of such borrowing, and allowed Canadian corporations to be more competitive in making investments, both in Canada and abroad.[21]

21 Supra note 8, at 6.11.

Taxation of Dividends Received from Foreign Affiliates

To avoid the double taxation of active business income earned by foreign subsidiaries and received as dividends by the domestic parent company, most countries use either the deferral method with credit, the exemption method, or some combination of the two. Canada's regime provides for the use of both methods but relies primarily on the exemption method.

The exemption method has long been part of the Canadian tax regime: it has been in place, in one form or another, since 1938. The rules were fundamentally changed at the time of the 1972 tax reform and have been subject to further revisions since that time. Under current law, dividends paid from active business income of a foreign affiliate of a corporation resident in Canada may be paid out of either exempt or taxable surplus.[22] Exempt surplus generally includes after-tax income from an active business carried on by the affiliate in a treaty country, provided that the affiliate is also resident in a treaty country, both under the common-law principle of central management and control, and for purposes of the applicable treaty. Active business income earned by a foreign affiliate resident or carrying on business in a non-treaty country is included in taxable surplus.

Dividends received by the Canadian corporate shareholder that are paid out of exempt surplus of a foreign affiliate are fully deductible to the shareholder (the exemption method). Dividends received by the shareholder that are paid out of taxable surplus are taxable to the shareholder, but a deduction is available in respect of applicable foreign taxes (the deferral method with credit). Since Canada has approximately 90 treaties in force or subject to ratification (one of the most extensive tax treaty networks in the world), in practice, dividends are rarely paid out of taxable surplus. Thus, the exemption method normally applies to dividends received by Canadian corporations from their foreign affiliates.

Is Interest Deductibility Compatible with the Exemption Method?

The budget documents state that Canada's existing tax rules result in a mismatch: interest expense on funds borrowed to invest in foreign affiliates is deductible, while income generated by those affiliates generally does not bear Canadian tax. On its face, this statement is true. But it does not answer the question of whether this mismatch is problematic from a tax policy or economic standpoint.

Under the exemption method, income derived from foreign direct investment is exempt from taxation in the investor country, and subject to tax only in the country in which the investment and business activities take place. The exemption method

22 To the extent that dividends paid by a foreign affiliate exceed its exempt and taxable surplus account balances, the dividends are deemed to be paid from pre-acquisition surplus, a notional account for which no computations are made. Dividends received out of pre-acquisition surplus (net of any foreign withholding taxes) reduce the tax cost of the foreign affiliate shares on which the dividends are paid.

is often viewed as a proxy for the deferral method with credit, on the assumption that the income in question has been subject to foreign tax at a rate comparable to that which would have been applicable in the investor country. If Canada's exemption method serves as a proxy for the deferral method with credit, then interest deductibility is consistent with global neutrality. On the other hand, if debt of a Canadian business enterprise is used to finance foreign investment in countries where the income is taxed at far lower rates than Canadian rates, interest deductions taken in Canada are not neutral: the cost of capital is lowered for the Canadian business, compared to investors in foreign jurisdictions with lower corporate income tax rates.

In light of the issue of the international competitiveness of Canadian business, the tax rules in place in other countries, and the need to strike a reasonable compromise between capital export and national ownership neutrality, we suggest that it is not entirely surprising that criticisms of the interest deductibility rule have, at times, been less than categorical, or that senior officials of the Department of Finance have consistently (at least until March 19, 2007) defended the need for deductibility. The 1992 report of the auditor general did not in fact propose any change; it only recommended that reviews of interest deductibility previously announced by the Department of Finance be completed.[23] The department replied with some vigour to the auditor general's report, noting the following with respect to the issue of interest deductibility:

> The principal concern raised in the note is that a Canadian resident who borrows money in order to acquire shares in a foreign affiliate will, subject to the general rules regarding interest deductibility, be able to deduct the interest on the borrowed money as an expense, even though the income earned by the foreign affiliate may not be subject to Canadian tax on a current basis and, in many cases, may be repatriated to Canada tax-free.
>
> While this clearly gives rise to a mismatching of income and expenses, it is important to note that, at least historically, it also represents the international norm. Departing from this norm (i.e., denying Canadians a deduction for interest when, in similar circumstances, other countries would permit an interest deduction for their residents) would have a significant impact on Canada's international competitiveness and, ultimately, could result in a considerable number of Canadian businesses either moving offshore or being forced out of foreign markets. Moreover, it is not always appropriate that the expenses related to a particular investment be deductible only against the income from that investment. For example, where an investment generates losses, such a narrow approach would have the effect of denying taxpayers a deduction for legitimate business expenses and would represent a significant disincentive for Canadians to invest in new ventures. Finally, the ability to repatriate certain income on a tax-free basis is intended both as a substitute for allowing a foreign tax credit in respect of the foreign source income and to eliminate any tax impediment to corporations reinvesting their foreign earnings in their Canadian operations.

