tax notes international

Volume 102, Number 13 ■ June 28, 2021

Canada and BEPS: What Goes Around Comes Round

by Nathan Boidman and Michael N. Kandev

Reprinted from *Tax Notes International*, June 28, 2021, p. 1815 tax notes international®

Canada and BEPS: What Goes Around Comes Round

by Nathan Boidman and Michael N. Kandev

Nathan Boidman

Michael N. Kandev

Nathan Boidman and Michael N. Kandev are with Davies Ward Phillips & Vineberg LLP in Montréal.

In this article, the authors dissect proposals in Canada's recent federal budget that stem from the OECD's base erosion and profit-shifting project, specifically anti-hybrid rules (action 2) and rules restricting interest and related deductions (action 4). They consider how the rules would interact with existing policies and express several concerns, particularly regarding the potential for overreach.

Canada is a founding member of the OECD and has been a leading participant in the OECD base erosion and profit-shifting initiatives. It is therefore surprising that Canada has been timid, if not reluctant, in adopting the OECD's anti-BEPS prescriptions. That is, until the 2021 federal budget (Budget 2021) was tabled on April 19.

After the OECD concluded the first stage of its BEPS initiative in late 2015, Canada's 2016 budget proceeded with a cautious and very limited implementation of the BEPS proposals, focusing on the OECD-mandated minimum standards.[1] Since 2015 Canada's fellow OECD members have implemented a number of the BEPS recommendations beyond the minimum standards, in particular BEPS action 2, dealing with hybrid arrangements, and action 4, dealing with interest. To that effect, the EU adopted its two anti-tax-avoidance directives,[2] and the 2017 U.S. Tax Cuts and Jobs Act reformulated the interest limitation in IRC section 163(j) and added anti-hybrid rules at sections 267A and 245A.[3]

Now it seems that what goes around comes around. In its first federal budget in two years, Canada has proposed new rules implementing BEPS actions 2 and 4. The former are intended to apply from July 1, 2022, while the latter will apply starting in 2023. No draft legislation was published as part of the budget papers, but the government has committed to issuing draft rules for comment this summer. In this article, we analyze at a high level these Budget 2021 proposals in anticipation of the specific legislative

---

[1] Nathan Boidman and Michael N. Kandev, "Canada Takes First BEPS Steps," *Tax Notes Int'l*, Apr. 25, 2016, p. 371.

[2] On Jan. 28, 2016, the European Commission presented its proposal for an anti-tax-avoidance directive as part of the anti-tax-avoidance package. On June 20, 2016, the EU Council adopted Directive (EU) 2016/1164 (ATAD) laying down rules against tax-avoidance practices that directly affect the functioning of the internal market. The measures in ATAD went into effect Jan. 1, 2019. Directive (EU) 2017/952 (ATAD 2) extended ATAD's anti-hybrid-rules beyond the EU and has applied since Jan. 1, 2020.

[3] Not only do those 2017 anti-hybrid rules bring to mind the groundbreaking work the United States did in that area 25 years ago with the adoption of IRC section 894(c) in 1997, the TCJA also saw the U.S. foreshadow and front-run the OECD-led 137-country inclusive framework negotiations for the pillar 2 minimum tax on controlled foreign corporations by adding the global intangible low-taxed income provisions to the IRC. Indeed, recent letters to the editor of this magazine focus on the temerity of the U.S. Treasury beseeching other countries to adopt a GILTI-based minimum tax to ameliorate the damage that GILTI does to the competitiveness of U.S. multinationals' CFCs. *See* Boidman, "GILTI: Dragging Tax Competition Down to the U.S.'s Level?" *Tax Notes Int'l*, Apr. 26, 2021, p. 443; and Boidman, "GILTI: The Devil Is in the Details," *Tax Notes Int'l*, May 10, 2021, p. 732.

rules, which we suggest appear to be overkill in relation to the Canadian situation.

