The Federal Budget's Interest Restrictions – Clear and Present Danger?

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Last week's federal Budget contained proposals (Budget Resolutions 24-29) that do nothing less than disallow interest deductions in respect of investments in foreign affiliates in the vast majority of situations. While one firm's Budget night release described this as the "most significant tax policy development in the international area since . . .1972", I am not sure that a lot of practitioners fully appreciated the ramifications of the proposals, at first anyway. In fact, some of the Budget papers themselves gave the impression that the interest disallowance applies to investments in "tax havens". However, the significance of the proposals became more apparent as the week wore on, and by the weekend, were becoming almost tantamount to the Budget itself**[1]**.

Make no mistake: the proposals potentially apply to any corporation that borrows to acquire the shares of a foreign affiliate, whether it resides in the US or somewhere in the Caribbean. Contrary to the impression that some commentary gave, the proposals are not confined to exotic international financing structures. They potentially apply to any borrowing to finance a foreign affiliate. It's that basic.

The restrictions on interest deductibility are on a tight time frame. They will apply to interest payable after 2007 on debt incurred on or after Budget day.**[ii]** Pre-existing non-arm's length debts will be subject to the restrictions after 2008;**[iii]** and the restrictions will apply to interest payable on pre-existing arm's length debts after 2009.**[iv]** Although the Budget indicates that the last-mentioned deadline is in recognition of difficulties companies might have in restructuring debt, since such debt typically has a fairly long term with stringent penalties often applying to prepayment, it is questionable whether many borrowers will be able to restructure in time.

As the Budget papers indicate, the disallowance rules (which apply separately to each foreign affiliate) will be achieved through an adaptation of the existing "tracing" rules for interest. While (in general) the deductibility of an interest expense will continue to depend on what the borrowed money giving rise to that expense is used for, the financing of a foreign affiliate (in particular) will no longer support an immediate deduction. Instead, the interest expense will be "pooled" for a deduction "if and as the foreign affiliate shares generate non-exempt income". More precisely, the amount included in income so as to allow the deduction will be net of deductions in respect of foreign affiliate dividends, etc.**[v]**

While there has been some suggestion about counter-measures to achieve deductibility, e.g., so-called "cash damming", these must contend with a broadly-worded anti-avoidance rule which is built into the proposals**[vi]**. In any event, cash damming is difficult to achieve in the best of circumstances; the prospect of using cash to invest in what is often a speculative foreign venture may pose additional risks.

Rationale for the Proposals

The rationale for these proposals is that Canada's current tax system allows tax deductions for interest on money borrowed to finance affiliates, while income from active businesses of a foreign affiliate does not attract Canadian tax as it is earned and, in the case of treaty countries, can be repatriated to the corporate level in the form of exempt surplus dividends. Thus, the Budget characterizes the deduction as a "subsidy". This concept is not new. A similar recommendation was made in the Mintz Committee Report**[vii]** released almost a decade ago, and was highlighted as an issue in the Auditor General's reports of 1992 and 20022**[viii]**.

The policy concerns that have been expressed over Canada's existing rules are not groundless. But the increasing cries of impairing competitiveness of Canadian businesses have a great deal of justification. Very often, especially with small or medium sized businesses, expansion into a foreign country will give rise to start-up losses so that foreign financing would not be immediately deductible. Another issue is whether such companies would be able to obtain foreign financing to begin with.**[ix]** While borrowing in, say, New York State may not pose much of a problem for even a fledgling business, how about South Carolina? Brazil? The Ukraine?**[x]**

Especially for larger public corporations, international investment decisions are made taking the tax effects into account. Knocking out tax deductions in midstream could make an important difference to the company's financial performance – to the point that vulnerability to foreign takeovers has been suggested**[xi]**. A comparison of the current proposals and the Mintz Committee Report recommendations reveals the severity of these proposals in these respects. While the Mintz Committee Report likewise recommended the disallowance of interest expenses on indebtedness incurred to invest in foreign affiliates,**[xii]** it also called for a "generous transition period" in view of transactions committed to under the existing rules, as well as a threshold amount of accumulated indebtedness in order to lighten the load for small and medium sized businesses. (I think that the ability of these businesses to finance international expansion is much more critical than it was a decade ago, when much of the expansion was south of the border. Consider such initiatives as outsourcing in developing countries, expansion into the former Soviet Bloc, and so on.**[xiii]**)

