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PROPOSED INTEREST DEDUCTIBILITY LIMITS:

SHOULD CLIENTS BE CONCERNED?

Clients and commentators have noticed a concerning item in the 2021 Budget – Interest Deductibility Limits. What does it mean? Should we be concerned? How will it affect Clients' plans, especially those plans that use borrowed money?

Most Clients won't need to worry about these proposed rules. For the most part, the rules are aimed at large multi-national entities, not incorporated Canadian small businesses. This post discusses the background to the proposed interest deductibility limits, and why they may not apply to most Clients. It does not discuss the proposed measures in detail.

Before we begin, it's important to note that the new rules are proposals only at this stage. The Department of Finance has promised draft legislation this summer. It is expected that Finance will receive feedback from interested parties on these rules before and after it releases draft legislation. Therefore, we can expect some modifications to these proposals as they move through the legislative process towards becoming law.

BACKGROUND

The proposal to limit interest deductibility comes from an international initiative Canada participates in as a member of the Organization for Economic Cooperation and Development (OECD). The initiative seeks to curb Base Erosion and Profit Shifting (BEPS). As the OECD puts it, "Base erosion and profit shifting (BEPS) refers to tax planning strategies used by multinational enterprises that exploit gaps and mismatches in tax rules to avoid paying tax."[1]

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[1] https://www.oecd.org/tax/beps/about/

Ideally, income generated from economic activity in a particular country should be taxed in that country. The attributes of such countries – highly skilled workers, transparent legal systems, respect for property rights, and so forth – make such countries attractive places to do business. However, those countries also may have higher taxes. While higher taxes help pay for the attributes that attract businesses to those countries in the first place, some businesses try to have it both ways. They want to do business where it's good to do business, but shift profits to related companies in lower tax jurisdictions. The shifting of profits to low tax countries produces an erosion of the tax base in countries where multinational enterprises do business.

AN EXAMPLE

Businesses can use debt to shift profits between countries. One way uses "thin capitalization". Canada already has thin-capitalization rules to restrict the ability of Canadian corporations and trusts to deduct interest expense on debt owing to certain related non-residents. This example describes how thin capitalization can erode a country's tax base. Assume that a corporation manufactures products in a high tax jurisdiction; but its parent corporation gives it minimal capital, forcing it to borrow heavily to fund its operations. The borrowed money comes entirely from other entities in the same corporate group, all of them in lower tax countries. The entity in the high tax country reduces its tax bill by paying and then deducting that interest. The creditor entities report their interest income, but pay tax at lower rates. The effect is to transfer profits from the highly taxed entity to the lower taxed entities, and reduce the corporate group's overall tax bill.

THE NEW RULES

The OECD has recommended a number of policies to fight BEPS. Member countries can incorporate those recommendations into their own tax systems. One of the recommendations is contained in a Report entitled, "Action 4: Limitation on Interest Deductions."[2] (Action 4) The Interest Deductibility

[2] https://www.oecd.org/tax/beps/beps-actions/action4/

Limits in Budget 2021 represent the Canadian government's commitment to implement the OECD's Action 4 into Canadian tax law.

In line with Action 4, Budget 2021 proposes limiting interest deductibility to a fixed ratio of a business' "tax EBITDA,"[3] its taxable income before taking into account earnings before "interest expense, interest income and income tax, and deductions for depreciation and amortization, where each of these items is as determined for tax purposes."[4] Budget 2021 describes its measure as providing "broad protection against base erosion, while still allowing businesses to deduct reasonable amounts of interest."[5]

Budget 2021 proposes phasing in the rules over two years, starting with a 40% limit for tax year 2023, falling to a 30% limit for 2024 and going forward. Above these limits interest will not be deductible. The proposed rules also outline measures for capturing transactions that may not legally be debt, but are functionally equivalent to debt. To the extent that the rules deny an interest deduction, they also allow the corporation to carry the unused part of the deduction back three years or forward twenty years. Canadian members of a group with interest deductibility capacity below the fixed thresholds would be able to transfer their deduction capacity to other Canadian members in their group that are above the thresholds.

EXCEPTIONS TO THE RULES

Budget 2021 describes in general terms who won't be affected by these new rules:

- Canadian-controlled private corporations that, together with any associated corporations, have taxable capital employed in Canada of less than $15 million (the top end of the phase-out range for the small business deduction).[6] This exempts most Canadian small businesses from the interest deductibility limits.

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[3] Earnings before Interest, Taxes, Depreciation and Amortization.

[4] Budget 2021, p. 643.

[5] Budget 2021, p. 642.

[6] Budget 2021, p. 643.

- Groups of corporations and trusts where aggregate net interest expense among their Canadian members is under $250,000. To the extent that smaller businesses are generally run with less debt than larger ones, this provision potentially exempts many Canadian small businesses.
- Standalone Canadian resident corporations, and Canadian corporations that are part of a corporate group with no non-resident members would not, in most cases, have their interest deductions limited under these rules. This exemption applies regardless of the business' size. The rationale for this exception is to continue to allow Canadian corporations within the same group to offset gains from one group member against losses from another group member. We don't have information on how wide the "in most cases" language will be, but expect the draft legislation to provide some clarity.

Further, we do not expect that the interest deductibility limits would apply to strategies offered by Sun Life for use with its products. None of Sun Life's strategies are intended to be used, or represented as being appropriate for use, with non-resident entities. If a Client is using a Sun Life strategy in a way that could trigger the application of the proposed rules limiting interest deductibility, they should speak with their tax advisor.

There's much in Budget 2021 to attract Clients' attention. The interest deductibility rules should only attract attention from a small number of Clients.

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