23 In addition to reviews of foreign-source income and of foreign affiliates. See Canada, *Report of the Auditor General of Canada to the House of Commons 1992* (Ottawa: Supply and Services, 1992), 46-51.

> Consequently, while the government continues to monitor developments in other countries, it has refrained from making changes that would have the potential to damage Canada's international competitiveness.[24]

The Standing Committee on Public Accounts of the House of Commons (PAC) met to consider the auditor general's 1992 report in December 1992 and twice in early 1993. David Dodge, then deputy minister of the Department of Finance, appeared before the PAC and defended tax-efficient financing structures, stating that they enhance the competitiveness of Canadian businesses and are not offensive in policy terms.[25] In April 1993, the PAC tabled its conclusions and recommendations in the House of Commons.[26] While highly critical of the Department of Finance in many other respects, the PAC was conspicuously guarded with respect to interest deductibility, noting that the government should "move cautiously" in this area and recommending that Finance study the question in depth before making changes to the law.

The 2002 report of the auditor general did little more than reiterate its prior recommendation that Finance review and reassess the interest deductibility rule, while quoting at some length from the report of the technical committee.[27]

In our view, it can be argued that interest deductibility on funds borrowed for foreign affiliate investment is indeed compatible with a broad exemption system such as that extant in Canada. It is also consistent with international norms and helps maintain the international competitiveness of Canadian business. On the other hand, it is not unreasonable for Canada to put some constraint on debt loading in Canada, in order to protect Canada's tax base and reduce the scope for excessive debt financing of both foreign and domestic investments.

Foreign Accrual Property Income

Taxpayers resident in Canada must include in income on a current basis their proportionate share of any FAPI earned by a "controlled foreign affiliate"[28] (CFA) (subject to deductions in respect of underlying foreign tax), whether or not the income is distributed by the affiliate as dividend payments. These rules apply to Canadian-resident individuals as well as to corporations, and to affiliates in treaty as well as non-treaty countries. The allocable amount is based on the taxpayer's participating

24 Ibid., at 53.

25 Canada, House of Commons, *Minutes of Proceedings and Evidence of the Standing Committee on Public Accounts*, 34th Parl., 3d sess., 1991-92, issue no. 38, December 10, 1992.

26 Canada, House of Commons, *Minutes of Proceedings and Evidence of the Standing Committee on Public Accounts*, Twelfth Report to the House, 34th Parl., 3d sess., 1991-92-93, issue no. 48, April 23, 1993.

27 Canada, *Report of the Auditor General of Canada to the House of Commons 2002* (Ottawa: Office of the Auditor General of Canada, December 2002), chapter 11, at 17-29.

28 "Foreign accrual property income" and "controlled foreign affiliate" are defined in subsection 95(1) of the Act.

percentage[29] determined at the end of each taxation year of the affiliate. Generally, no further Canadian tax is imposed when FAPI is repatriated to Canada as dividend payments, although deductions may be available at that time for foreign withholding tax imposed on the dividends.

Income characterized as FAPI is included in taxable surplus. FAPI that is earned by a foreign affiliate that is not a CFA of the Canadian taxpayer is not taxable on an accrual basis: rather, it is taxable when it is ultimately paid to the taxpayer as dividends (the deferral method with credit).

FAPI includes an affiliate's income from property and taxable capital gains from dispositions of certain property (generally, property that is not used or held for the purpose of gaining or producing income from an active business). The definition of FAPI was substantially expanded in scope by the 1995 foreign affiliate amendments, and there are various sources of active business income that are, in fact, characterized as FAPI. In addition to property income of a purely passive nature, FAPI now includes income from an investment business unless the affiliate employs more than five full-time employees (or their equivalent) in the active conduct of the business, as well as specified types of income earned by a foreign affiliate where the corresponding deduction erodes the Canadian tax base.

There are also certain relieving provisions, which provide specific exceptions in the case of income that arises from payments between different foreign affiliates of the same Canadian taxpayer, and would otherwise be characterized as FAPI.[30] It is this exemption from FAPI that is the primary target of the revised proposal, in the context of interaffiliate payments of interest, and to the extent that the relevant interaffiliate debt can reasonably be considered to have been funded by interest-bearing indebtedness of the Canadian corporate shareholder. Our comments and concerns with respect to the revised proposal are set out in a later section of this article.

PROBLEMS WITH THE BUDGET PROPOSAL

In our view, the original budget proposal could have been substantially improved to reduce its harmful impact on global-oriented businesses, while still moving toward greater global neutrality and protection of Canada's tax base. We comment below on problems with the budget proposal that arise with respect to existing debt, debt incurred on or after the budget date, and the mechanics of the proposal. Many of these comments, and in particular those related to the mechanics of the budget proposal, apply equally to the revised proposal.

Existing Debt

Canadian businesses have made significant investment and financing decisions that rely on the existing tax rules. The budget proposal included no grandfathering and provided for an extremely limited transition period. As a result, many debt structures

29 Defined in subsection 95(1) of the Act and regulation 5904 of the Income Tax Regulations.

30 Paragraph 95(2)(a) of the Act.

would have become inefficient from a tax viewpoint in a very short period of time, resulting in an increased cost of capital that some businesses may not have been able to bear. And there were additional problems.

