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David G. Duff[*]

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Introduction

Among the ways in which multinational enterprises (MNEs) can shift profits from one jurisdiction to another in order to minimize taxes, one of the most simple and widely-employed involves the payment of interest to related parties and third parties. Since interest is generally deductible to the payer and included in computing the recipient's income,[1] related-party debt can be used to increase deductible interest expenses in relatively high-tax jurisdictions with corresponding income inclusions in relatively low-tax jurisdictions.[2] Where a jurisdiction exempts or defers the taxation of income from foreign affiliates, moreover, interest on related- or third-party debt that is used to finance the production of this income can reduce the borrower's taxable income without a corresponding income inclusion. For these reasons, it is not surprising that the Organisation for Economic Cooperation and Development's *Action Plan on Base Erosion and Profit Shifting* (BEPS) identified the deduction of interest and other

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[1] This discussion assumes that interest payments will continue to be deductible to the payer and included in computing the recipient's income for the foreseeable future. According to a recent study, most countries tax debt and equity differently, allowing a deduction for interest expense and including interest income at ordinary rates, while denying any deduction for dividends paid and typically granting relief for dividends received in the form of an exemption, exclusion or credit. James Gadwood and Paul Morton, "Interest deductibility: the implementation of BEPS Action 4: General Report" Subject 1, *Cahiers de Droit Fiscal International*, vol. 104A (Rotterdam: International Fiscal Association, 2019) 9-44 at 20.

[2] Although the text refers to relatively high- and low-tax "jurisdictions", it is more accurate to refer to entities that are subject to relatively high or low rates of taxation, which may depend on special rules rather than general tax rates. For simplicity, however, I refer here to relatively high-tax jurisdictions and relatively low-tax jurisdictions.

financial payments as a significant source of BEPS concerns,[3] and that BEPS Action 4 was charged with developing "recommendations regarding best practices in the design of rules to prevent base erosion through the use of interest expense … and other financial payments that are economically equivalent to interest payments."[4]

Although the OECD released its Final Report on BEPS Action 4 in October 2015[5] and an update on this Report in December 2016,[6] Canada has yet to indicate whether it will take any action to implement any of the best practices recommended in these Reports.[7] In the meantime, several jurisdictions, including the United States, have implemented measures that are broadly consistent with the OECD's "recommended approach" to introduce a "fixed ratio rule" limiting an entity's net deductions for interest (and payments economically equivalent to interest) to 10% to 30% of the entity's earnings either before interest, taxes, depreciation and amortization (EBITDA).[8] At the same time, corporate tax rate reductions in the United States

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[3] Organisation for Economic Cooperation and Development (OECD), *Action Plan on Base Erosion and Profit Shifting*, (Paris: OECD, 2013) at 16 [hereafter BEPS Action Plan].
[4] *Ibid*. at 17. In general, references to in this article to "interest" include references to payments that are economically equivalent to interest.
[5] OECD, *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments*, *Action 4 – 2015 Final Report*, (Paris: OECD, 2015) [hereafter Final Report on BEPS Action 4].
[6] OECD, *Limiting Base Erosion Involving Interest Deductions and Other Financial* Payments, Action 4 – 2016 Update, (Paris: OECD, 2016) [hereafter BEPS Action 4 Update].
[7] This is in notable contrast to the federal government's recent ratification of the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS*, which implements various treaty-related measures under other BEPS action plans, including in particular BEPS Action 6 on tax treaty abuse.
[8] See Final Report on BEPS Action 4, supra note 5 at 11; and BEPS Action 4 Update, *supra* note 6 at 13. For a recent summary of developments in other jurisdictions, see Gadwood and Morton, *supra* note 1. For explanations of the U.S. rules in the *Tax Cuts and Jobs Act* (TCJA), see Peter Harris, Michael Keen and Li Liu, "Policy Forum: International Effects of the 2017 US Tax Reform – A View from the Front Line" (2019) 67:1 *Can. Tax J.* 27-39; Ken McKenzie and Michael Smart, "Policy Forum: Business Tax Reform in the United States and Canada" (2019) 67:1 *Can. Tax J.* 57-66; and Ken McKenzie and Michael Smart, *Tax Policy Next to the Elephant: Business tax Reform in the Wake of the US Tax Cuts and Jobs Act,* Commentary No. 537, (Toronto: C.D. Howe Institute, March 2019). For discussions of the UK rules, see

and the United Kingdom increase the risk of profit shifting out of Canada, making it advisable for Canada to reconsider its rules for the deduction of interest expenses and other base eroding payments.[9]

This article considers how Canada should respond to the recommendations of BEPS Action 4 in light of recent developments in the U.S. and other jurisdictions. The first section explains the ways in which interest payments may be used to shift profits from one jurisdiction to another in order to minimize taxes, considering both inbound investments and outbound investments, and why this base erosion and profit shifting may be problematic as a matter of tax policy. The second section reviews Canadian responses to these profit shifting strategies prior to BEPS Action 4. The third section summarizes the recommendations of BEPS Action 4 and the extent to which these recommendations have been implemented in other countries. A final section concludes by considering how Canada should respond to BEPS Action 4 in light of recent developments in other countries.

Base Erosion and Profit Shifting through the Deduction of Interest Expenses

As the BEPS Action Plan explains, the deductibility of interest expenses can give rise to base erosion and profit shifting in the context of inbound investments and outbound

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Richard Collier, Michael Devereux and Strahil Lepoev, "Proposed UK Changes on the Tax Deductibility of Corporate Interest Expense" [2017] *British Tax Review* 60-79; Daniel Head and Kashif Javed, How to handle the new corporate interest restriction" *Tax Journal* (27 October 2017) 10-15; and Antony Ting, "Creating Interest Expense Out of Nothing at All – Policy Options to Cap Deductions to 'Real' Interest Expense" [2018] *British Tax Review* 589-605. See also the discussion of the interest limitation rule in the EU Anti-Tax Avoidance Directive (ATAD), in Ana Paula Dourado, "The Interest Limitation Rule in the Anti-Tax Avoidance Directive (ATAD) and the Net Taxation Principle" (2017), 26:3 *EC Tax Review* 112-121.

[9] See, e.g., Harris, et. al., *supra* note 8 at 36-37; McKenzie and Smart, *Tax Policy Next to the Elephant*, *supra* note 8 at 8.

investments.[10] From an inbound perspective, the risk of BEPS relates primarily to lending from an entity that is subject to little or no tax in one jurisdiction to a related entity that is subject to a relatively high rate of tax in another jurisdiction. Since the distinction between debt and equity makes little economic difference to related entities, it is relatively easily for these entities to convert what might otherwise be non-deductible dividend payments into deductible interest payments by reducing the equity element of an investment and increasing the amount of debt (thin capitalization). Where the amount of the debt exceeds the amount that the borrower could obtain from an arm's length party, it is arguable that the excess debt should be regarded as equity and the interest paid on this excess debt should be characterized as a distribution. Where the debt exceeds the group's third-party debt, moreover, a strong case can be made that the loan results in unacceptable base erosion and profit shifting.

From an outbound perspective, the risk of BEPS involves the use of related- or third-party debt by an entity that is subject to a relatively high rate of tax in order to finance the production of income by a related entity that is subject to little or no tax in another jurisdiction, which can be is distributed to the first entity in the form of exempt or deferred dividends. To the extent that the interest on the debt is currently deductible by the borrowing entity while the dividends that it receives from the related entity are either exempt from tax or taxable on a deferred basis when received, the interest expense can be used to shelter other income from tax in the first jurisdiction, thereby eroding its tax base. Since the debt finances the production of income by a related entity in another jurisdiction, moreover, the arrangement effectively shifts profits to this other jurisdiction.

[10] BEPS Action Plan, *supra* note 3 at 16.