Even with these exemptions, the proposals were nonetheless described as, commercially, "the most provocative" in the Mintz Committee Report.**[xiv]** If Mintz was "provocative", what is the appropriate term for a proposal that appears without current consultation, and with no exemptions whatever? As I peer out from my office onto the TD Centre behemoths, my guess is that the tax drones in the neighbouring towers spend a big chunk of their waking hours doing outbound financing transactions, virtually all of which must have been blown to bits by the proposal. Canadian financial institutions will not only lose a lot of transactions, they may also lose customers to foreign-based banks which are better equipped to finance outside of Canada**[xv]**. (Ironically, this might be heightened by other Budget proposals which may adversely affect Canadian lenders: the Canada-U.S. Treaty is to be amended so that withholding tax and cross-border interest payments will be eliminated.**[xvi]** Once the Canada-U.S. withholding exemption, in respect of arm's length interest payments comes into effect[xvii], withholding on interest will be eliminated for all arm's length non-residents.)

To make such fundamental changes without warning does little to build confidence in Canada's business environment, especially when this is hard on the heels of other proposals in the international area which the business community is finding problematic.

There is no point in debating whether these proposals should have been put forward – we're in it, and the potential for economic damage is significant. The biggest damage will occur if they drag on like the other proposals in the international area. Each day that goes by where there continues to be a real possibility that they may come to pass, there will be a clear and present danger of serious financial damage, as uncertainty will mean that financing business will leave the country. Another fundamental issue is how a "provocative" – and seemingly dormant – suggestion can suddenly re-emerge a decade later, without further discussion, or safeguards for pre-existing transactions and smaller businesses. I can understand a surprise announcement when there is a clear and present danger to the tax base, as was the case with income trusts. However, I am not aware of any similar threat which would justify these proposals. So on reflection, perhaps as disturbing as the proposals themselves is the e *process* involved: the government seems to be following a course of ushering in fundamental changes to tax policy without consultation with the business and tax communities.

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[i] Some of the articles that appeared after Budget night include "Tax Tweak Puts a Kink in Foreign Acquisitions" *ROB*, March 21; "Tax Move Threatens Businesses Abroad", *Financial Post*, March 21; "Flaherty May Revisit Tax Change", *Financial Post*, March 22; "Ottawa Firm on Scrapping Tax Break", *ROB*, March 23; and "Ottawa May Get Windfall from Tax Crackdown", *ROB* March 24.

[ii] Otherwise then pursuant to an agreement in writing entered into before that date.

[iii] Or after the expiry of its current term, if sooner.

[iv] Or after the expiry of its current term, if sooner.

[v] Budget Resolution 24 provides that no deduction be allowed in respect of "interest relating to an investment in a foreign affiliate", except as allowed by Budget Resolution 28. Budget Resolution 26 specifies what is included in "interest relating to an investment in a foreign affiliate" and contains anti-avoidance provisions targeted at indirect financing, as well as transactions designed to avoid the restrictions. Budget Resolution 27 defines the "disallowed interest pool" of a taxpayer as consisting of: (a) the amount of the pool at the end of the preceding taxation year; (b) current non-deductible amounts per Budget Resolution 24; in excess of: (c) amounts deductible under Budget Resolution 28 for the immediately preceding taxation year. Also subtracted

are: (d) the net non-taxable portion of the capital gain computed in (c), and (e) a number of deductions for the particular year, namely foreign accrual tax applicable (subsection 91(4)), as well as dividends deductible under subsection 91(5) or paragraphs 113(1)(a) to (c). Perhaps the justification for the offsets in (e) is that the corporation, having received tax-free income, should therefore lose entitlement to interest deductions.

Budget Resolution 28 allows a deduction computed based on amounts included in income, including taxable capital gains from the disposition of shares or debt of the foreign affiliate, less various offsets, including foreign accrual taxes applicable, as well as dividends deductible under subsection 91(5), 113(2) or paragraphs 113(1)(a) to (d). It seems to me that these deductions would generally provide a high offset (i.e., restrict deductions relating to the disallowed interest pool) unless income were earned in a low-tax jurisdiction where exempt surplus is not generated.