Consider, for example, a Canadian company that has been in existence for 50 years and has accumulated a significant amount of debt during that period (likely through a myriad of merged and successor corporations), to invest in both domestic and foreign assets. In addition to significant Canadian assets and equity, the corporation has an extensive foreign affiliate network, and business and treasury operations in many countries around the world. As a practical matter, under the budget proposal, it would likely have been impossible for either the taxpayer or the tax administration to determine which portion of the corporation's indebtedness would be subject to the denial rule and which would not. And even if a Canadian business could make an informed estimate of the impact of the budget proposal on existing debt, it might have proved impossible to restructure the "tainted" debt, for any number of contractual, economic, or regulatory reasons.

Even with grandfathering, difficult issues would have arisen. For example, consider a Canadian business with significant existing, and "tainted," debt. Several months after the budget date, in a rationalization of its capital structure, the business completes a secondary offering of shares, and also enters into third-party borrowings with new lenders. The proceeds from the equity offering and from the new borrowings are used in part to repay the old debt and in part to fund new business acquisitions. It is intuitive that there should be substituted debt rules in the context of grandfathering, and that all or some portion of the new debt in this example should be eligible for ongoing grandfathering. But how can one ever draft such a rule? The budget took the opposite approach: the transition period would have ended as soon as the current term of the existing debt expired.

In short, the budget proposal was virtually untenable in the context of existing debt, and grandfathering or a more generous transition period, while important, would have represented only a partial solution.

Debt Incurred On or After the Budget Date

The hurdles, issues, and problems with respect to debt incurred on or after March 19, 2007 were equally daunting. Prospectively, there would have been many situations where it could have proved difficult or impossible for foreign affiliate investments to proceed.

Lenders generally look to the creditworthiness of the Canadian parent, and may be unwilling to lend to the foreign affiliate, even with a parent company guarantee. Lenders routinely seek the best possible security—in other words, full recourse to the Canadian parent—and not limited recourse obtained through a guarantee, with the attendant uncertainties of enforcing the guarantee, should this be necessary. Also, in those situations where it does prove feasible for the affiliate to borrow, the interest rate charged by a third-party lender will invariably be higher.

A government spokesperson stated that, in these circumstances, the Canadian parent should simply borrow, and lend at interest to the foreign affiliate. In theory, a Canadian corporation that intends to acquire 100 percent of a foreign affiliate could borrow from a third party and lend the proceeds to an affiliate in the other country. But there are numerous obstacles to doing so. First, unless the Canadian parent borrows in the currency of the relevant foreign country, a loan from the parent to its foreign subsidiary will likely result in foreign exchange risk in at least one of the two countries, and potential taxation of foreign exchange "gains"—which, in the context of the global consolidated group, are fictitious. Second, there may be withholding tax on cross-border interest payments, for which the Canadian parent will generally not be able to claim a credit. Third, restrictions on deductibility will often apply in the other country, similar to Canada's own thin capitalization rules, with the result that interest expense may not be deductible in either country: although interest expense for amounts paid to the Canadian parent may be denied in the foreign country, the receipt will still be taxable to the Canadian parent and applied against its own interest expense on third-party borrowings. Beyond all of the foregoing, there will be additional restrictions in specific circumstances, such as blocked-currency rules that may prevent the payment of interest or repayment of principal by the foreign subsidiary.

The potential problems with the budget proposal were even more significant in the many situations where a Canadian business intends to acquire less than 100 percent of a foreign affiliate (or to make additional investments in the affiliate). Assume, for example, that a Canadian corporation, Canco, intends to acquire 40 percent of a foreign affiliate operating company. Canco forms a wholly owned acquisition subsidiary (Subco) in the other country, and Subco obtains third-party financing in that country to fund the acquisition. Subco now has interest expense in the other country; but unless it has other assets and operations in that country, or is subject to tax consolidation or group relief rules, Subco cannot deduct its interest expense. The result? Again, there is no ability to deduct interest expense, either in Canada or in the investee country, on funds borrowed to finance the foreign affiliate investment. It is normally impossible in such situations to "push down" indebtedness from Subco to the target affiliate, even in those (extremely limited) circumstances where the other shareholder(s) might be agreeable to doing so.

In summary, under the budget proposal, many Canadian-based businesses would have been severely hampered from competing globally, particularly given that foreign-based multinationals do not face similar constraints. We suggest that this is why none of Canada's major competitors have adopted the type of total denial rule initially proposed in the budget.

Mechanics of the Budget Proposal

In addition to the obstacles described above that arise from business, regulatory, and capital market constraints, further problems arise as a result of the proposed application of the tracing method. These problems will apply equally in the context of the revised proposal.

While tracing is the method used and understood in Canada for determining interest deductibility, and while the tracing method does not suffer from the even more severe distortions that inevitably result under allocation formulas,[31] the mechanics of the method in the context of a measure as significant as the proposed denial of interest deductibility should be considered.