Although generally viewed as wholly separate issues, the distinction between these BEPS risks can break down when one takes the perspective of a multinational group with entities in multiple jurisdictions subject to different rates of tax. As Michael Graetz demonstrates in a stylized example involving a multinational group with entities in three jurisdictions, the ability of the group to locate debt and equity in the jurisdictions from which it obtains the greatest overall tax advantage means that the location of a debt in one jurisdiction in order to finance an equity investment in another jurisdiction can simultaneously be viewed as an instance of outbound BEPS and an example of inbound BEPS attributable to thin capitalization.[11] From this perspective, it follows that a principled response to the use of related- and third-party debt for BEPS purposes is to allocate the group's net third-party interest expense among the members of the group based on their share of the assets or income of the group as a whole.[12]

From a tax policy perspective, the use of interest deductions for BEPS purposes may be questioned on several grounds.[13] Beginning with equity or fairness, the opportunity to reduce taxes through the deduction of interest expenses on inbound and outbound investments creates a competitive advantage for groups operating internationally over those operating

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[11] Michael J. Graetz, "A Multilateral Solution for the Income Tax Treatment of Interest Expenses" (2008), 62 *Bulletin for International Taxation* 486-493 at 488, concluding that "economically similar transactions will fit into different traditional analytic boxes depending on which country is examining the transaction and where the borrowing takes place." The connection between inbound and outbound aspects of interest deductibility is particularly clear in the context of so-called "debt dumping" in which a foreign controlled entity borrows funds in order to finance an equity investment in a related entity in another jurisdiction.

[12] *Ibid*., preferring allocation by assets over allocation by income as "conceptually more sound" and "probably easier to implement." See also Choe Burnett, "Intra-Group Debt at the Crossroads: Stand-Alone versus Worldwide Approach" (2014), 6 *World Tax Journal* 40-76; J. Vleggeert, "Interest Deduction Based on the Allocation of Worldwide Debt" (2014), 68(2) *Bulletin for International Taxation* 103-107; and Ting, *supra* note 8.

[13] See, e.g., Final Report on BEPS Action 4, *supra* note 5 at 15-16.

exclusively in a domestic market. From an efficiency perspective, this form of BEPS undermines capital ownership neutrality, creating a tax preference for assets to be held by multinational groups instead of domestic enterprises. It also creates a tax-induced bias in the cross-border context towards debt financing, accentuating an already existing tax bias toward debt finance under most income taxes, due to the different tax treatment of returns to debt and equity. Finally, the use of interest deductions for BEPS purposes reduces government revenues, which can have other distributional and efficiency implications to the extent that reduced revenues lower government expenditures or are offset through other taxes.[14] For these reasons, it is not surprising that countries have adopted various approaches to limit opportunities for BEPS through the deduction of interest expenses, nor that the OECD decided to address this form of base erosion and profit shifting in BEPS Action 4.

Canadian Limits on the Deduction of Interest Expenses Prior to BEPS Action 4

Although Canada has yet to indicate whether it will implement any of the best practices recommended in the Final Report on BEPS Action 4, it has several rules that limit the deduction of interest expenses for international tax planning, including in particular thin capitalization rules for inbound investments by specified non-residents and foreign affiliate dumping rules for outbound investments by Canadian resident corporations that are controlled by non-resident corporations.[15] Before turning to the recommendations of BEPS Action 4, this section reviews

[14] Graetz, *supra* note 11 at 488.
[15] For a recent overview of these and other Canadian rules affecting the deduction of interest expense in the international context, see Amanda Heale and John Leopardi, "Canada" in *Cahiers de Droit Fiscal International*, vol. 104A (Rotterdam: International Fiscal Association, 2019) 191-209.

Canadian experience with rules limiting the deduction of interest expenses on inbound and outbound investments.[16]

Interest on debt-financed inbound investments

Canada was one of the first countries in the world to enact thin capitalization rules for inbound investments, which were introduced in 1972.[17] Although originally applicable only to resident corporations, the rules were recently broadened to include resident trusts, partnerships of which a resident corporation or trust is a partner, and branches of non-resident corporations and trusts operating in Canada.[18]

Unlike thin capitalization rules in several countries which apply only where a resident borrower is controlled by a non-resident lender, the Canadian rules apply at a lower threshold, where the non-resident lender and non-arm's length persons own at least 25% of the resident corporation's shares by votes or value or 25% of the fair market value of all beneficial interests in the trust.[19] In these circumstances, the rules disallow the deduction of otherwise deductible interest expenses on "outstanding debts to specified non-residents" to the extent that these debts exceed 1.5 times the "equity amount" of the corporation or trust.[20] Where the borrower

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[16] The discussion below is based on David G. Duff, "Action 4 of the OECD Action Plan on Base Erosion and Profit Shifting Initiative: Interest and Base-Eroding Payments – Insights from Canadian Experience" (2015) 69 *Bulletin for International Taxation* 350-354 at 351-354.

[17] Department of Finance, Report of the Technical Committee on Business Taxation (Ottawa: Department of Finance, 1997) at 6.26 [hereafter Report of the Technical Committee].

[18] *Income Tax Act*, R.S.C. 1985, c. 1 (5th Supp.), s. 18(4) [hereafter "ITA"].

[19] *Ibid*., definitions of "specified shareholder" and "specified beneficiary" in s. 18(5)

[20] *Ibid*., definitions of "outstanding debts to specified non-residents" and "equity amount". In general, the equity amount of a corporation is the total of all retained earnings of the corporation at the beginning of the year, the average of the corporation's contributed surplus in the year to the extent that it was contributed by a specified non-resident shareholder, and the average of the corporation's paid-up capital in the year excluding the paid-up capital in respect of shares owned by a person other than a specified non-resident shareholder, and the equity amount of a trust is the sum of its tax-paid earnings

is a corporation or partnership of which a corporation is a member, the disallowed interest expense is deemed to be a dividend.[21] Where the borrower is a trust or a partnership of which a trust is a member, the trust may designate the disallowed interest expense as a payment of trust income to the non-resident beneficiary.[22]

While these thin capitalization rules apply to back-to-back loans, they do not otherwise apply to arm's length debt, even if guaranteed by a specified non-resident shareholder or beneficiary. To the extent that guaranteed debt is easily substituted for non-arm's length debt, this would appear to be a serious deficiency in the Canadian rules.[23] Notwithstanding this concern, both the 1997 Report of the Technical Committee on Business Taxation and the 2008 Report of the Advisory Panel on Canada's System of International Taxation questioned extension of the thin-capitalization rules to debt guaranteed by specified non-residents on the grounds that this could "disrupt normal commercial financing arrangements"[24] and "increase the complexity of the current system and compliance burden of business."[25] Although the federal government proposed to extend the thin capitalization rules to guaranteed debt in the 2000 Federal Budget,[26] it withdrew the proposal in the face of considerable criticism.[27]

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and contributions to the trust from specified non-resident beneficiaries less capital distributions to specified non-resident beneficiaries.

[21] *Ibid*., s. 214(16).

[22] *Ibid*., s. 18(5.4). Although the trust may deduct this designated payment in computing its income, the designated amount is subject to withholding tax under Part XIII and the trust may be subject to tax under Part XII.2.

[23] Brian J. Arnold, *Reforming Canada's International Tax System: Toward Coherence and Simplicity*, (Toronto: Canadian Tax Foundation, 2009) at 308.

[24] Report of the Technical Committee, *supra* note 17 at 6.29.

[25] Department of Finance, Advisory Panel on Canada's System of International Taxation, Final Report, *Enhancing Canada's International Tax Advantage*, (Ottawa: Department of Finance, 2008) at para 5.29 [hereafter Report of the Advisory Panel].

[26] Hon. Paul Martin, *The Budget Plan 2000: Better Finances Better Lives*, (February 28, 2000) at 248.

If the aim of the thin capitalization rules is to prevent base erosion and profit shifting, moreover, it is unclear why the rules take into account only debt owed to specified non-residents and equity (other than retained earnings) contributed by specified non-residents, rather than all debt and equity of the relevant corporation or trust.[28] Although amended rules might continue to disallow the deduction of interest expenses only on debts owing to specified non-residents,[29] considering all debt and equity would provide a better measure of thin capitalization.