Context: Interest Deductibility in Canada

Both BEPS action 2 and action 4 are ultimately about interest deductibility. While the latter is directly a limitation thereon, the former is also most relevant in relation to interest. The proposals in Budget 2021 seeking to implement these OECD action 2 and action 4 recommendations touch upon one of the most controversial areas of Canadian tax law.

As a basic matter, Canadian tax law treats interest as a nondeductible capital expenditure for taxpayers other than money lenders. However, section 20(1)(c) of the Income Tax Act (Canada) permits the deduction of interest on specified conditions: To be deductible, interest must be paid in the year or payable in respect of the year under a legal obligation to pay interest on borrowed money used for the purpose of earning income from a business or property or an amount payable for property acquired for the purpose of gaining or producing income from the property or for the purpose of gaining or producing income from a business. Generally, interest is not deductible if it relates to gaining or producing exempt income or if it exceeds a reasonable amount.

Volumes have been written about interest deductibility in Canada[4] and likely more will be written in the future. Most recently, the Canadian Tax Foundation ran an issue of its publication, *Perspectives on Tax Law & Policy*, dedicated to a debate over whether interest deductibility in Canada should be subject to strict limitations.[5] The anti-hybrid and interest limitation proposals in Budget 2021 will likely spur further debate and controversy for years to come.

BEPS Action 2: Anti-Hybrid Rules

In simple terms, hybrid mismatch arrangements are cross-border structures that utilize differences in the tax treatment of entities, financial instruments, or other contractual arrangements under the laws of two or more countries to obtain a particular, enhanced tax result. A simple example is that of an amount that is deductible interest to a payer but is treated as exempt dividends to a recipient. Hybrid mismatches were addressed in the 2015 OECD final report on action 2, "Neutralising the Effects of Hybrid Mismatch Arrangements." The action 2 report recommended rules to limit the tax benefits from the use of hybrid mismatch arrangements. The two main forms of hybrid arrangements addressed by the action 2 report are:

- deduction/non-inclusion mismatches, which arise when a country allows a deduction in respect of a cross-border payment, the receipt of which is not included in fully taxable income within a reasonable period in the other country; and
- double deduction mismatches, which arise when a tax deduction is available in two or more countries in respect of a single economic expense.

The action 2 report also addressed imported mismatches, which generally arise when a payment is deductible by an entity resident in one country and included in the ordinary income of a recipient entity resident in a second country, but that ordinary income is set off by a deduction under a hybrid mismatch arrangement between the second entity and an entity resident in a third country.

Finally, a supplement to the action 2 report recommended additional rules to address branch mismatch arrangements, which generally

---

[4] *See, e.g.*, Paul Tamaki, "Interest Deductibility," Canadian Tax Foundation Conference Report, 1:1 (2003); Scott Bodie and Jehad Haymour, "Recent Trends in Interest Expense Deductibility," 15(1) *Can. Petroleum Tax J.* 51 (2002); Sandra E. Jack, "Selected Current Issues Regarding Interest Deductibility," 15(1) *Can. Petroleum Tax J.* 89 (2002); Trevor Thomson and Gregory J. Quinn, "Financing Alternatives for Small and Medium-Sized Businesses," Canadian Tax Foundation Conference Report, 33:1 (2007); Bill MacLagan, "Interest Deductibility," British Columbia Tax Conference, 10:1 (2009); Howard J. Kellough, "Justice Bowman's Decisions on the Deductibility of Interest," 58 (Supp.) *Can. Tax J.* 211 (2010); Melanie Huynh, Eric Lockwood, and Michael Maikawa, "Foreign Affiliates: Tracing the Purpose and Use of Funds," 59(3) *Can. Tax J.* 571 (2011); Didier Fréchette and Ryan Rabinovitch, "Recent Issues Relating to Interest Deductibility and Non-Traditional Forms of Indebtedness," Canadian Tax Foundation Conference Report, 27:1 (Nov. 2011); Boidman, Héléna Gagné, and Kandev, "Interest Deductibility in Canada: What's the Fuss?" *Tax Notes Int'l*, July 13, 2015, p. 161; Marie-Eve Gosselin and Paul Lynch, "A Review of Interest Deductibility Since *Ludco*," Canadian Tax Foundation Conference Report, 7:1 (2015); Brian J. Arnold, "The Relationship Between Restrictions on the Deduction of Interest Under Canadian Law and Canadian Tax Treaties," 67(4) *Can. Tax J.* 1051 (2019); and Eric Luu, "Interest Deductibility," Practical Insights: Taxnet Pro (Nov. 2020).