Consider, for example, a foreign investor who intends to acquire a Canadian target company, using the proceeds from domestic Canadian borrowings as partial currency for the acquisition. Assume that the Canadian target has significant domestic assets and, in addition, has both direct and indirect ownership interests in a number of foreign affiliates. The foreign investor forms a Canadian acquisition entity, Canco. Canco borrows from a third party and also receives an equity contribution from the foreign investor. Canco uses the proceeds from the borrowing and the equity contribution to acquire 100 percent of the shares of the Canadian target. It is not clear, under the budget proposal, whether Canco's interest expense is deductible, in whole or in part, or how this determination may be made; nor is it obvious that the answer can be found in Canadian jurisprudence to date.[32] It therefore appears that the budget proposal (and now the revised proposal) would require a somewhat complex hybrid tracing regime, combined with statutory ordering rules.

As a separate matter, consider a simpler example. Two Canadian corporations, Canco 1 and Canco 2, have each invested $50 in Canadian assets and $50 in foreign affiliates. Each company has a 1:1 debt-to-equity ratio. Canco 1 used proceeds from borrowed funds to acquire its domestic assets, and equity financing for its investment in foreign affiliates. Accordingly, under the budget proposal, all of Canco 1's interest expense would be deductible. Canco 2 did the reverse and, while Canco 2 is otherwise in exactly the same economic and business position as Canco 1, all of Canco 2's interest expense would be denied under the budget proposal. The same anomalous result would obtain under the revised proposal if both Cancos used tax-efficient structures for their respective foreign affiliate investments.

We do not suggest that some type of allocation or apportionment rule would be more suitable than the tracing method. To the contrary, as we have discussed above, allocation formulas produce even more arbitrary and random results, along with greater complexity.[33] We do believe, however, that some moderation must be brought to bear to make tracing a fairer and more efficient approach, and to recognize that the real issue is the extent to which excessive debt deductions are taken in Canada. Our recommendation in the context of the budget proposal was a safe harbour, as described briefly below.[34]

---

31 See the earlier discussion on the application of interest allocation rules when foreign income is exempt from Canadian tax. See also the report of the technical committee, supra note 8.

32 For examples of uncertainties that arise (and continue) under the tracing method, see the decisions of the Supreme Court of Canada in *Ludco Enterprises Ltd. et al. v. The Queen*, 2001 DTC 5505, and *The Queen v. Singleton*, 2001 DTC 5545.

33 Supra notes 17 and 31 and the accompanying text.

34 The approach we now recommend in the context of the revised proposal—namely, the introduction of a comprehensive domestic thin capitalization rule—would obviate the need for either tracing or apportionment.

Safe Harbour Approach

Notwithstanding the significant problems noted in the section immediately above, and the issues of global competitiveness of Canadian business and international standards discussed earlier in this article, it may still be argued that the Canadian regime of full interest deductibility, together with a comprehensive exemption regime and the existing passive income rules, is somewhat generous at the margin, and that some limitations are appropriate. If, on the basis of this argument, the government had decided to maintain the interest denial as set out in the budget proposal, we would have suggested that the legislation should provide for a safe harbour, so that only excessive interest deductions would be subject to denial, and some safeguard would be in place against the numerous potential adverse results discussed above.

In this regard, in an earlier draft of this article (prepared before the revised proposal was announced), we suggested the introduction of a safe harbour for debt incurred by a Canadian corporate group, up to a prescribed percentage of the group's investment in net Canadian domestic assets, computed before net debt or equity.[35] Subject to this safe harbour, the denial rule proposed in the budget would generally apply. Interest expense on funds borrowed to invest, directly or indirectly, in foreign affiliates would be subject to denial, using the tracing method. However, interest on indebtedness of a Canadian corporate group would be allowed in all circumstances, up to the prescribed percentage of the amount or value of net Canadian domestic assets. In other words, under our proposed safe harbour, debt would be "positively" traced to a percentage of net Canadian assets before denial applied.

The proposed safe harbour recognized that many Canadian businesses are not highly leveraged and should not be impeded from international expansion efforts, provided that there is sufficient protection of the Canadian revenue base. Thus, for taxpayers financing foreign affiliate investments, allowing a certain level of interest deductions in Canada would be appropriate. We suggest that this approach would have provided a more reasonable limitation on the deductibility of interest expense related to foreign affiliate investment, mitigating the risk of damage to Canadian global competitiveness. As a practical matter, the safe harbour would also have served as a buffer, addressing and limiting the various potential adverse and anomalous results described earlier in this article, including transition issues.

To address the administrative and compliance burden for small and medium-sized business, we also suggested that consideration be given to a separate de minimis exemption applicable to debt below a specified threshold—for example, $25 million—incurred by a Canadian corporate group to finance foreign affiliate investment.

35 A higher prescribed percentage may have been appropriate in the context of certain industries, such as financial institutions and real estate, or different supporting rules might have applied.