A further deficiency of Canada's thin capitalization rules is the inflexibility of a fixed ratio, particularly when data consistently demonstrates that debt to equity ratios vary widely among different industries[30] as well as among firms within industries.[31] While one alternative to a single fixed ratio would be to adopt different ratios for different industries,[32] a more principled approach would be to apply a debt to equity ratio for each entity in a corporate group based on the ratio of the group's external debt to its equity. As explained below, the Final Report on BEPS Action 4 includes an optional group-ratio rule in addition to a fixed ratio,

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[27] Department of Finance News Release, "Finance Minister Clarifies Certain Income Tax Measures in the 2000 Budget" (May 9, 2000).

[28] Arnold, *supra* note 23, at 313, arguing that "[f]or the purpose of calculating the amount of a corporation's debt and equity, all of its debt and equity should be taken into account".

[29] *Ibid*.

[30] See, e.g., Report of the Advisory Panel*, supra* note 25 at Table 5.2, reporting average debt to equity ratios from 2000 to 2005 ranging from 0.17 for insurance carriers and related activities to 3.76 for utilities. See also Tim Edgar, Jonathan Farrar and Amin Mawani, "Foreign Direct Investment, Thin Capitalization, and the Interest Expense Deduction: A Policy Analysis" (2008), 56 *Canadian Tax Journal* 803-869 at Table 2, reporting mean debt to equity ratios from 1996 to 2005 ranging from approximately 0.2 in certain retail sectors to over 2.8 for real estate and over 45 for hotels and motels.

[31] See, e.g., Edgar, Farrar and Mawani*, supra* note 30 at Table 2, reporting standard deviations ranging from 0.063 for water transportation to approximately 3.5 for real estate and over 5 for hotels and motels.

[32] See, e.g., Arnold, *supra* note 23, at 313, recommending a higher ratio for financial institutions and other industries that are typically highly leveraged.

allowing a taxpayer that would otherwise be subject to the fixed ratio to deduct interest expenses up to the group ratio.[33]

Interest on debt-financed outbound investments

Until 1972, Canadian corporations could not deduct interest on borrowed money that was used to invest in Canadian or foreign subsidiaries.[34] Since then, Canada has allowed a deduction for interest on borrowed funds used to earn dividends, even if these dividends are effectively exempt from tax as inter-corporate dividends from taxable Canadian corporations or as exempt dividends from foreign affiliates.[35]

Under rules enacted in 1972, dividends from a foreign affiliate were originally exempt only if the affiliate was a resident of a state with which Canada has entered into a tax treaty.[36] Although Canada had only 16 tax treaties when these rules were adopted in 1972, this number increased substantially in the 1980s and 1990s and Canada now has over 90 tax treaties. As a result, what was once predominantly a credit system for dividends from foreign affiliates gradually morphed into what is predominantly an exemption system.

As this change became apparent in the 1990s, concerns were raised in some quarters that the deduction of interest expenses on debt used by Canadian corporations to acquire

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[33] See *infra*, notes 93-111 and accompanying text. As explained below, however, the OECD's recommended approach generally contemplates a group ratio rule based on earnings rather than assets.
[34] Report of the Technical Committee, *supra* note 17 at 6.11.
[35] Since the dividends are included in computing the recipient corporation's income under ITA subsection 82(1) or 90(1), interest on the borrowed funds is deductible under ITA subparagraph 20(1)(c)(i). To the extent that dividends received are deductible in computing taxable income under ITA subsection 112(1) or 113(1), however, the dividends are effectively exempt.
[36] ITA, s. 113(1)(a) and the definition of "exempt surplus" in s. 5907 of the *Income Tax Regulation*, CRC, c. 945, as amended. These rules were amended in 2007 to extend exempt surplus status to foreign affiliates residing in states with which Canada has entered into a tax information exchange agreement.

shares of foreign affiliates was eroding the Canadian corporate income tax base.[37] In 1998, the Report of the Technical Committee on Business Taxation considered the issue in detail, concluding that Canadian MNEs had "significantly increased" their borrowings in Canada over the previous years,[38] and recommending a tracing rule as the simplest and most familiar way to restrict the deduction of interest on borrowed funds used to earn exempt dividends.[39]

Although the Liberal Government of the day did not act on the Technical Committee's recommendation, the Conservative Government proposed a broad tracing rule to limit the deduction of interest expenses on indebtedness incurred to acquire shares of a foreign affiliate in the 2007 Federal Budget.[40] As Brian Arnold relates, however, "[t]he outrage of corporate Canada was predictable, swift, and effective."[41] A few weeks after the Budget was tabled, the government quietly withdrew its original proposal, replacing it with a targeted anti-avoidance rule that would disallow the deduction of interest expenses on borrowed funds used in double-dip financing arrangements in which an interest deduction was also available in another

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[37] See, e.g., The Report of the Auditor General of Canada to the House of Commons, (Ottawa: Supply and Services, 1992) at 46-51.

[38] Report of the Technical Committee, *supra* note 17 at 6.12. This finding is consistent with academic studies cited in the Final Report on BEPS Action 4, *supra* note 5 at 17, concluding that multinational groups leverage more debt in subsidiaries located in high tax countries, that thin capitalization is strongly associated with multinational groups, and that foreign-owned enterprises use more debt than domestically-owned enterprises.

[39] Report of the Technical Committee, *supra* note 17 at 6.14, recommending a "broadly drafted" rule that would disallow the deduction of interest on "borrowings that can reasonably be considered, having regard to all of the circumstances, to have been used to assist, directly or indirectly, another person to make the foreign direct investment."

[40] Hon. James M. Flaherty, *The Budget Plan 2007: Aspire to a Stronger, Safer, Better Canada*, (Ottawa: Department of Finance, March 19, 2007) at 242-243.

[41] Arnold, *supra* note 23, at 118.

jurisdiction.[42] At the same time, the government also announced that it would establish an expert panel to "undertake further study and consultations, with a view to building on the measures in the March 2007 budget, and identify additional measures to improve the fairness and competitiveness of Canada's system of international taxation."[43]

When the Advisory Panel reported in 2008, one of its most pointed recommendations was that the government should repeal the anti-double dip provision, which it did before the provision came into effect.[44] The Advisory Panel also rejected the idea of "any restrictions on the deductibility of interest expense incurred by Canadian companies to invest in foreign affiliates"[45] on the following grounds:

> Our research shows that many businesses based in other countries can deduct interest on borrowed money to invest in a foreign company even though dividends from the foreign company, when repatriated, will be either exempt or mostly free from home country tax. While some countries have introduced targeted rules aimed at restricting outbound financing arrangements, many such arrangements are widely available. The Panel believes that Canada's tax system should not create disadvantages for Canadian businesses when they compete abroad.
>
> Canadian businesses need flexibility in raising capital and structuring the financing of their foreign acquisitions and expansions to be competitive with businesses based in other countries. In the Panel's view, this pragmatic concern is of greater weight than the theoretical basis for denying interest deductions on money borrowed to invest in foreign companies or in respect of outbound financing arrangements.[46]

At the same time, the Advisory Panel expressed "significant tax policy concerns" regarding debt dumping or debt pushdown transactions in which a Canadian corporation

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[42] Department of Finance, "Canada's New Government Improves Tax Fairness with Anti-Tax-Haven Initiative" News Release 2007-041 (14 May 2007). See also the accompanying Backgrounder, "International Tax Avoidance and 'Tax Havens' (14 May 2007).
[43] Backgrounder, *supra* note 42.
[44] S.C. 2009, c. 2, s. 6(1), repealing ITA, s. 18.2.
[45] Report of the Advisory Panel*, supra* note 25 at para. 4.155.
[46] *Ibid*. at paras. 4.165 and 4.166.