[vi] Budget Resolution 26(b) potentially catches any amount that is otherwise deductible by the taxpayer and may reasonably be considered to be in connection with a transaction or event or a series of transactions or events a main purpose of which was to avoid the rules. It remains to be seen how such a provision would "play out" in respect of large multinational corporations with complex corporate structures.

[vii] *1997 Report of the Technical Committee on Business Taxation*, hereinafter the "Mintz Committee Report".

[viii] In the 1992 report, the Department of Finance defended the rules on the basis of competitiveness. In the 2002 report, the Department argued that corporate tax reductions would mean that Canada will become a relatively less attractive jurisdiction for multinationals to locate their debt financing and interest expenses, but that it would "continue to assess . . . the treatment of expenses incurred to make investments in . . . affiliates."

[ix] Although the Canadian parent might furnish guarantees and the like, this may mean little to a foreign financial institution.

[x] One possibility is to borrow in Canada and on-lend at interest; however, foreign tax credit restrictions may arise where foreign withholding tax is applicable; a subsection 20(12) deduction is, of course, inefficient. The preferable course of action may be to borrow outside of Canada.

[xi] See "Ottawa May Get Windfall from Tax Crackdown", *ROB* March 24, in which a senior tax practitioner cited the proposals as the "most misguided . . . I've seen out of Ottawa in 35 years".

[xii] The Mintz Committee Report recommended that the disallowed interest should be added to the cost base of the shares of the relevant foreign affiliate and accumulated in a "disallowed interest account". To the extent that dividends are received on those shares from taxable surplus, a deduction would be available; however, unlike the current proposals, accumulated balances in the disallowed interest account would not be available as an offset against FAPI. As noted previously, instead of an acb increase, Budget Resolution 28 provides that the disallowed interest pool would be deductible against capital gains from the disposition of shares or debt of the foreign affiliate.

[xiii] Consideration should be given to possible competitive advantages of providing a transitional period/grandfathering.

[xiv] See "Taxing Foreign Business Income", Nick Pantaleo, and Scott Wilkie, 98 CMC, p.8:18. Ironically. an editorial on the Budget by Jack Mintz appearing in the March 21st edition of the *Financial Post* made no mention of the proposals.

[xv] A partner in my firm, who asked to remain anonymous, thinks that one of the beneficiaries of this proposal may well be foreign banks doing business in Canada. "They already potentially have a competitive advantage over Canadian banks in targeting Canadian companies that also operate outside of Canada because of their infrastructure in other parts of the world. This may give them another leg up because they can lend to the foreign sub and be more comfortable in taking guarantees and security from the Canadian parent, if required to support the credit".

It has been stated that the (very similar) Mintz Committee Report proposal ". . .will raise the cost of capital of Canadian-based multinational companies. This could result in Canada's suffering adverse economic effects in terms of foreign and domestic investment, industrial growth, international trade, income, and employment." See Pantaleo and Wilkie, *op. cit.* p. 8:24.

[xvi] For interest paid to non-arm's length persons, withholding tax will be limited to 7% in the first year following the entry into force of the changes, to 4% in the second year, and nil thereafter. For arm's length persons, withholding tax on interest will be eliminated beginning with the first calendar year that commences after entry into force, i.e., when both countries have completed the procedures to enact the treaty changes into their laws.

There are several other proposals in the international area. For example, the Budget proposes that exempt surplus be extended to include non-treaty countries with which Canada has a comprehensive tax information exchange agreement ("TIEA"). On the other hand, non-TIEA-country earnings (including from active business) will be taxed as FAPI. Although a country will generally be a non-TIEA country only if five years have elapsed from the time TIEA negotiations begin or from the time that Canada invited the country to enter into such negotiations, one may still ask whether it is fair to force investors to either report FAPI or pull up stakes in the particular jurisdiction.

For taxation years of foreign affiliates commencing after 2008, deemed active business income, per various provisions in paragraph 95(2)(a) will be conditional on the taxpayer having a "qualifying interest". The Budget also indicates that treaty benefits will be extended to U.S. LLCs. However, there is no indication in the Budget that other issues pertaining to LLCs will be addressed.

[vii] Annex 5, page 419 may give the impression that the blanket arm's length withholding tax exemption would not come into effect until the Canada-US Treaty exemption on both arm's length and non-arm's length interest is fully phased-in; however, the Department of Finance has indicated that this is not the case.