[5] *See* all the articles in 2(1) *Persp. on Tax L. & Pol'y* (Mar. 2021).

produce mismatches similar to hybrid mismatch arrangements.

Currently, Canadian tax law does not contain any anti-hybrid rules, except for some provisions in Article IV(7) of the Canada-U.S. income tax convention.

While noting that the government can use existing Canadian income tax rules to challenge some hybrid arrangements, Budget 2021 now proposes to implement specific rules to address hybrid mismatch arrangements that involve Canadian taxpayers. The unique role of hybrids carried out by and for U.S. multinationals means U.S. taxpayers will typically also be involved.

In general terms, Budget 2021 explains that payments made by Canadian residents under hybrid mismatch arrangements will not be deductible for Canadian income tax purposes to the extent that they give rise to a further deduction in another country[6] or are not included in the ordinary income of a nonresident recipient.[7] Conversely, to the extent that a payment made under such an arrangement by an entity that is not resident in Canada is deductible for foreign income tax purposes, no deduction in respect of the payment would be permitted against the income of a Canadian resident.[8] Any amount of the payment received by a Canadian resident would also be included in income and, if the payment is a dividend, it would not be eligible for the deduction otherwise available for some dividends received from foreign affiliates.[9] In effect, these rules would neutralize a mismatch by aligning the Canadian income tax treatment with the income tax treatment in the foreign country.

Budget 2021 does not contain draft legislation implementing these proposals. However, in annex 6 to the budget, the government provided the following summary blueprint:

- "The proposed rules would be mechanical in nature and would not be conditioned on a purpose test." In other words, motive is assumed to be self-evident.
- "With limited exceptions, the proposed rules would apply in respect of payments between related parties and payments under certain arrangements between unrelated parties that are designed to produce a mismatch."
- "The ordering rules recommended by the [action 2] report would also apply to ensure that the proposed rules are coordinated with similar rules in other countries." For example, a deduction denial is given priority over a defensive rule including an amount.

The proposed rules to address hybrid arrangements will be implemented in two separate legislative packages. The first package would comprise rules to neutralize a deduction/non-inclusion mismatch arising from a payment in respect of a financial instrument. This first legislative package would be released for stakeholder comment later in 2021, and those rules would apply as of July 1, 2022. The second legislative package would be released for stakeholder comment after 2021, and those rules would apply no earlier than 2023. This package would comprise rules consistent with the action 2 recommendations that were not addressed in the first package and that, presumably, address situations that are of lesser concern to the Canadian government.

The above, in particular the priority focus on "financial instruments,"[10] is indicative of the fact that beyond Canada's desire to conform to OECD dogma, it intends first and foremost to address structures that it does not like. It seems that one type of hybrid arrangement that may be the primary target of the proposed anti-hybrid rule

[6] An example, discussed later in this subsection in terms of a tower financing structure for Canadian acquisitions of U.S. targets, is the interest payment by the hybrid partnership or corporation that is deductible in both countries.

[7] *See, infra*, the discussion regarding the Canada Revenue Agency's July 5, 2019, notice.

[8] This structure is not known in Canada.

[9] This affects frequently used outbound financing strategies for U.S. acquisitions by Canadian parties.