(CanSub) controlled by a foreign corporation (Parent) uses borrowed funds to acquire shares of another related foreign corporation (ForSub).[47] According to the Report of the Advisory Panel:

> Where there is no other connection between the businesses conducted by CanSub and ForSub and especially where CanSub does not take part in the management of ForSub or share or benefit from an increase in the value of ForSub's operations subsequent to CanSub's investment, such a transaction has the effect of inappropriately reducing CanSub's Canadian tax liability. It permits Parent to leverage its existing Canadian operations by simply reorganizing the group's ownership structure. The reorganization may not have had any purpose other than to shift deductible expenses into Canada. As a result, the reorganization reduces the Canadian tax base, generates no new economic activity in Canada, and provides little or no benefit to Canadians.[48]

For these reasons, the Panel recommended a specific anti-avoidance rule that would either disallow the deduction of interest expenses paid by a foreign-controlled Canadian corporation on borrowed funds "used to purchase, directly or indirectly, an equity interest in a related foreign corporation"; or "apply an appropriate level of Canadian tax to the purchase price paid by the foreign controlled Canadian corporation in respect of the direct or indirect acquisition of the equity interest in the related foreign corporation" such as by deeming the purchase price to be a dividend subject to withholding tax in Canada.[49]

Presumably regarding the tracing approach to be complicated and relatively easy for taxpayers to circumvent, the government settled on the second approach, introducing a "foreign affiliate dumping" rule in the 2012 Federal Budget.[50] Enacted as s. 212.3 of the ITA, this rule generally applies whenever a corporation resident in Canada (CRIC) acquires shares or debt of, or contributes capital to, a corporation that either is a foreign affiliate of the CRIC or becomes a foreign affiliate after this investment, regardless of whether the investment is

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[47] *Ibid*. at paras. 5.51 and 5.52.
[48] *Ibid*. at para. 5.53.
[49] *Ibid*. at para. 5.57.
[50] Hon. James M. Flaherty, *Canada's Economic Action Plan 2012: Jogs, Growth and Long-Term Prosperity*, (March 29, 2012) at 423-425,

financed by debt or internal funds of the CRIC. In these circumstances, the rule generally deems the CRIC to have paid and its foreign parent to have received a dividend equal to the amount by which the amount invested in the foreign affiliate exceeds the equity of the foreign parent in the CRIC. In this respect, the foreign affiliate dumping provision functions as an anti-surplus-stripping rule rather than an interest expense limitation by discouraging debt dumping as well as other transactions that can be construed as economic substitutes for the distribution of dividends by the CRIC to its foreign parent.

BEPS Action 4 and the Implementation of Best Practices

Canadian experience with rules limiting the deduction of interest expenses suggests that it is much easier for countries acting on their own to enact measures preventing base erosion and profit shifting by non-residents than it is to adopt measures preventing base erosion and profit shifting by resident MNEs.[51] More generally, as the Final Report of BEPS Action 4 explains, because “a robust approach to restrict interest deductions by a single country could adversely impact the attractiveness of the country to international business and the ability of domestic groups to compete globally” it follows that “unilateral action by countries is failing to tackle some of the issues at the heart of this problem.”[52]

For this reason, the Report concludes, “a consistent approach utilising international best practices would be a more effective and efficient way of addressing concerns surrounding the

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[51] For a similar conclusion, see Brian J. Arnold and James R. Wilson, *Aggressive Tax Planning by Multinational Corporations: The Canadian Context and Possible Responses*, University of Calgary School of Public Policy Research Papers, vol. 7, no. 29 (September 2014) at 26, observing that “historically, Canada has been vigilant about protecting the Canadian tax base from aggressive tax planning by non-residents [but] has not been particularly concerned about the erosion of the domestic tax base by Canadian multinationals.”
[52] Final Report on BEPS Action 4, *supra* note 5 at 17-18.

use of interest in base erosion and profit shifting."[53] Although this "best practices" approach does not establish "minimum standards" like those for some other BEPS Actions such as tax treaty abuse, the OECD expects domestic rules "to converge through the implementation of agreed common approaches, … enabling further consideration of whether such measures should become minimum standards."[54] This section reviews the "best practice" recommendations in BEPS Action 4 and the extent to which recent developments in other jurisdictions reflect the "convergence" sought by the OECD.

BEPS Action 4 Recommendations

Before turning to its best practices recommendations, the Final Report on BEPS Action 4 begins by reviewing existing approaches to limiting the use of interest expenses for BEPS purposes, identifying six broad groups:

1. Arm's length tests, which compare the level of interest or debt in an entity with the position that would have existed had the entity been dealing entirely with third parties.
2. Withholding tax on interest payments, which are used to allocate taxing rights to a source jurisdiction.
3. Rules which disallow a specified percentage of the interest expense of an entity, irrespective of the nature of the payment or to whom it is made.
4. Rules which limit the level of interest expense or debt in an entity with reference to a fixed ratio, such as debt/equity, interest/earnings or interest/total assets.
5. Rules which limit the level of interest expense or debt in an entity with reference to the group's overall position.
6. Targeted anti-avoidance rules which disallow interest expenses on specific transactions.[55]

[53] *Ibid*. at 18.
[54] OECD, *Background Brief: Inclusive Framework on BEPS*, (January 2017) at 9 [hereafter OECD Background Brief].
[55] Final Report on BEPS Action 4, *supra* note 5 at 19.

Although the Report notes than an arm's length test considers "the particular commercial circumstances of an entity or group" and "recognises that entities may have different levels of interest expense depending on their circumstances," it rejects this approach as a best practice to limit the deduction of interest expenses on the grounds that it is "resource intensive and time consuming for both taxpayers and tax administrations to apply" and uncertain in application because "each entity is considered separately after arrangements are entered into."[56] It also rejects withholding taxes as a best practice to address BEPS-related interest expenses on the grounds that withholding tax rates would have to match corporate tax rates to eliminate BEPS opportunities but are generally reduced to much lower levels (sometimes to zero) under bilateral tax treaties,[57] and rejects rules disallowing a specified percentage of an entity's interest expense on the basis that these rules do not specifically target BEPS risks associated with high levels of debt.[58] At the same time, it suggests that "these rules may still have a role to play within a country's tax system alongside the best practice approach, either in supporting those rules or in meeting other tax policy goals,"[59] concluding on this basis that countries may "continue to apply an arm's length test, withholding tax on interest, or rules to disallow a percentage of an entity's total interest expense, so long as these

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[56] *Ibid*., recognizing however that uncertainty can be reduced through advance agreements with tax administrations.
[57] *Ibid*. at 20, adding that "there are broader policy reasons why some countries do not currently apply withholding tax to interest payments, which could make the introduction of new taxes difficult."
[58] *Ibid*. at 20, observing that these rules are "likely to be more effective in reducing the general tax preference for debt over equity, than in targeting base erosion and profit shifting involving interest."
[59] *Ibid*

do not reduce the effectiveness of the best practice approach in tackling base erosion and profit shifting."[60]

In contrast to these rules, the Report bases its best practice approach on "a combination of some or all of the rules in groups 4 to 6".[61] According to the Report:

> A general limit on interest deductions would restrict the ability of an entity to deduct net interest expense based on a fixed financial ratio. This could be combined with a rule to allow the entity to deduct more interest up to the group's equivalent financial ratio where this is higher…. These general rules should be complemented by targeted rules to address planning to reduce or avoid the effect of the general rules, and targeted rules can also be used to tackle specific risks not covered by the general rules. This approach should provide effective protection for countries against base erosion and profit shifting involving interest, but should not prevent businesses from raising the debt finance necessary for their business and commercial investments.[62]

The following discussion considers each element of this best practices approach, addressing the rationale for and design of a fixed ratio rule, an optional group ratio rule, optional rules providing for the carryover of disallowed interest expense and unused interest capacity, and targeted anti-avoidance rules.