PROBLEMS WITH THE REVISED PROPOSAL

Targeted Structures

As discussed above, the revised proposal substantially narrowed the focus of the interest denial rule by targeting certain tax-efficient structures that the government now considers offensive. These structures, called double-dips, allow Canadian multinationals to finance investments in foreign affiliates, generally by routing debt through a low-tax intermediary and taking two interest deductions—one in Canada and the second in the country where the foreign affiliate resides. A simple example of this type of structure is shown in figure 1.

In this example, a Canadian corporation, Canco, owns a foreign affiliate finance entity, Finco, and a foreign affiliate operating entity, FA Opco. Canco borrows from a bank and uses the proceeds as a contribution of equity to Finco. Finco then lends at interest to FA Opco, and FA Opco uses the proceeds in its active business operations. The interest income received by Finco does not constitute FAPI because it is recharacterized as active business income to Finco.[36] In addition, provided that the interest expense reduces FA Opco's exempt earnings, and that Finco is resident in a treaty country, the interest income received by Finco constitutes exempt surplus.[37]

In this example, the revised proposal would deny Canco's interest expense paid to the third-party bank.[38]

The revised proposal also targets so-called tower structures—tax-efficient financing structures that take advantage of the different approaches to entity characterization that apply in Canada and the United States. A typical example is shown in figure 2.

In this example, a Canadian corporation, Canco, forms a US partnership, USP.[39] USP borrows from a bank and contributes the proceeds as equity to its wholly owned Canadian subsidiary, Cansub; Cansub in turn invests the proceeds in equity of a wholly owned US entity, US LLC.[40] US LLC then lends to US Opco, a US operating affiliate wholly owned by Canco. US Opco uses the funds in its active business operations. Under the existing rules, the third-party interest expense incurred by USP is allocated to Canco and is deductible in Canada by Canco. Separately, the interest

36 Paragraph 95(2)(a) of the Act.

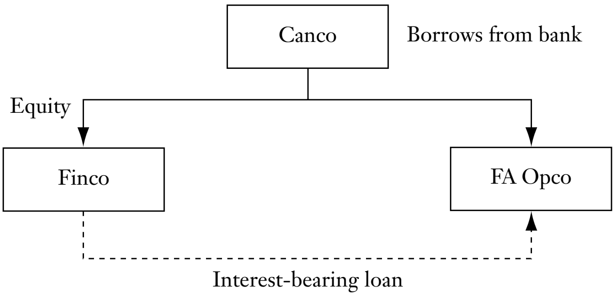
37 The Department of Finance Backgrounder, supra note 2, refers to Finco as "Havenco" and frames the revised proposal in the context of an "Anti-Tax-Haven Initiative," even though the foreign affiliate finance entity in this type of structure is almost always located in a country with which Canada has entered into a comprehensive tax treaty.

38 Net of a grossed-up deduction with respect to foreign taxes paid by Finco on its interest income.

39 Because USP requires at least two partners, a wholly owned Canadian subsidiary of Canco would also hold a small partnership interest.

40 Cansub would typically be a Nova Scotia unlimited liability company, so that both Cansub and US LLC would be "disregarded entities" for US federal income tax purposes.

FIGURE 1 Example of a Simple Double-Dip Structure



paid by US Opco to US LLC provides a second deduction, this time for US federal income tax purposes, to US Opco.[41]

In this example, again, the revised proposal would deny Canco's third-party interest expense.[42]

Technical Issues

There are a number of technical issues and problems that arise under the revised proposal, particularly from its apparent reliance on double-tracing—that is, tracing the proceeds from borrowed funds to investments in foreign affiliates, and then determining whether those borrowed funds are linked with an offending interaffiliate debt.

First, rules must be developed for determining whether, and to what extent, funds borrowed by a Canadian corporation will be considered to have been used by it to invest, directly or indirectly, in shares or indebtedness of a foreign affiliate. As discussed above,[43] it appears that this first test may require a complex hybrid tracing regime, combined with statutory ordering rules. Second, under the revised proposal, rules must also be developed for determining whether the Canadian borrowing can reasonably be considered to have funded an offending interaffiliate debt. This second test also introduces issues and problems.

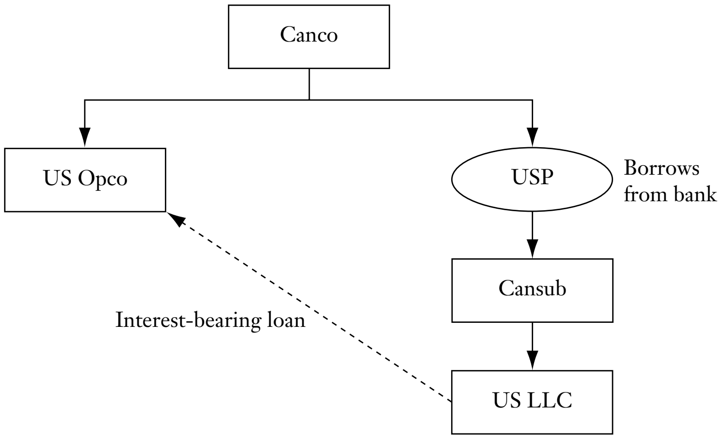
Consider, for example, a situation where a Canadian corporation, Canco, borrows from a bank and invests the funds directly in shares of a wholly owned foreign

41 Under US entity characterization rules, USP is taxable as a corporation, while Cansub and US LLC, being "disregarded entities," are ignored. For US federal income tax purposes, the interest income received by US LLC is therefore applied against the third-party interest paid by USP.