[10] In terms of taxonomy, it is proper to distinguish between (i) a hybrid financial instrument, such as an instrument that is debt from the perspective of the source country but equity from the perspective of the residence country (for example, mandatorily redeemable preferred shares issued by a Luxembourg company to a Canadian parent); (ii) a hybrid entity, such as an entity that is treated as a partnership in one country but is (or has elected to be) a corporation in the other (for example, a reverse hybrid partnership in a Canada-U.S. tower structure); and (iii) a hybrid arrangement, such as several contractual arrangements that are combined in their treatment from an economic substance perspective and seen as debt in the source country but seen separately in the residence country (for example, a Canada-U.S. repo structure). Budget 2021 does not appear to adopt this distinction.

was the one described in a Canada Revenue Agency notice to tax professionals on July 5, 2019. The situation involved a U.S.-owned Canadian subsidiary that was capitalized with both debt and equity in compliance with Canada's thin capitalization ratio. The Canadian corporation funds the annual interest it owes on the borrowing from its U.S. parent by entering into agreements for the forward sale of treasury shares with a U.S. limited liability company subsidiary of the U.S. parent. Prepayments received from the LLC under the forward sale agreements, which are funded by annual contributions from the U.S. parent to the LLC, are used by the Canadian corporation to make interest payments to the U.S. parent. This arrangement presumably was intended to avoid generating interest income recognition in the United States while providing an interest deduction in Canada.

In its notice, the CRA stated:

> Hybrid mismatch arrangements are tax plans intended to secure a tax advantage within a multinational enterprise by exploiting differences in the tax treatment of the same financial instrument or entity between different jurisdictions. . . . [The CRA] has resolved a file regarding a hybrid mismatch arrangement involving the deduction of non-arm's length interest in a series of transactions that included a forward subscription agreement . . . on the basis that paragraphs 247(2)(b) and (d) of the Income Tax Act and transfer pricing penalties applied.
>
> It is the CRA's general view that such transactions are undertaken primarily to obtain a tax benefit and that they would not be undertaken by parties dealing at arm's length. When the CRA finds transactions similar to the example below, the Transfer Pricing Review Committee will be consulted regarding the application of paragraphs 247(2)(b) and (d). Where these paragraphs apply, related transfer pricing penalties will generally apply on the basis that taxpayers engaging in this type of tax planning did not use reasonable efforts to use arm's length prices, terms and conditions in their transfer pricing.

The CRA's recent loss before the Federal Court of Appeal (an appeal for which was denied by the Supreme Court) in *Cameco*,[11] the transfer pricing transaction recasting rule case, makes the basis for the CRA's position above even more tenuous than it might otherwise be — although Budget 2021 also announced a review of the transfer pricing rules in light of *Cameco*. Hence, the government's presumed desire for a mechanical anti-hybrid instrument rule that would clearly block the above type of transaction.

It is also likely that in the fullness of time, when the full package of anti-hybrid rules is implemented, Canadian tax law would also contain the defensive rule, which mandates an inclusion of hybrid mismatch amounts that were deductible at source and that the payer country did not attack. This would be another nail in the coffin of various outbound structures that were used by Canadian multinationals and that have been significantly impeded by legislative changes in the United States and the EU. For example, the traditional tower financing structure we recently discussed in these pages in relation to the Tax Court case in *Emergis*[12] was impeded by the 2018 announcement of proposed regulations (REG-104352-18) under the anti-hybrid rules and the dual-consolidated loss rules.[13]

All in all, while the proposed Canadian anti-hybrid rules will likely be extremely complicated, their practical effect may be limited because other countries have already moved to stamp out hybrid mismatches, and as suggested in our May 3 article, there may be a reversion to pre-hybrid era financing strategies.

---

[11] *See Cameco Corp. v. Canada*, 2021 CanLII 10731 (SCC); and Boidman and Jesse Boretsky, "Supreme Court Confirms Cameco's Epic Transfer Pricing Victory," 50(4) *Tax Mgmt. Int'l J.* 199 (Apr. 2, 2021), which references the underlying decisions of the Tax Court of Canada (2018 TCC 195), Canada's Federal Court of Appeal (2020 FCA 112), and commentaries thereon. On the TCC decision, see also Steve Suarez, "The *Cameco* Transfer Pricing Decision: A Victory for the Rule of Law and the Canadian Taxpayer," *Tax Notes Int'l*, Nov. 26, 2018, p. 877.