Fixed ratio rule

Although a principled approach to limit the deduction of BEPS-related interest expenses would allocate the net third-party interest expense of corporate groups among its members based on their share of the assets or income of the group as a whole,[63] the consistent application of an allocation rule along these lines would require agreement on the definition of the group to which the rule would apply, on the calculation of the group's net third party interest expense, and on the manner in which such expenses would be allocated among

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[60] *Ibid*. at 20-21.
[61] *Ibid*. at 21.
[62] *Ibid*.
[63] *Supra* note 12 and accompanying text.

members of the group.[64] As a result, although the Final Report on BEPS Action 4 acknowledges that worldwide allocation would be an ideal approach,[65] it recommends a fixed ratio rule as a much simpler approach for entities to apply and tax administrations to administer,[66] with an optional group ratio rule as supplementary rule that could permit the deduction of interest expenses exceeding the fixed ratio.[67]

While a fixed ratio rule could be based on a ratio debt to equity, as with Canada's thin capitalization rules, or on a ratio of interest expense to earnings, the Final Report on BEPS Action 4 favours the latter approach for several reasons. First, because the use of interest payments for BEPS purposes depends on the deductible expenses incurred by an entity, a limit based on a ratio of interest to earnings addresses the risk of BEPS more directly than a limit based on a ratio of debt to equity.[68] Second, since it would be impractical to measure the fair market value of an entity's assets in order to determine the value of its equity, a ratio based on interest to earnings may provide a more accurate measure of an entity's economic activity than a ratio based on debt to equity.[69] Third, to the extent that an interest to earnings ratio links allowable interest deductions to taxable income, the rule is more robust against tax planning

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[64] Duff, *supra* note 16 at 350.
[65] Final Report on BEPS Action 4, *supra* note 4 at 18, stating that "a consistent approach utilising best practices … should encourage groups to adopt funding structures whereby: (i) the net interest expense of an entity is linked to the overall net interest expense of the group; and (ii) the distribution of a group's net interest expense should be linked to income-producing activities."
[66] *Ibid*. at 47.
[67] *Ibid*. at 57-66; BEPS Action 4 Update, *supra* note 6 at 117-168.
[68] Final Report on BEPS Action 4, *supra* note 5 at 37 and 43, stating that "measuring economic activity using earnings should be the most effective way to ensure that the ability to deduct net interest expense is matched with the activities that generate taxable income and drive value creation."
[69] *Ibid*. at 44-45, noting that amortized historical costs "could give rise to inconsistencies depending upon the age of assets" would generally exclude internally created intangible assets, and would be "subject to influence by decisions of management, for instance on depreciation periods and the timing of revaluations and write downs."

than a debt to equity ratio,[70] which may be manipulated by increasing the level of equity in an entity.[71] Fourth, a rule based an interest to earnings ratio can also be easily adapted to exclude specific categories of income from the definition of earnings, so that the rule limits the deduction of interest expenses on borrowed funds used to finance tax-exempt and tax-deferred income.[72] Fifth, since the OECD's best practices approach would also apply to payments such as guarantee fees, notional interest on derivative instruments and the finance cost element of finance lease payments,[73] an interest to earnings ratio is more amenable to the inclusion of these payments than a debt to equity ratio for which a corresponding debt may not exist.[74] Sixth, while a limit based on a ratio of interest to earnings automatically addresses BEPS risks resulting from an excessive rate of interest, a limit based on a debt to equity ratio requires an additional set of rules, such as an arm's length test, to address these risks.[75] Finally, the Report adds, since the amount of an entity's debt may vary throughout a taxable period, while interest expenses automatically reflect changes in borrowings throughout the period, an interest to earnings ratio provides "a more accurate picture of the entity's actual taxable position over the period" than a debt to equity ratio.[76] Although the last two reasons seem somewhat overblown in the Canadian context, given a reasonableness limit on the deduction of interest expenses[77]

[70] *Ibid*. at 26 and 43, noting that: "Where the level of deductible expense in an entity is linked to earnings, a group can only increase net interest deductions in a particular country by increasing earnings in that country. Similarly, any restructuring to move profits out of a country will also reduce net interest deductions in the country."
[71] *Ibid*. at 21.
[72] *Ibid*. at 43.
[73] *Ibid*. at 29-31.
[74] *Ibid*. at 37 and 43.
[75] *Ibid*. at 37, adding that this additional step would "increase complexity."
[76] *Ibid*.
[77] ITA, s. 20(1)(c).

and an averaging approach for computing debt and equity under the thin capitalization rules,[78] the other reasons provide a strong case for a rules based on an interest to earnings ratio as opposed to a debt to equity ratio.[79]

Regarding the design of this fixed ratio rule, the Report recommends that it should limit an entity's net interest expenses, not gross interest expense,[80] that earnings should be defined as earnings before interest, taxes, depreciation and amortization (EBITDA) less non-taxable income such as exempt dividends or branch profits subject to a participation exemption,[81] and that the fixed ratio of allowable net interest expenses should fall within a "corridor" of 10% to 30% of EBITDA.[82] Although a limit on gross interest expense would be administratively simpler and more robust to tax planning, a net interest rule would reduce the risk of double taxation and allow an entity to borrow from third parties and on-lend funds within a group without limiting its gross income expense.[83] Defining earnings as EBITDA is favoured on the grounds that it is "the most common measure of earnings currently used by countries with earnings-based tests" and "a measure of earnings which is often used by lenders in deciding how much interest expense an entity can reasonably afford to bear"[84] – though the Report also states that a

[78] ITA, s. 18(4)(a)(i) and the definition of "equity amount" in s. 18(5).
[79] For a contrary view, which among other things questions reliance on EBITDA as a reliable and consistent measure of a taxpayer's economic activity, see Craig Elliffe, "Interest Deductibility: Evaluating the Advantage of Earnings Stripping Regimes in Preventing Thin Capitalization" [2017] *New Zealand Law Review* 257-284.
[80] Final Report on BEPS Action 4, *supra* note 5 at 38-39.
[81] *Ibid*. at 44, adding that appropriate adjustments should be made to address BEPS considerations where dividends or branch income are subject to tax with a credit.
[82] *Ibid*. at 49-50.
[83] *Ibid*. at 38. Since entities may disguise other forms of taxable income as interest and/or use interest expenses to shelter net interest income from tax, the Report also recommends "targeted provisions to disallow gross interest expense in specific situations identified as posing base erosion and profit shifting risk." *Ibid* at 39.
[84] *Ibid*. at 44.

country may chose to adopt earnings before interest and taxes (EBIT) as an alternative definition of earnings.[85] And the suggested range of 10% to 30% aims to exclude a majority of multinational groups while limiting opportunities for significant BEPS through the deduction of interest expenses.[86] Given the pragmatic choice of a fixed ratio rule, each of these recommendations seems reasonable.

As for the scope of the rule, the Report suggest that it should at a minimum apply to all entities that are part of a multinational group,[87] but could also apply to domestic groups and standalone entities that pose particular BEPS risks.[88] Where a rule applies only to multinational groups, the Report also recommends a targeted rule to prevent BEPS through interest payments to related parties and third parties under structured arrangements such as back-to-back loans.[89] Where a group has more than one entity in a particular country, it also suggests that the ratio should apply to overall position of the domestic group, which would allow a highly leveraged entity to deduct interest expenses if the net interest to EBITDA ratio of the domestic group adheres to the fixed ratio.[90] The Report also recommends an optional *de minimis* monetary threshold to exclude low-risk entities and reduce administration and

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[85] *Ibid*. at 45. Because EBIT is always smaller than EBITDA for any entity with depreciation and amortization, the application of a fixed ratio at a specific rate will necessarily be less generous where the definition of earnings is based on EBIT than EBITDA.
[86] *Ibid*. at 49-50, referring to financial data of publicly-traded multinational groups indicating that 62% of these groups would be able to deduct all net third party interest expense under a fixed ratio of 10% and 87% of these groups would be able to deduct all net third party interest expense under a fixed ratio of 30%. Where a fixed ratio rule bases its definition of earnings on EBIT rather than EBITDA, it follows that the range of ratios might be larger than 10% to 30%.
[87] *Ibid*. at 33-34. For this purpose, the Report defines a multinational group as "a group that operates in more than one jurisdiction, including through a permanent establishment", and generally considers an entity to be part of a group if it is "directly or indirectly controlled by a company, or the entity is a company which directly or indirectly controls one or more other entities."
[88] *Ibid*. at 33.
[89] *Ibid*. at 34 and 72-74.
[90] *Ibid*. at 33.

