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December 29, 2021

The Honourable Chrystia A. Freeland, P.C., M.P.
Deputy Prime Minister and Minister of Finance
Department of Finance Canada
90 Elgin Street
Ottawa, Ontario K1A 0G5
Canada

Re: Comments on Proposed Interest Deductibility Limits in Budget 2021

Dear Minister Freeland:

On behalf of Tax Executives Institute, Inc. ("TEI"), I am pleased to share our initial comments on the government's proposal to introduce a new limitation on the deduction of business interest expense, as described in the federal budget documents tabled in the House of Commons on April 19, 2021 ("Budget 2021").[1] Although Budget 2021 contemplates the release of draft legislative proposals for comment, we felt it prudent to share our preliminary feedback in an effort to inform the government's deliberations.

About TEI

TEI was founded in 1944 to serve the professional needs of in-house tax professionals. Today, the organization has 57 chapters across North and South America, Europe, and Asia, including four chapters in Canada. Our approximately 6,500 members represent 2,800 of the world's leading companies, many of which either are resident or do business in Canada. Over 15 percent of TEI's membership comprises tax professionals who work for Canadian businesses in a variety of industries across the country. TEI members are responsible for the tax affairs of their employers and must contend daily with provisions of the tax law relating to the operation of business enterprises. The following recommendations reflect the views of TEI as a whole but, more particularly, those of our Canadian constituency.

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[1] Dep't of Fin. Can., Budget 2021, Annex 6, *Tax Measures: Supplementary Information* 643–46 (Apr. 19, 2021).

As the preeminent association of in-house tax professionals worldwide, TEI is dedicated to the development of sound tax policy, compliance with and uniform enforcement of tax laws, and minimization of administration and compliance costs to the mutual benefit of government and taxpayers. TEI is committed to fostering a tax system that works—one that is administrable and with which taxpayers can comply in a cost-efficient manner. The diversity, professional training, and global viewpoints of our members enable TEI to bring a balanced and practical perspective to the legislative proposals discussed herein.

Background

Budget 2021 proposes to introduce an earnings-stripping rule in Canada consistent with the recommendations in the Action 4 Report of the OECD/G20 Base Erosion and Profit Shifting ("BEPS") Project.[2] The recommended approach described in that report would limit the amount of net interest expense (i.e., interest expense, including payments economically equivalent to interest, as well as other financing-related expenses, less interest and financing-related income) that may be deducted to a fixed share of earnings. Specifically, the report recommended a "best practice approach" comprising three elements: (i) a *fixed ratio rule* that would limit an entity's net interest deductions to a fixed percentage of its profit, measured using earnings before interest, taxes, depreciation, and amortisation ("EBITDA") based on tax numbers ("tax EBITDA"); (ii) a *group ratio rule* that would allow an entity exceeding the benchmark fixed ratio to deduct interest expense up to the net third party interest/EBITDA ratio of its group, where this amount is higher; and (iii) *targeted rules* to address specific BEPS risks that remain.

As described in Budget 2021, the proposed earnings-stripping rule would limit the amount of net interest expense that a corporation may deduct in computing its taxable income to no more than a fixed ratio of the corporation's tax EBITDA. For these purposes, Budget 2021 explains that:

- tax EBITDA would exclude, among other things, dividends to the extent they qualify for the inter-corporate dividend deduction or the deduction for certain dividends received from foreign affiliates;

- interest expense and interest income would include not only amounts that are legally interest but also certain payments that are economically equivalent to interest and other financing-related expenses and income;

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[2] OECD, *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4 – 2016 Update, OECD/G20 Base Erosion and Profit Shifting Project* (2017), http://dx.doi.org/10.1787/9789264268333-en [hereinafter "BEPS Action 4 Report"]. The term "earnings stripping" generally refers to the payment of excessive deductible interest that is tax exempt, or partially tax exempt, in the hands of a related person (i.e., a foreign person or tax-exempt entity).

- the measure of interest expense would exclude interest that is not deductible under existing income tax rules, including the thin capitalization rules, which would continue to apply; and

- interest expense and interest income related to debts owing between Canadian members of a corporate group would generally be excluded.

To facilitate transition, Budget 2021 explains that the proposed earnings-stripping rule would be phased in, with a fixed ratio of 40% for taxation years beginning on or after January 1, 2023, but before January 1, 2024, and 30% for taxation years beginning on or after January 1, 2024. Budget 2021 also describes a proposed "group ratio" rule, under which interest expense would be deductible above the 30% threshold if the taxpayer is part of a consolidated group whose ratio of net third party interest to book EBITDA implies that a higher deduction limit would be "appropriate." Budget 2021 generally provides that interest expenses denied under the proposed rules would be able to be carried forward for up to 20 years or back for up to three years.