42 In this example, the offending double-dip income, as defined in the revised proposal, is the interaffiliate interest received by US LLC from US Opco. By seeking to target more conventional tax-efficient structures and the tower structure in a single legislative measure, the revised proposal would result in an inappropriate application of the rule in many other situations involving ordinary-course, same-country payments, an issue that will presumably be addressed as part of the legislative drafting process.

43 See the comments and analysis above under the heading "Mechanics of the Budget Proposal."

FIGURE 2 Example of a Tower Structure



affiliate operating company, FA 1. At a later date, Canco sells the shares of FA 1 to a third party for cash, realizing a substantial capital gain, and uses all of the proceeds to invest in a new operating affiliate, FA 2, using a tax-efficient double-dip structure. Canco's initial third-party indebtedness stays in place. In this situation, could the new interaffiliate debt reasonably be considered to have been funded, in whole or in part, by the proceeds of Canco's indebtedness and, if so, how does one make this determination?

As a separate example, consider a situation where Canco borrows from a third party and uses the proceeds to invest in shares of a wholly owned foreign affiliate finance company, Finco. Finco uses the proceeds to lend to a foreign affiliate operating company, Opco, also wholly owned by Canco. Canco's interest expense is denied under the revised proposal. Subsequently, a new investor, Canco Purchaser, using proceeds from new third-party borrowings as partial currency for the transaction, acquires all of the shares of Canco, and also contributes equity to Canco, allowing Canco to repay its initial indebtedness. In this example, does the original interaffiliate debt established between Opco and Finco result in a denial of all or some portion of the interest on Canco Purchaser's new third-party indebtedness? And again, if so, how does one make this determination?

Tax Policy Considerations

The primary target of the revised proposal is the exemption from FAPI for inter-affiliate payments of interest where the corresponding deduction reduces active business income of the payer affiliate.[44] However, the interaffiliate exemption, in and of itself, simply ensures that active business income of one foreign affiliate of a

44 Paragraph 95(2)(a) of the Act.

Canadian taxpayer is not, as a result of a deductible interaffiliate payment of interest, rents, or royalties, characterized as FAPI in the hands of the recipient affiliate. It has little to do directly with the Canadian domestic revenue base, other than ensuring that characterization as FAPI is generally restricted to passive income received by foreign affiliates on portfolio investments.[45]

Nevertheless, the interaffiliate exemption could encourage a certain amount of debt placement in Canada, and therefore some erosion of the Canadian tax base. Even in those situations where third-party financing could be obtained at competitive rates in the target country, the ability to double-dip would argue in favour of the Canadian business making the borrowing and using the proceeds to fund the foreign target through a tax-efficient financing structure. However, even if the interaffiliate exemption were repealed, it is unlikely that this would have a major impact on the level of Canadian borrowing for foreign affiliate investment, given Canada's high corporate tax rates on profits, the fact that lenders routinely seek the best possible security (in this case, the creditworthiness of the Canadian parent), and the difficulty of borrowing in the foreign country when the Canadian business holds (or intends to acquire) less than 100 percent of the foreign affiliate. In addition, little evidence is available to show that debt financing in the investor jurisdiction is affected by the availability of these types of double-dip financing structures.[46]

The revised proposal will therefore be largely ineffective in achieving tax policy objectives. It is also limited in two other respects. First, it targets interaffiliate interest deductions, but only if the relevant interaffiliate debt is linked to a Canadian borrowing. Taxpayers who use excess cash (including, perhaps, cash resulting from cash damming techniques) for foreign affiliate investment do not suffer under the rule. Second, the revised proposal targets only interaffiliate indebtedness, to the exclusion of other debt substitutes, such as certain factoring arrangements, leases and licences, derivative contracts, and hybrid instruments. However, we do not argue for an extension of the rule,[47] since we believe that a far better approach is available.

45 As discussed above, in addition to purely passive property income, FAPI includes income from an investment business as defined in subsection 95(1) and specified types of income earned by a foreign affiliate where the corresponding deduction erodes the Canadian tax base. However, none of these income sources relate to interaffiliate payments.