compliance costs.[91] It also contemplates an option to exclude certain public benefit projects on the grounds that the nature of these assets and their close connection with the public sector mean that they present little or no risk of BEPS.[92]

Group ratio rule

Although the Final Report on BEPS Action 4 recommends a fixed ratio rule as a simpler rule for entities to apply and tax administrations to administer,[93] it also contemplates an optional group ratio rule as supplementary rule that could permit the deduction of interest expenses exceeding the fixed ratio.[94] The purpose of this rule is to allow the deduction of interest expenses incurred by highly leveraged groups where this interest is attributable to external debt of the group at a whole rather than base erosion and profit shifting.[95] By providing this flexibility for highly leveraged groups, moreover, the Report suggests that the fixed ratio can be set relatively low, "making sure that the fixed ratio rule is effective in combating base erosion and profit shifting, while the group ratio rule compensates for the blunt operation of such a rule."[96]

As with a fixed ratio rule, a group ratio rule could be based asset-based or earnings-based, allowing the deduction of net interest expenses above the fixed ratio either where the entity's equity to total assets ratio equals or exceeds that of the group (an "equity escape rule"), or where its net interest to EBITDA ratio does not exceed the net third-party interest

[91] *Ibid*. at 35. Where the ratio applies to individual entities separately, not the overall position of domestic groups, the Report also suggests anti-fragmentation rules to prevent a group from avoiding the rule by establishing multiple entities, each of which falls below the threshold.
[92] *Ibid*. at 39-40.
[93] *Ibid*. at 47.
[94] *Ibid*. at 57-66, BEPS Action 4 Update, *supra* note 6 at 117-168.
[95] *Ibid*. at 127.
[96] Final Report on BEPS Action 4, supra note 5 at 57.

expense to EBITDA ratio of the group as a whole.[97] While an asset-based approach is more likely than an earnings-based approach to disallow the deduction of interest expenses incurred by an entity that is more highly leveraged than its group, it may be more generous than an earnings-based approach for an entity with losses, provided that it is not more highly leveraged than the group as a whole.[98] Although the OECD considers both alternatives consistent with its best practices approach,[99] both the Final Report on BEPS Action 4 and the 2016 Update devote most of their attention to the design and operation of a group ratio rule using a net third party interest to EBITDA ratio.[100]

In order to apply such a rule, it is necessary first to define the group whose net third party interest to EBITDA ratio must be determined, then to calculate both the net third party interest expense of this group and the EBITDA of this group (making appropriate adjustments for exempt income and income that is sheltered from tax by foreign tax credits), and finally to compare the ratio of the group's net third party interest to EBITDA to that of the entity (or domestic group).[101] Beginning with the definition of a multinational group, the Report suggests that "a practical and workable definition of a group is one that is based on a consolidated group for financial accounting purposes" including "a parent company and all entities which are fully

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[97] For a brief discussion of issues involved in the design of an equity escape rule, see *ibid*. at 91-92 (Annex C).
[98] *Ibid*. at 58.
[99] *Ibid*.
[100] *Ibid*. at 58-66; and BEPS Action 4 Update, *supra* note 6 at 119-168. Although the attention that the OECD devoted to an earnings-based group ratio rules strongly suggests that this is its preferred alternative, this may also be because no country applied an earnings-based group ratio rule prior to BEPS Action 4, while more than one country applied an equity escape rule.
[101] Final Report on BEPS Action 4, supra note 5 at 59-63.

consolidated on a line-by-line basis in the parent's consolidated financial statements."[102] To the extent that these consolidated financial statements do not include related parties outside the group, however, the Report recommends either expanding the definition of a group to include specified related parties or adding a targeted anti-avoidance rule to prevent a group from inflating its net third party interest to EBITDA ratio by paying interest to a related party outside the group.[103]

Likewise with a group's net third party interest expense and EBITDA, the Report recommends that the calculation of these amounts can generally be based on figures taken from a group's consolidated financial statements,[104] though the Report also contemplates specific adjustments to these amounts to ensure a more accurate picture of the group's net third party interest expense and earnings.[105] It also suggests that countries may choose to allow an "uplift" of net third party interest expense of up to 10% in order to "reduce the risk that all of a group's actual net third party interest expense is not taken into account",[106] and proposes special rules to address the impact of loss-making entities on the operation of a group ratio rule.[107]

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[102] *Ibid*. at 59. Where a country adopts a group ratio rule in addition to a fixed ratio rule, the Report adds that the country may want to use the same definition of a group for the fixed ratio rule in order to reduce the risk that an entity that is subject to the fixed ratio rule cannot access the group ratio rule. *Ibid*. at 33.
[103] *Ibid*. at 60.
[104] *Ibid*. at 62 and 63.
[105] *Ibid*. at 62-63; and BEPS Action 4 Update, *supra* note 5 at 123-130, for example, including in computing a group's net third party interest expense interest that is included within other categories of income or expense in the consolidated income statement and excluding interest payments to related parties that are not members of the group. See also *Ibid*. at 132-33, suggesting that the group's EBITDA be adjusted to take into account the interest income and expense of associates and joint venture entity.
[106] Final Report on BEPS Action 4, *supra* note 5 at 62-63.
[107] *Ibid*. at 65-66; and BEPS Action 4 Update, *supra* note 6 at 139-143.

Although it is impossible for this article to examine each element of the OECD's group ratio rule in detail, the rationale for such a rule as a supplement to a fixed ratio rule is sound, and the OECD's approach seems to be administratively feasible since consolidated financial statements are often publicly available and provide relatively reliable information on the finances of worldwide groups.[108] Whether an earnings-based approach is preferable to an equity escape rule, however, is less clear, particularly to the extent that an earnings-based approach requires additional rules to address circumstances in which individual entities or groups have negative EBITDA.[109] For this reason, it is perhaps not surprising that the Final Report on BEPS Action 4 acknowledged that no country applied an earnings-based group ratio rule, while more than one country applied an asset-based rule,[110] nor that most countries with a group ratio rule after BEPS Action 4 apply an equity escape rule rather than an earnings-based approach.[111]

Carryover of disallowed interest expense and unused interest capacity

Where net interest expenses of an entity exceed the limit set by a fixed ratio rule, these expenses may be allowed under a group ratio rule. If a country does not adopt a group ratio rule or the interest expenses exceed the limit under the group ratio rule, however, the deduction of these "excessive" interest expenses will be disallowed. In this circumstance, the Final Report on BEPS Action 4 explains that countries may want to permit disallowed interest

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[108] For a contrary view, see Elliffe, *supra* note 79 at 271-274.

[109] Final Report on BEPS Action 4, *supra* note 5 at 65-66; BEPS Action 4 Update, *supra* note 6 at 139-143.

[110] Final Report on BEPS Action 4, *supra* note 5 at 58, referring to Finland and Germany.

[111] Gadwood and Morton, *supra* note 1 at 32, reporting that six European Union countries (Finland, France, Germany, Hungary, Luxembourg and Malta) as well as Norway supplement their earnings-based fixed-ratio rule with an equity-escape rule", while Argentina, Denmark and the United Kingdom supplement their earnings-based fixed-ratio rule with an earnings-based group-ratio rule.

expenses to be carried over to other taxation years – either forward to subsequent taxation years or both forward and back to previous taxation years.[112] In addition, the Report suggests, where an entity's net interest expenses are less than the interest expense that would be allowed under a fixed ratio or a group ratio, countries may way to allow the carryover of unused interest capacity that could be used in other taxation years to allow the deduction of interest expenses exceeding the fixed ratio or group ratio in those years.