Discussion

Existing Tax Legislation and Comparison to Other Countries' Approaches

Canada's Income Tax Act currently includes several provisions that address the deductibility of interest for federal income tax purposes.[3] These include the general limitations in paragraph 20(1)(c), the thin capitalization rule in subsection 18(4), and the foreign affiliate dumping rules in section 212.3. The rules in paragraph 20(1)(c) provide the general statutory framework for the deductibility of interest expense in computing a taxpayer's income from a business or property. The rules in subsection 18(4) and section 212.3, by contrast, are restrictive provisions designed to limit the amount of deductible interest expense in certain circumstances.

TEI strongly encourages the Department of Finance ("Department") to consider the competitiveness of Canada's tax system when drafting legislation for this new earnings-stripping rule. The issue of competitiveness in this context was specifically raised in the final report of the government's Advisory Panel on Canada's System of International Taxation, entitled *Enhancing Canada's International Tax Advantage* (the "Report").[4] Although the Report was issued in 2008, many of the concerns it articulated about Canada's competitiveness for international capital remain equally relevant today. Perhaps most relevant here is paragraph 4.153 of the Report, which states:

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[3] Unless otherwise indicated, all references to "section," "subsection," or "paragraph" herein are to sections, subsections, or paragraphs of the Income Tax Act, R.S.C. 1985, c. 1 (5th Supp.), as amended.

[4] Advisory Panel on Can.'s Sys. of Int'l Tax'n, *Final Report – Enhancing Canada's International Tax Advantage* (2008), https://publications.gc.ca/collections/collection_2009/fin/F2-184-3-2008E.pdf.

> The guiding principles of tax policy are not dependent on the ebb and flow of the marketplace. Canadian businesses must compete in global markets at all times; however to hobble their ability to compete and invest in the future at the worst of times would not be consistent with the principles guiding our analysis. It is clear that businesses in many of Canada's trading partner nations are not restricted in their ability to deduct interest expenses incurred to invest in foreign affiliates and use various outbound financing arrangements.

Many of Canada's trading partner nations have implemented provisions similar to the proposed earning-stripping rule described in Budget 2021. In so doing, however, many of these countries also amended or replaced one or more existing limitations on the deductibility of interest expense. For example, when Germany implemented its interest deductibility limitations in 2008, it also removed its thin capitalization rules for the deductibility of interest on related-party debt, which were materially similar to subsection 18(4). And when France implemented its interest deductibility limitations in 2019, it not only modified its thin capitalization regime but also repealed restrictions on the deduction of interest expense related to debt on acquisitions of non-French (and non-EU/EEA) entities. Furthermore, when the United States enacted its comprehensive tax reform legislation in 2017, it included meaningful pro-growth measures (e.g., 100% bonus depreciation) that benefit many taxpayers subject to its new limitation on the deduction of business interest expense.

Another important factor to consider when evaluating competitiveness in this context is that, unlike most developed countries, Canada does not permit consolidated reporting for tax purposes; all members of a corporate group must compute their tax liabilities and file returns separately. Conversely, most of Canada's trading partner nations that have implemented similar interest deductibility limits also have tax regimes that allow filing on a consolidated basis or the transfer of losses between related companies. The importance of this distinction cannot be overstated as it frustrates the ability of Canadian companies to implement intercompany financing and similar arrangements that are commonplace among their non-Canadian competitors.

Although it is difficult to directly compare other countries' tax systems to Canada's, it is important to review each country's rules as a whole to determine whether adopting the proposed earnings-stripping rule would make Canada more—or less—competitive relative to other countries with which Canada competes for international capital. It also important to keep in mind that Canada's economy is relatively small compared to those of its major trading partner nations, particularly the United States. Accordingly, TEI respectfully asks the Department to ensure that any legislation to implement the proposed earnings-stripping rule described in Budget 2021 will assure the competitiveness of Canada's international tax system—for Canadian and inbound businesses alike—when compared with the tax systems of Canada's major trading partners.

Existing Debt Structures and Restructuring of Financing

There are significant commercial reasons why Canadian-controlled multinational enterprises borrow at the parent-company level, including: borrowing rates and terms from lenders; depth of capital markets; transaction costs; and regulatory considerations. It is typically inefficient for debt financing to be "broken up" among individual business segments or jurisdictions, because it generally is the parent company that has the relationship with the market to obtain the most favourable financing options.