46 See Jack Mintz and Alfons Weichenrieder, "The Indirect Side of Direct Investment: Multinational Company Finance and Taxation" (mimeograph, Center for Economic Studies and Ifo Institute for Economic Research (CESifo), Munich, 2007). In a review of German foreign direct investment, leverage in foreign subsidiaries did not seem to be affected by financing structures involving third-country conduit companies. However, there was a strong substitute of third-party debt for intercorporate debt in the foreign subsidiaries if conduit companies were not available. Further tests would be needed to determine whether the German parent company's leverage was affected by the existence of conduit financing strategies.

47 For example, by repealing the application of paragraph 95(2)(a) in the context of interaffiliate debt and debt substitutes.

The US Response to Double-Dip Structures

Many other countries allow their multinationals to use tax-efficient structures for foreign investment similar to those used by Canadian businesses. A prime example is the United States.

For many years, US multinationals were able to take advantage of tax-efficient double-dip structures as a result of US entity characterization principles, and eventually these principles were enacted by the "check-the-box" regulations.[48] Even so, a new provision was added to the Internal Revenue Code in 2006[49] that is essentially identical to the Canadian interaffiliate interest exemption that the revised proposal seeks to marginalize. In general terms, section 954(c)(6) of the Code provides that dividends, interest, rents, and royalties received by a controlled foreign corporation (CFC) of a US corporation from a related CFC shall be exempt from the subpart F provisions, provided that the payment does not reduce subpart F income[50] of the payer. Commenting on the provision, the report of the House Committee noted:

> Most countries allow their companies to redeploy active foreign earnings with no additional tax burden. The Committee believes that this provision will make U.S. companies and U.S. workers more competitive with respect to such countries . . . [and] that the provision will enable U.S. companies to make more sales overseas, and thus produce more goods in the United States.[51]

The dichotomy between the US measure and the revised proposal is striking. The United States does not seek to prevent the reduction of foreign taxes, and protect the revenue bases of other countries; rather, it has adopted a number of initiatives that seek to protect its own tax base. These measures include the so-called earnings-stripping provisions,[52] debt-equity recharacterization for US businesses that are too highly levered,[53] and comprehensive limitation-on-benefit provisions included in the US tax treaty network.

OUR PROPOSAL FOR A MORE COHERENT APPROACH

On the assumption that deductibility of interest on funds borrowed for foreign affiliate investment is to be targeted, we suggest that a more reasonable approach must

48 Regulations under section 7701 of the Internal Revenue Code of 1986, as amended (herein referred to as "the Code"), effective January 1, 1997.

49 Section 954(c)(6) of the Code, as enacted on May 17, 2006 by the Tax Increase Prevention and Reconciliation Act of 2005, Pub. L. no. 109-222. The provision applies to the years 2006 to 2008 inclusive, but could, of course, be extended by Congress at the end of that period.

50 Or income effectively connected with a US trade or business.

51 HR rep. no. 109-304, 109th Cong., 1st sess. (November 17, 2005), 45.

52 Section 163(j) of the Code.

53 Section 385 of the Code and supporting case law.

be developed, to protect the Canadian revenue base while respecting international norms, and without unduly damaging the ability of Canadian business to compete globally. We also suggest that both the budget proposal and the revised proposal were developed too much in isolation and that, rather than focusing narrowly on foreign affiliate investments, a more holistic approach should be considered.

Deductions for interest expense may reduce the Canadian revenue base in a great number of situations that have nothing to do with foreign affiliate investment. With respect to inbound investment, the existing Canadian thin capitalization rules may apply, but generally only to the extent that the Canadian corporation borrows funds from a non-resident shareholder with the requisite ownership interest of at least 25 percent (by votes or value).[54] Third-party debt, whether or not guaranteed by the non-resident investor, is not subject to the existing thin capitalization rules, nor does such debt reduce the amount that can be borrowed from non-resident shareholders under the rules. Also, the definition of "equity" for purposes of the existing rules suffers from a number of deficiencies. For example, the amount of equity represented by share capital and contributed surplus is appropriately restricted to amounts invested by the specified non-resident investor; on the other hand, retained earnings of the Canadian corporation are fully included in the computation of "equity." In short, the existing Canadian thin capitalization rules have had very little impact on Canadian debt dumping by foreign investors, or on the significant erosion of our domestic revenue base that results.

Another important issue not addressed by the revised proposal, in terms of its economic impact and the erosion of the Canadian revenue base, relates to leveraged buyouts of Canadian businesses by private equity pools and Canadian tax-exempt entities. We suggest that this issue must also be carefully considered and addressed in the context of any proposed limitation on interest deductibility in Canada.

While interest deductibility is, of course, not objectionable in policy terms or as a matter of principle, it is reasonable to ask whether some general and comprehensive limitation should apply, having regard to the various types of issues and situations described above, including, but not restricted to, foreign affiliate investment. Our proposal in this regard, as an alternative to the revised proposal, is the development of a comprehensive domestic thin capitalization rule, which would apply to all indebtedness of a Canadian corporate group, both arm's-length and non-arm's-length, and would deny interest expense (and other financial costs) to the extent that total indebtedness of the group exceeds a specified threshold—for example, 75 percent[55] of the amount or value of the group's investment in net Canadian domestic assets, computed before net debt or equity of the group.