Although these carryover provisions would lessen the impact of an earnings-based fixed ratio rule on entities with relatively volatile earnings, the existence of these rules could create new BEPS risks since entities with unused interest capacity could be incentivized to increase net interest expenses or decrease EBITDA in future periods if unused interest capacity can be carried forward, while a provision allowing entities to carry back disallowed interest expenses may encourage entities to increase net interest expenses oar decrease EBITDA in a current taxation year in order to carry disallowed interest expenses back to prior taxation years with unused interest capacity.[113] Carryover provisions also create valuable tax attributes, which would presumably be subject to restrictions on their use following a change in control of the entity.[114] For these reasons, where carryover provisions are contemplated, these might reasonably be limited to the carry forward of disallowed interest expenses.

Targeted rules

A final element of the OECD's proposed best practices approach involves targeted rules that supplement more general interest limitation rules or prevent the avoidance of these

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[112] *Ibid*. at 68-70.
[113] *Ibid*. at 69.
[114] *Ibid.*

general rules.[115] Emphasizing that “targeted rules can also provide an effective response to some base erosion and profit shifting risk”, for example, the Final Report on BEPS Action 4 states that a country may, in addition to a fixed ratio rule, apply a thin capitalization rule based on a fixed debt to equity ratio in order to disallow interest on excessive debt, and that this rule could disallow the deduction of interest expenses “even where an entity does not exceed the level of net interest expense permitted under the fixed ratio rule.”[116] As noted earlier, the Report also recommends a targeted rule to prevent base erosion and profit shifting through interest payments to related parties and third parties under structured arrangements such as back-to-back loans.[117] It also suggests that countries should adopt anti-avoidance rules to combat arrangements designed to reduce an entity’s net interest expense such as converting interest expense into a different form of deductible expense or converting other taxable income into a form which is economically equivalent to interest.[118]

Implementation of Best Practices in Other Countries

In the years since the Final Report on BEPS Action 4 was released in 2015, several jurisdictions around the world have moved to implement key elements of the OECD’s best practices approach. In 2016, for example, the European Union adopted an Anti Tax Avoidance Directive (ATAD), requiring member states to implement a number of anti tax avoidance provisions, including an interest limitation rule based on the recommendations of BEPS Action

[115] *Ibid*. at 71-74.
[116] *Ibid*. at 71.
[117] Supra, text accompanying note 89.
[118] Final Report on BEPS Action 4, *supra* note 5 at 72.

4, in most cases no later than January 1, 2019.[119] According to Article 4 of this Directive, the interest limitation rule should include the following elements:

> (1) a fixed ratio rule limiting the deduction of net interest expenses exceeding 30% of a taxpayer's EBITDA less tax-exempt income;
>
> (2) a monetary threshold of €3 million and exemptions for standalone entities and loans used to fund long-term public infrastructure projects where the project operator, borrowing costs, assets and income are all in the European Union;
>
> (3) a group ratio rule allowing a taxpayer that is a member of a consolidated group for financial accounting purposes to deduct net interest expenses exceeding the fixed ratio either (a) where the ratio of the taxpayer's equity to its assets is at least 2% less than the equity to asset ratio of the group or (b) where the ratio of the taxpayer's net interest to EBITDA is no greater than the net interest to EBITDA ratio of the group; and
>
> (4) either an unlimited carry forward of disallowed interest expense, an unlimited carry forward and a three-year carry back of disallowed interest expense, or an unlimited carry forward of disallowed interest expense and a five-year carry forward of unused interest capacity.[120]

In accordance with this Directive, most EU member states (including the United Kingdom for now) have either retained or adopted interest limitation rules with an earnings-based fixed ratio set at 30% of the taxpayer's net interest expense to EBITDA less tax-exempt income.[121] Several have also retained or introduced a group ratio rule permitting the deduction of interest expenses above the fixed ratio, although most of these rules take the form of an

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[119] EU Council Directive 2016/1164 (12 July 2016), Article 11(1). Where a member state has targeted rules for preventing BEPS risks which are "equally effective" to the interest limitation provisions set out in the Directive, Article 11(6) provides that the state may apply these targeted rules until the earlier of the date when OECD members publish an agreement on minimum standards for BEPS Action 4 or January 1, 2024.

[120] *Ibid*., Article 4.

[121] Gadwood and Morton, *supra* note 1 at 27-30, reporting that all EU states except Finland have adopted a 30% fixed ratio of net interest expense to earnings, that Finland's ratio is 25% and Norway (a non-EU member state) has also adopted a 25% fixed ratio.

assets-based equity escape rule, rather than an earnings-based rule.[122] As well, most EU member states permit an unlimited carry forward of disallowed interest expense and many also allow a five-year carry forward of unused interest capacity.[123] Finally, most EU member states have also adopted a *de minimis* monetary threshold of €3 million or an equivalent amount in domestic currency.[124]

Outside the EU, however, countries appear to have been much slower to implement the recommendations of BEPS Action 4, though at least eight countries have retained or introduced an earnings-based fixed ratio rule consistent with the OECD's best practices approach.[125] Most significantly for Canada, moreover, the United States amended its existing earnings-stripping rule effective January 1, 2018, adopting an earnings-based fixed ratio rule that limits a taxpayer's deduction of net interest expenses to 30% if its adjusted taxable income, which is based on EBITDA for taxation years beginning before 2022 and EBIT for subsequent taxation years.[126] Although this provision allows an unlimited carry forward of disallowed interest expense,[127] it does not include a group ratio rule and provides no carry over for unused interest

[122] *Ibid*. at 31-32, explaining that six EU member states (Finland, France, Germany, Hungary, Luxembourg and Malta) apply an equity escape rule, and that only Denmark and the United Kingdom apply an earnings-based group ratio rule.
[123] *Ibid*. at 33.
[124] *Ibid*. at 34-35.
[125] *Ibid*. at 27-28, reporting that of 24 branch reports from non-EU countries eight (Argentina, India, Japan, Norway, the Republic of Korea, the Republic of Srpska, and the United States of America) had an earnings-based fixed ratio rule consistent with the OECD's best practices approach, while sixteen (including Canada) did not.
[126] *Internal Revenue Code*, §163(j). Before 2018, this provision limited the deduction of interest expenses paid by U.S. corporations to non-residents and tax-exempt entities to 50% of adjusted taxable income, with a safe-harbour if the corporation's debt to equity ratio did not exceed 1.5 to 1.
[127] *Ibid*. §163(j)(2).

capacity. Nor does it include a general monetary threshold, though it exempts small businesses with average gross receipts of $25 million or less over the previous three years.[128]

Whither Canada?

As explained earlier in this article, although Canada has several rules that limit the deduction of interest expenses for international tax planning, its thin capitalization rules are deficient in several respects,[129] and it has failed to adopt any general limitation on the deduction of interest expenses on borrowed money used to produce exempt dividends from foreign affiliates – notwithstanding recommendations to this effect dating back to the 1990s and limitations proposed in the 2007 Federal Budget.[130] As the Advisory Panel on Canada's System of International Taxation emphasized in 2008, the main reason to reject more robust limits on the deduction of interest expenses is not theoretical, but a pragmatic concern about international competitiveness in an environment in which other countries do not apply such limits on the deduction of interest expenses for international tax planning.[131] A key objective of BEPS Action 4 was to address this collective action by promoting "a consistent approach utilising international best practices"[132] -- towards which it expects domestic rules to converge.[133]

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[128] *Ibid*. §163(j)(3).

[129] *Supra* notes 17-33 and accompanying text.

[130] *Supra* notes 34-51 and accompanying text. As explained earlier, the foreign affiliate dumping rules play a more limited role and are only partly designed to address concerns regarding the deductibility of interest expenses.

[131] Report of the Advisory Panel*, supra* note 25 at paras. 4.165 and 4.166, cited at *supra*, text accompanying note 46.