[12] *Emergis v. The Queen*, 2021 TCC 23. *See also* Boidman and Kandev, "The *Emergis* Hybrid Financing Case: Déjà Vu?" *Tax Notes Int'l*, May 3, 2021, p. 633.

[13] *See* Boidman and Kandev, "Expected Adverse Effects of Proposed U.S. Anti-Hybrid Regulations on Inbound Financing by Canadian MNEs," *Tax Notes Int'l*, Feb. 11, 2019, p. 623. The anti-hybrid regulations were finalized Apr. 7, 2020.

BEPS Action 4: Interest Limitation

Budget 2021 proposes a new general limitation on the deductibility of interest and similar expenses based on a fixed ratio of tax earnings before interest, taxes, depreciation, and amortization, starting in 2023. There should be no mistake that this proposal would be a fundamental change in the structure of Canada's tax system. The long runway for implementation of the proposals implies that the government expects there will be complex drafting issues and extensive commentary and lobbying on the rules, which touch upon one of the most fraught topics in Canadian tax law.[14]

The proposal is in some ways not a surprise because interest deductibility limitation rules of this type have been in the works since at least 2015, when the OECD released recommendations to that effect as part of its BEPS initiative, and several other jurisdictions (including the EU and the United States) have introduced rules generally in line with the OECD's action 4 prescriptions.

More specifically, subject to some exceptions, the deductibility of interest and other financing-related expenses — both between related and arm's-length parties — would be denied to corporations, partnerships, and trusts to the extent these expenses, net of interest and financing-related revenue, exceed a fixed ratio of the entity's tax EBITDA. For 2023 the ratio is proposed to be 40 percent; for later years, it would be reduced to 30 percent in line with the OECD's recommendations and the broadly settled international standard.

The rules will include relieving provisions to address groups of entities, which would allow members of a group to effectively share unused capacity to deduct interest. Special rules are proposed for banks and life insurance companies that would generally prohibit the transfer of unused capacity to other members of their corporate group that are not also regulated banks or insurance entities.

Any interest denied under the new rules would be available to be carried back up to three years and carried forward up to 20 years, in line with Canada's carryover provisions for noncapital losses.

The stated purpose of these rules is threefold:

- the erosion of the Canadian tax base through interest payments to related nonresidents in low-tax jurisdictions;
- the use of debt to finance investments that earn nontaxable income; and
- circumstances in which a Canadian business bears a disproportionate amount of a multinational group's third-party borrowing.

We proceed to comment on the government's overall proposal in line with these three principles.

Related-Party Interest to Low-Tax Jurisdictions

Interest or other financing expenses paid and received among non-arm's-length parties are one of the fundamental building blocks of cross-border tax planning and a primary focus of the OECD BEPS initiative. Hence, countries are justified to adopt limitations to the deductibility of base eroding payments. Since 1972 Canada has been a pioneer in this regard with its thin capitalization rule, which generally limits the deductibility of interest on outstanding debt to specified nonresidents[15] that exceeds the 1.5-1 debt-equity ratio specified under section 18(4) ITA.[16] Canada's thin capitalization regime has withstood the test of time: It is well understood, easily administrable, and was updated in 2012 and 2014. This begs the question of how the new proposed general anti-stripping rule should interact with the existing thin cap regime. Budget 2021 explicitly answers that the new rules would not apply to interest that is not otherwise deductible, including under the thin capitalization rules, which will continue to apply. The concern in this regard is about rising complexity and overlap between the two regimes. Another concern is that while the stated focus of

[14] That runway, if anything, grew longer with the comments on the endless issues raised by the proposals by each successive speaker — culminating with Shawn Porter, the head of tax policy in Canada's Department of Finance — at the May 3-5 combined annual seminar of the Canadian branch of the International Fiscal Association and the inaugural joint meeting of the Canadian, Mexican, and U.S. branches of IFA.

[15] Generally, nonresidents who own 25 percent or more of votes and value of the payer or non-arm's-length parties.