TEI is concerned that the proposed earnings-stripping rule described in Budget 2021 may be based on the erroneous assumption that Canadian-controlled multinationals can, within a short period of time, revise their capital structures by recapitalizing foreign affiliates (to increase deductible borrowing by those affiliates) to de-lever the parent company. There are many legal, regulatory, and tax impediments that can prevent Canadian parent companies from efficiently restructuring corporate borrowings with foreign affiliates or converting existing equity investments into loans to foreign affiliates. Consider the following examples:

- In cases where a Canadian parent company has borrowed funds to invest in or acquire a foreign affiliate, it typically is neither permissible nor feasible—under commercial terms or legal obligations governing the parent or its affiliates—to push existing debt down into foreign affiliates. Significant break fees, such as make-whole payments or prepayment penalties, could also apply. Taxpayers may not be able to easily restructure certain debt instruments (e.g., hybrid debt that receives equity treatment from a credit rating agency but is legally debt for tax purposes can be issued only by the Canadian public parent company). Additionally, current financial arrangements would also need to be considered, including restrictive distribution covenants in loan agreements and existing commercial agreements.

- There are foreign currency exchange implications of unwinding financing arrangements or recapitalizing an equity investment in a foreign affiliate. These implications could be significant (e.g., where a Canadian parent company has hedged its foreign exchange exposure based on a certain term of its external debt and the debt is now required to be repaid early to address tax law changes).

- Foreign tax rules may make it prohibitive or costly to "push down" corporate borrowings or change existing equity investments into loans to foreign affiliates, including withholding taxes on foreign-source interest and dividends, as well as the fact that some jurisdictions impose withholding taxes on returns of capital. In addition, there are prohibitive rules in some jurisdictions where the refinancing of debt could cause the new debt not to qualify for transition provisions (e.g., refinanced debt to the United States could be subject to the new final regulations regarding the treatment of certain interests in corporations as stock or indebtedness under section 385 of the Internal Revenue Code).

- Foreign corporate laws may impose limitations on the ability to make distributions in the foreign jurisdiction.

- There are some specific cases where regulatory requirements could potentially penalize companies for borrowing in the United States versus Canada. For example, capital adequacy tests imposed by the Office of the Superintendent of Financial Institutions are designed in a manner that encourage Canadian financial institutions to borrow in Canada even where the funds are used for foreign expansion. Borrowing in the foreign jurisdiction would translate into an unfavorable impact in the financial institution's solvency ratio.

Given all these impediments to the efficient restructuring of corporate borrowings, TEI respectfully urges the Department to provide an exemption for interest expenses derived from pre-existing debt obligations in any legislation to implement the proposed earnings-stripping rule. Providing for such an exemption would also be consistent with the explicit recommendations in the Action 4 Report of the OECD/G20 BEPS Project, which Budget 2021 purports to follow:

> [A] country may exclude interest on existing loans from the scope of rules, either for a fixed period or indefinitely. This may be particularly relevant for third party loans which form part of a group's regulatory capital, as these loans are often long-dated and there may be substantial penalties if they are repaid early. In any case, these "grandfathering" rules should only apply to loans entered into before interest limitation rules are announced, and should cease to apply if a loan is subsequently re-financed or if the terms of the loan are significantly modified, to the extent this results in an increase to the tenor of the loan, the principal of the loan or to the rate of interest that applies.[5]

TEI recommends that the Department exempt interest expenses derived from pre-existing loans from the scope of the proposed rule indefinitely. If the Department were compelled to do so only for a fixed period, however, TEI would recommend that any transition rules permit the refinancing of pre-existing debt in appropriate cases (e.g., where the same principal amount is involved in the refinancing and the refinancing is used for the same purpose).

Problematic Application in Certain Industries

TEI is concerned that the proposed earnings-stripping rule, as described in Budget 2021, does not contemplate the provision of any sectoral exemptions like those found in the tax laws of Canada's trading partner nations. The following discussion highlights two specific industry sectors for which such exemptions would be warranted for legitimate commercial or public policy reasons.

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[5] BEPS Action 4 Report, *supra* note 2, para. 539, at 190.

Financial Institutions

TEI respectfully submits that it would be counterproductive to impose an additional limitation on financial institutions, including insurance companies, with respect to the allocation of net interest expense and tax EBITDA. Public borrowings by Canadian multinational insurance and other financial institutions typically occur at the level of the ultimate parent company. In other jurisdictions such as the United Kingdom, France, and the United States, there are no restrictions on the ability to include net interest income and tax EBITDA of a financial institution within a consolidated group, regardless of the type(s) of business carried on by other members of the group. It follows, therefore, that any limitation on the ability to utilize net interest expense and tax EBITDA within a group that includes a financial institution would necessarily place Canadian-parented groups at a competitive disadvantage relative to their foreign-parented counterparts.

