Canada Makes Major Revisions to Interest Proposals

by Steve Suarez

The Canadian Department of Finance on May 14 announced major revisions to a federal budget proposal that would limit the deductibility of interest expenses and other borrowing costs related to investments in foreign affiliates.

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The Canadian Department of Finance on May 14 announced major revisions to a proposal previously announced in the federal budget to limit the deductibility of interest expenses and other borrowing costs incurred with Canadian taxpayers' investments in foreign affiliates. (For prior coverage, see *Tax Notes Int'l*, Mar. 26, 2007, p. 1166, *Doc 2007-6959* [**PDF**], or *2007 WTD 55-1*.) The budget proposal, as originally announced, would have limited the tax deductibility of those amounts to income from foreign subsidiaries that is taxed in Canada.

In the weeks following the budget, the business community and tax experts criticized this interest deductibility initiative, largely on the basis that the proposed restrictions were overly broad and would make Canada's tax system less competitive. (For prior coverage, see *Tax Notes Int'l*, Apr. 30, 2007, p. 436, *Doc 2007-10386* [**PDF**], or *2007 WTD 81-1*.) This would have put Canadian businesses at a competitive disadvantage relative to their foreign counterparts, although foreign acquirors of Canadian companies would also have been affected to some extent.

The May 14 announcement scales back the budget proposal to a much narrower measure directed at some transactions that produce deductions for interest expense and other borrowing costs in more than one jurisdiction, commonly known as double dips.

Like the original budget proposal, the revised proposal deals with the deductibility of interest expense on borrowed money (FA- related debt) that is directly or indirectly used to acquire or make an investment in a foreign affiliate of the borrower or a person not dealing at arm's length with the borrower. However, the revised proposal will only deny interest deductibility on FA-related debt if a foreign affiliate in the borrower's corporate group has deducted the same or similar interest expense elsewhere on interaffiliate debt, and if that debt is linked or traceable to the borrower's own interest expense. That is, it targets double dips. As a result, the revised proposal is much narrower than the budget proposal.

The revised proposal is applicable to interest expense payable in 2012 and later years, regardless of when the debt was incurred, providing a four-and-a-half-year transition period. The new transition period represents a considerable improvement over the budget proposal.

An advisory panel of experts will be asked to study the broader issue of the competitiveness of the Canadian tax system -- in particular, Canada's taxation of foreign income -- and to produce a final report by the end of 2008.

The materials released by the Department of Finance on May 14 include a short paper discussing the background to the proposal and what Finance is seeking to achieve, as well as a brief technical description of the proposed amendments to the tax statute necessary to achieve this. (The materials are available at http://www.fin.gc.ca/news07/07-041e.html.)

Detailed draft legislation is not included. This will be developed with assistance from a roundtable of tax experts and Finance officials and released in early summer. A final version will be introduced in the House of Commons in the fall.

Targeted Transactions

The notes from Minster of Finance Jim Flaherty's address and the Department of Finance background paper describe the May 14 proposal as being focused on double dips. The description of the proposal in those materials is phrased somewhat differently from the technical description of the proposal that is included with them, which is likely a first cut at trying to produce wording that encapsulates what the broader pronouncement is targeting.

The most important element of the proposal is that "single-dip" transactions are not affected. Whereas the budget proposal would have denied interest expense incurred to invest in a foreign affiliate except when investment generated income taxable in Canada, the proposal apparently requires some form of double deduction to be applicable. Thus, borrowing to invest in a foreign affiliate that generates income not subject to Canadian corporate tax will not, in and of itself, result in the related interest expense being nondeductible. The new rules apply only when the borrowing is traced to some other transaction that produces an essentially similar deduction elsewhere in the borrower's corporate group of foreign affiliates.

Two double-dip mechanisms are identified in the new materials. One involves a Canadian corporation using a foreign affiliate located in a tax haven jurisdiction, the other is an arbitrage arrangement (described as a tower structure) based on the fact Canada and the United States characterize some entities differently for tax purposes.

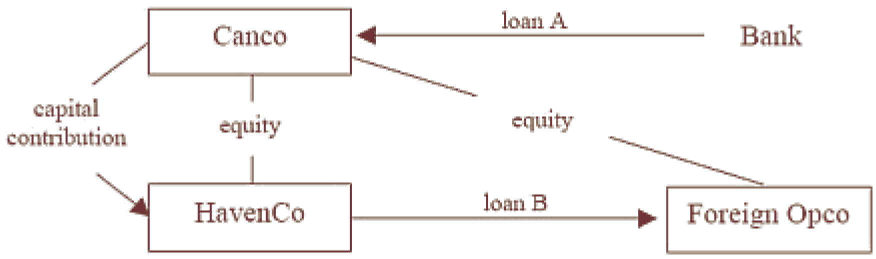
Double-Dip Example

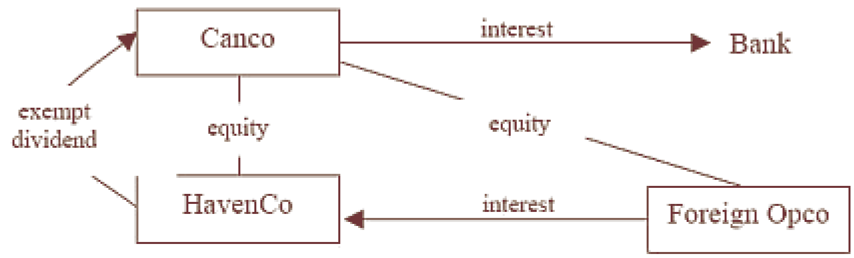
The basic double-dip transaction is illustrated in Figure 1, where Canco borrows from a bank (loan A), uses the money to make a capital contribution to a subsidiary (Havenco) in a low-tax jurisdiction, which in turn loans the money (loan B) to a foreign operating affiliate of Canco (Foreign Opco) for use in its active business. Interest paid by Foreign Opco is generally deductible to it under its home country tax laws if the borrowed money was used in its business. Interest received by Havenco, less any withholding tax levied by Foreign Opco's home country, is subject to little or no tax in its home country, characterized in the Finance materials as a tax haven).