54 Subsection 18(4) and related sections of the Act.

55 The prescribed percentage(s) would need to be developed after a review and analysis of data on existing leverage ratios by industry, and of revenue impacts. Such review and analysis is beyond the scope of this article.

The ratio of 75 percent is based on an implicit debt-to-equity ratio of 3:1. Equity as otherwise computed would effectively be reduced to the extent that it is supported by foreign affiliate investment. In addition, equity would not be restricted (as it is under Canada's existing thin capitalization rules) to equity contributed or invested by certain specific shareholders.

This approach would be consistent with similar measures recently adopted by some European countries and by Australia. In Australia, for example, new thin capitalization rules were introduced with effect from July 2001. Separate rules apply to inbound versus outbound investment. In both cases, however, the base test (safe harbour) is 75 percent of investment in net domestic Australian assets.[56] A specific provision allowing a deduction for interest expense on funds borrowed to finance exempt foreign participations[57] was introduced coincident with the enactment of the new thin capitalization rules.

Under our proposal, the basis on which investment in Canadian domestic assets would be measured must be defined, and the more obvious choices (in increasing order of complexity) would be accounting values, tax values, or, by election, fair market value.[58] In addition, different ratios or approaches must be considered in the context of specific industries, such as financial institutions.[59]

One disadvantage of our proposed domestic thin capitalization rule, in the context of foreign affiliate financing, is that it effectively ignores the extent to which foreign affiliates may have been directly financed with third-party borrowings. On the other hand, the rule would permit full deduction of interest expense up to a reasonable amount, so that there should be no adverse tax or economic impacts of incurring additional indebtedness to finance foreign affiliate investment, provided that the Canadian corporate group stays within the allowable limit.

This approach would address both foreign affiliate investment and the other situations described above. For example, in the foreign affiliate context, consider a Canadian corporation that has invested $5,000 in Canadian domestic assets and an additional $5,000 in its foreign affiliates. The Canadian corporation in this example would be entitled to deductions for interest expense on borrowings (both arm's-length and non-arm's-length, and relevant to either domestic or foreign investment) up to but not exceeding 75 percent of its investment in domestic assets. In the case

56 For inbound investment, the maximum allowable debt is generally the greater of the safe harbour and the "arm's length debt amount." For outbound investment, it is generally the greatest of three amounts: the safe harbour, the "arm's length debt amount," and the "worldwide gearing debt amount" (which may allow taxpayers to support higher levels of domestic debt, having regard to external debt and equity levels of the worldwide group).

57 Section 25-90 of the Income Tax Assessment Act 1997, added by Act No. 162 of 2001.

58 In the United States, the interest apportionment rules applicable to its credit regime include an election to prepare calculations based on current fair market value.

59 In Australia, different rules apply to financial institutions. For example, the rules applicable to authorized deposit-taking institutions are based, in general terms, on prescribed levels of capitalization rather than prescribed levels of debt.

of inbound investment, and more generally any investments in Canadian businesses by private equity pools or other investors, interest deductions on borrowed funds would again be limited, on the basis of the prescribed ratio of borrowings to net assets of the Canadian business.

CONCLUDING COMMENTS

In our view, the revised proposal to deny deductions for interest expense in the context of double-dip financing structures is poorly targeted, and will be largely ineffective in achieving tax policy objectives. We believe that, as an alternative, the government should develop a more general approach, both to protect Canada's domestic revenue base and to encourage greater competitiveness of Canadian business. As a condition for competitiveness, any proposal to restrict interest deductibility should be coupled with significant reductions in the corporate income tax rate.

We believe that restrictions on interest deductibility are not inappropriate for businesses with unreasonable levels of debt financing in Canada. The approach we suggest is a comprehensive domestic thin capitalization rule. There are, of course, a number of issues to be reviewed and considered. What threshold of ownership interest should apply for purposes of determining the Canadian corporate group, and what rules are required to minimize the potential for double-counting of indebtedness in tiered structures?[60] Should interest expense on indebtedness in excess of the prescribed ratio be denied, or suspended for possible carryover to other taxation years? And to the extent that foreign affiliates have incurred third-party borrowings in excess of the general domestic thin capitalization ratio, should additional relief be considered? While these and other questions must be reviewed and considered, the questions are not daunting—nor are the answers elusive. In simplest terms, our suggested approach represents a variation of the thin capitalization rules that already apply in Canada, and of similar rules that apply in many other countries.

We accordingly suggest that, as an alternative to a narrow measure that addresses only foreign affiliate investment, the government undertake a consultative process with a view to developing a more coherent approach to the issue of interest deductibility.

60 In addition, to the extent that one Canadian corporation has an ownership interest in a second Canadian corporation with foreign affiliate investments, and assuming that the two corporations do not form part of the same corporate group for purposes of the domestic thin capitalization rule, should the rules provide for a proportionate reduction of the first corporation's domestic equity with respect to the underlying foreign affiliate investment of the second corporation?