Public Infrastructure and Large Capital Projects

Likewise, it would be inappropriate to apply the proposed earnings-stripping rule to limit the deductibility of interest expense related to large capital projects, including public infrastructure projects ("P3 projects"). P3 projects in Canada would be very negatively impacted by the proposal described in Budget 2021. The financial models prepared for these projects generally reflect operating losses in the early years, with profitability in later years as construction is completed. By their very nature, public infrastructure and other large capital projects require substantial initial capital outlays to build and, in many cases, large ongoing capital outlays to maintain. These projects are long term (20–30 years or more), have evolving risks throughout their development and construction lifecycles, and are generally undertaken by a consortium of unrelated parties. Limiting the ability of these businesses to deduct their project-related interest expenses would not only frustrate the public policies that promote such investments but also make Canada an outlier among its trading partner nations.

Carryover Periods

As noted above, Budget 2021 generally provides that interest expenses denied under the proposed earnings-stripping rule could be carried forward for up to 20 years or back for up to three years. This approach would differ markedly from the approach adopted by several EU member states and the United States, which permit unused interest expense to be carried forward indefinitely. It would also negatively affect the many Canadian corporations that hold long-term investments in foreign affiliates. Because the ultimate gain on disposition of a foreign affiliate may be taxable in Canada, it would be inappropriate to deny a deduction for interest expenses related to such investments simply because the proposed 20-year carryover period has expired. For these reasons, among others, TEI respectfully recommends that the proposal be revised to allow disallowed interest expense to be carried forward indefinitely.

Definition of Group and Group Ratio

Under the aforementioned "group ratio" rule, interest expense would be deductible above the proposed 30% threshold in cases where the taxpayer is part of a consolidated group whose ratio of net third party interest to book EBITDA implies that a higher deduction limit would be appropriate. To that end, TEI encourages the Department to take the following comments into account when drafting legislative definitions for the terms "group" and "group ratio."

- The term "group" should be defined for this purpose to include *all* related Canadian companies, including those that may be owned by related non-residents.

- Many taxpayers in Canada carry on business through trusts that are widely held and may be publicly listed. It is unclear from the description in Budget 2021, however, whether such business trusts would be viewed as members of the consolidated group in this context. TEI suggests that publicly held trusts be included in the definition of a group for this purpose, including in cases where they are at the top of the ownership chain.

- If the group ratio calculation is based on book EBITDA, then TEI suggests that all forms of generally accepted accounting principles ("GAAP") be deemed acceptable for this purpose. This approach would allow taxpayers to use their audited consolidated financial statements, since not all taxpayers prepare their financial statements based on the same GAAP.

- Partnerships that are owned by Canadian taxpayers with other partners that are non-residents—whether related or at arm's length—should be specifically addressed in the legislation to ensure that congruity is achieved with corporate related entities that may be co-owned with arm's length parties.

Definition of Interest

As described in Budget 2021, for purposes of the proposed earnings-stripping rule, interest expense and interest income would include not only amounts that are legally interest but also certain payments that are economically equivalent to interest and other financing-related expenses and income. TEI is concerned about the potential overinclusiveness of this standard and would encourage the Department to consider the following comments in drafting a legislative definition.

- External legal costs and certain financial institution fees, to the extent capitalized as debt-issuance costs, could, as amortized, be treated as interest expense. The amortization of such costs should not be treated as interest.

- Similar concerns exist with respect to foreign currency exchange gains and losses, which should not be included within the definition of interest income or expense.

- Another area of concern involves companies that routinely use supply chain finance arrangements, in which a company offers customers extended payment terms in exchange for entering into a three-party transaction—between the company, the customer, and a third-party bank—to factor their receivables. For financial reporting purposes, the company may account for the factoring discount (if exercised) as a reduction in sales, not as interest. This "discount" on the factored receivable should not be included within the definition of interest.

Definition of EBITDA

Finally, TEI encourages the Department to provide additional clarity concerning the definition of EBITDA for purposes of the proposed earnings-stripping rule. Ideally, EBITDA would be based on Division B income (Net Income for Tax Purposes)—taxable income *before* the application of losses or section 110 deductions. Note that this approach would also include any income related to foreign accrual property income.

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TEI appreciates the opportunity to share our preliminary feedback with the Department, and we look forward to engaging in meaningful, substantive consultations with Department officials following the release of draft legislation. TEI's comments were developed jointly by a working group of interested members under the aegis of TEI's Canadian Income Tax Committee, whose chair is Patricia Likogiannis. Principal responsibility for drafting TEI's comments was exercised by Watson M. McLeish, TEI Tax Counsel. If you have questions about TEI's comments, please contact Ms. Likogiannis at (905) 431-4565 or patricia.likogiannis@gm.com, or Mr. McLeish at (202) 470-3600 or wmcleish@tei.org.

Respectfully submitted,

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