For Canadian purposes, Havenco's interest income on loan B is treated as active business income (ABI) because it is traceable to Foreign Opco's active business. As a result, a dividend from Havenco to Canco is effectively free of Canadian tax as being from Havenco's exempt surplus. Essentially, the Canadian tax system exempts dividends received from foreign affiliates that are attributable to active business income earned in and by a foreign affiliate resident in a country with which Canada has a tax treaty. The exemption is based on the idea that treaty partners generally levy tax on that income at rates comparable to Canadian rates.

Having used the borrowed money from loan A to invest in Havenco, Canco can generally deduct the interest expense it incurs to the bank, and the result is that both Foreign Opco and Canco have incurred deductible interest expense with little or no taxable income in Havenco and no incremental taxable income in Canco.

Figure 1





In this structure, the use of a tax haven (Havenco) as a country where interest income can be earned with little or no tax leakage is an important element of the structure. Tower structures generally achieve a similar result by taking advantage of the different ways that Canada and other jurisdictions classify business entities. That is, one country treats the enterprise as a flow-through entity while the other treats it as a corporation.

In both cases the interest income, which would normally be treated as passive income and taxable to Canco in Canada (subject to a credit for any foreign taxes paid on it), is recharacterized as ABI. The reclassified income is eligible to be repatriated back to Canada tax-free as exempt surplus.

Observations

The Department of Finance's description of the revised proposal seems to target double dips where certain factors are present, as follows:

- The second deduction occurs in a foreign affiliate of the Canadian borrower; that is, the proposal looks down, not up, for the second deduction (if the Canadian borrower has a foreign parent that is able to claim a deduction related to the Canadian borrower's own debt, that would not appear to be relevant);
- The second deduction is somehow attributable to the debt that the Canadian borrower has incurred (FA-related debt); and
- Either a tax haven or some form of entity classification arbitrage has been used to achieve a double dip.

Thus, not all forms of double dips would necessarily be targeted. The technical description of the proposal is phrased a little differently, denying interest deductibility on FA-related debt to the extent of the Canadian borrower's double-dip income. That can be roughly described as the amount of any reclassified income earned by a foreign affiliate of the Canadian borrower, less any foreign tax paid on the deemed ABI (grossed up to reflect Canadian rates). No specific mention is made of tax havens or entity arbitrage, and it would appear that any foreign jurisdiction with a tax rate lower than the applicable Canadian rate could attract at least the partial application of this provision. While the technical description of the proposal is interesting, the draft legislation being produced for early summer should provide a better indication of what Finance is targeting, but in any case will apply only after 2011.

It should also be observed the general description of the proposal leaves Finance some wiggle room to go after other forms of tax planning that achieve similar results.[1] One would also expect the advisory panel referred to in the proposal will be considering other forms of potential tax leakage in the Canadian system. As a result, the proposal should be viewed as one step in a larger process rather than a definitive statement from Finance of the limits of acceptable tax planning.

It is not immediately obvious why Finance is so concerned with double-dip transactions, or whatever subset thereof is ultimately the subject of legislation. A transaction in which different entities each claim a deduction based on their own borrowings does not necessarily amount to claiming a deduction twice. Separate entities are just that, and it is quite possible for related transactions to produce income in two or more separate entities without relief from double taxation. Thus, references to "double deductions" are something of a misnomer -- the same taxpayer is not claiming the same deduction twice.

If a debt meets the Canadian requirements for interest deductibility, the fact that another country allows interest on a related debt incurred by another entity to be deductible would not seem particularly relevant as a matter of Canadian tax policy. One could reasonably suggest that transactions that reduce the foreign taxes paid by a Canadian taxpayer's foreign affiliates are good for the Canadian economy because they make the Canadian taxpayer that much more competitive. Faced with a choice between claiming a deduction in Canada or in a foreign jurisdiction (but not in both), in many circumstances it may well be that Canadian multinationals choose to take the Canadian deduction and thereby reduce Canadian tax revenues.

The revised proposal still poses many questions, and it represents something of a mixed blessing. It is clearly a major improvement over the March budget proposal, is much more focused, and provides a more reasonable transition period for taxpayers to order their affairs. However, the targeting of double dips is a little puzzling, and a compelling reason for denying Canadian taxpayers the ability to have separate entities each claim interest deductions on their own debts has yet to be articulated.

The degree to which this proposal, if enacted, would put Canadian taxpayers at a competitive disadvantage versus foreign counterparts has to be examined further. The 4-1/2-year transitional period is not as long as the 10 years suggested by an advisory committee that considered this issue several years ago. Hopefully there will be further refinements to this proposal.

FOOTNOTE

[1] The proposals also respond to certain structures that do not use a tax haven or other low-tax jurisdiction. For example, complex tower structures seek to arbitrage differences between Canadian and U.S. rules to obtain the same result as the double dip.

END OF FOOTNOTE

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