[132] Final Report on BEPS Action 4, *supra* note 5 at 18, cited at *supra*, text accompanying note 53.

[133] OECD Background Brief, *supra* note 54 at 9, cited at *supra*, text accompanying note 54.

Although it is fair to conclude that implementation of the recommendations in BEPS Action 4 is, as a recent report concludes, "very much ongoing",[134] it is notable that most EU member states have adopted a version of the OECD's best practices approach including in particular an earnings-based fixed ratio rule, and that the United States and several other countries have also introduced earnings-based fixed ratio rules consistent with the main recommendation of BEPS Action 4.[135] At the same time, corporate rate reductions in the United States and the United Kingdom have increased the risk of profit shifting out of Canada.[136] In this changed international environment, it is time for Canada to revisit its rules for the deduction of interest expenses, having regard to the best practices in BEPS Action 4 and the implementation of interest limitation rules in EU member states and the United States.

To this end, Canada should start with an earnings-based fixed ratio rule consistent with the rules adopted by EU member states and the United States, limiting a taxpayer's net interest expenses to 30% of its EBITDA less exempt dividends from foreign affiliates. However deficient EBITDA may be as a reliable and consistent measure of an entity's earnings and however crude a 30% ratio is as a benchmark for limiting the deduction of interest expenses, this approach has clearly become the norm in many countries and would address at least some of the deficiencies in Canada's thin capitalization rules and impose a valuable limit on the deduction of interest on borrowed money that is used to finance outbound investments producing exempt dividends. Although one might expect this 30% ratio to decrease over time as these rules become more common, particularly if they are combined with a group ratio rule providing relief for interest

[134] Gadwood and Morton, *supra* note 1 at 27.
[135] *Supra*, text accompanying notes 119-128.
[136] *Supra*, text accompanying note 9.

expenses exceeding the fixed ratio, there is no reason why Canada should adopt a lower ratio than other countries, particularly when Canada has had no prior experience with an earnings-based fixed ratio rule.

Consistent with the best practices approach in BEPS Action 4, this fixed ratio rule should at a minimum apply to entities that are members of a multinational group, which as an initial matter may be defined either on the basis of direct and indirect control or according to consolidated financial statements.[137] As with Canada's thin capitalization rules, however, which apply at a lower threshold of ownership, these definitions might be expanded In order to limit opportunities for avoidance through payments to related parties that are not members of the multinational group. Also like Canada's thin capitalization rules, the rule should presumably also apply to interest payments by trusts and partnerships, as well as non-residents carrying on business in Canada.

Also consistent with the best practices approach, the rule should probably include a monetary threshold and an exemption for long-term public infrastructure projects. Although a monetary threshold would have to be applied at the level of a domestic group or accompanied by anti-fragmentation rules in order to prevent abuse,[138] such a threshold could reduce administrative and compliance costs for small- and medium-sized enterprises for which the

[137] In addition to taxpayers that are members of multinational groups, it can also be argued that payments to tax exempt entities should also be subject to a limitation on the deduction of interest expenses on the grounds that these interest payments erode the Canadian tax base in the same way as interest payments to non-residents. Brian Arnold, "The Arnold Report" no. 114 (November 14, 2018). This article does not address this proposal.

[138] Since Canada does tax corporate groups on a consolidated basis, it may make more sense to introduce anti-fragmentation rules than to define the concept of a domestic group for the purposes of applying a monetary threshold – even though similar considerations presumably enter into either exercise.

risks of BEPS are likely less than they are for larger MNEs. In addition, as explained earlier, most EU member states have also adopted a *de minimis* monetary threshold of €3 million or an equivalent amount in domestic currency,[139] and the United States exempts small businesses with average gross receipts of $25 million or less over the previous three years.[140] An exemption for long-term public infrastructure is incorporated into Article 4 of the EU ATAD and is generally justified on the grounds these projects involve little or no risk of BEPS.

Whether Canada should also adopt a group ratio rule, however, is much less certain. Although a group ratio rule has a more principled rationale than a fixed ratio rule, such a rule would add another layer of complexity to what would already be a novel set of rules, and could be difficult to administer even with financial information available from consolidated financial statements. As well, the need for a supplementary group ratio rule is reduced if the fixed ratio rule adopts a relatively high ratio like 30%, which is a the top of the OECD's suggested range. For these reasons, it is perhaps not surprising that neither the United States nor many EU member states have opted to enact a group ratio rule in addition to their earnings-based fixed ratio rules. For all these reasons, Canada might reasonably defer the introduction of any group ratio rule in order to benefit from other countries' experience and until such time as a fixed ratio is reduced. If and when Canada does adopt a group ratio rule, it should also consider whether an equity escape rule would be less complex and easier to explain than an earnings-based approach.

Without a group ratio rule, of course, taxpayers whose net interest expenses exceed the fixed ratio will not be able to deduct these expenses even if their net interest to EBITDA ratio is

[139] *Supra*, text accompanying note 124.
[140] *Supra*, text accompanying note 128.

less than that of the worldwide group or their equity to asset ratio equals or exceeds that of the worldwide group. Where the fixed ratio is based on net interest expenses to EBITDA, this is a particular concern for entities with volatile earnings, which may have negative EBITDA, resulting in the disallowance of all net interest expenses. In this case, it is arguable that a fixed ratio rule should be accompanied by relatively generous carryovers for disallowed interest expense and unused interest capacity. On the other hand, as explained earlier, these carryovers can create new BEPS risks since entities with unused interest capacity that can be carried forward could be encouraged to increase net interest expenses or decrease EBITDA in future years, and entities with disallowed interest expenses that can be carried back may be encouraged to increase net interest expenses or decrease EBITDA in the current taxation year order to utilize unused interest capacity in previous years.[141] As well, carryover provisions create valuable tax attributes that must be subject to anti-avoidance rules preventing their transfer to other taxpayers, adding to complexity.

Although most EU member states appear to have adopted relatively generous carryover provisions for disallowed interest expenses and unused interest capacity, the United States and most other non-EU countries have introduced more limited carryover provisions allowing only the carry forward of disallowed interest expenses without any time limit.[142] Considering the potential problems associated with more generous carryover provisions, Canada would be wise to limit any carryovers to the carry forward of disallowed interest expenses – which, as in the United States and many other countries might reasonably be without any time limit. If this form

[141] *Supra*, text accompanying note 113.
[142] Gadwood and Morton, *supra* note 2 at 33.

of relief is considered inadequate, it would be better to reconsider a group ratio rule than more generous carryover provisions.

A further question concerns the status of existing rules restricting the deduction of interest expenses for international tax planning, specifically the thin capitalization rules and the foreign affiliate dumping rules. Although it might be argued that these rules would be unnecessary if Canada were to adopt a more general rule limiting the deduction of interest expenses, these rules also serve other purposes – effectively re-characterizing debt as equity (and interest payments as dividends) in the case of the thin capitalization rules and preventing surplus-stripping in the case of the foreign affiliate dumping rules. As well, the best practices approach in BEPS Action 4 includes targeted anti-avoidance rules in addition to more general rules limiting the deduction of interest expenses. For these reasons, it would be best for Canada to retain these rules.

Finally, since a more general limitation on the deduction of interest expenses in the international context will presumably increase government revenues, some thought should be given to accompanying measures that might enhance Canada's international tax competitiveness, particularly in an environment where other countries, particularly the United States, have significantly reduced their corporate tax rates largely eliminating what had been a significant tax advantage for Canada. Short of more fundamental reforms that would require a more comprehensive review of Canada's tax system,[143] these measures might reasonably include phased reductions in the federal corporate tax rate that would lessen the risk of profit-

[143] See, e.g., McKenzie and Smart, *supra* note 8 at 537, expressing a preference for "a more fundamental corporate tax-system reform along the lines of a rent tax, rather than tinkering with depreciation allowances and/or the statutory rate

shifting out of Canada and incentivize future investment in Canada without creating significant windfall gains for existing investments.