[16] Section 18(4) ITA. *See* Boidman, Gagné, and Kandev, *supra* note 4.

the limitation is related-party interest paid to low-tax jurisdictions, the proposal does not seem intended to be limited to such payments.

Investments Earning Nontaxable Income

Canada's interest deductibility rule in ITA section 20(1)(c) does not allow a deduction for interest that relates to exempt income. However, active business profit dividends from treaty-based foreign affiliates received by a Canadian company in accordance with Canada's participation exemption, while not exempt, are nontaxable income — that is, they are included in income but are deducted from taxable income. This seems to be the focus of this concern of the government. While it is recognized that the Canadian tax system is intentionally built this way to allow Canadian multinationals to borrow domestically to fund their foreign operations without forgoing interest deductibility, Canada's tax policymakers have struggled with the appropriateness of this for a long time.

That introspection has led to both aborted legislative initiatives that should not have been aborted and enacted legislative initiatives that should have been aborted or curtailed at least in part. In the first category, there was a proposal 40 years ago[17] that was never enacted that would have, *inter alia*, limited the deductibility of interest on funds borrowed to finance investment in foreign affiliates to the amount of dividends therefrom that was actually subject to Canadian tax. And 26 years later, in 2007 there was the ill-fated anti-double-dip rule of section 18.2, which emulated the 1981 initiative and was fully enacted but was ultimately repealed before its 2012 effective date.

In the second category, there are the now 9-year-old foreign affiliate dumping (FAD) rules in section 212.3 of the ITA that in our view are a classic case of legislative overkill. These rules are understood to have been enacted as a result of the government's frustration with its inability to enact more robust general interest deductibility limitations. The rules penalize two types of transactions in which a Canadian corporation is foreign controlled, but as a matter of reasonable and sound tax policy, only one should be the target — and that type of transaction has a direct line to the concerns that drove the 1981 and 2007 initiatives. Those transactions would involve tax planning that is devoid of economic effect.

For example, suppose a foreign-owned Canadian corporation that has profitable Canadian operations borrows C $100 million at 5 percent and invests it in preferred shares of a foreign subsidiary of the foreign parent that carries a dividend coupon a tick above the borrowing rate. The dividends would presumably be tax free under Canada's participation exemption system, while the interest on the borrowed funds would be deductible against the Canadian corporation's taxable Canadian profits. This arrangement in no way augments the economics of the Canadian corporation — it merely serves to reduce the Canadian tax bill. It fully warranted a legislative response. And it drew one — but not a fully appropriate response that would have avoided disturbing other bona fide arrangements, rather in a fashion with that effect.

It would have been reasonable to revert to the interest deduction restriction notions seen in the 1981 and 2007 projects and, in the above situation, deny a deduction of the interest paid. That not only would have been faithful to Canadian tax standards and principles involving financing transactions — that is, evaluating the deductibility factor — but would have avoided the unnecessary effects on the second type of transaction that is now targeted by FAD.

Instead, the government chose the radical (but in this case understandable) response of treating the investment in the preferred shares as a dividend distribution by CanCo to the foreign parent — as if CanCo borrowed and used the proceeds to pay a dividend to the foreign parent, which then made the preferred share investment. But incomprehensibly, this deemed dividend rule did not stop in its application with the above offensive preferred share arrangement but was extended to any investment in a foreign affiliate by a foreign-controlled Canadian corporation, even when the Canadian corporation will benefit fully in the future from the investment and even if there are no interest payment/deduction aspects.

[17] Canada, Department of Finance, "Budget Papers: Supplementary Information and Notice of Ways and Means Motions on the Budget," at 25 (Nov. 12, 1981).

Incredulously, if a foreign corporation owns a viable foreign subsidiary with an agreed value of C $100 million, owns a Canadian subsidiary with cash on hand of C $100 million, and sells the foreign subsidiary to the Canadian subsidiary for C $100 million cash, the latter will (subject to some possible exceptions) be deemed to pay a C $100 million dividend to the foreign parent.

That aspect of the FAD rules takes them totally out of the circle of factors relevant to interest deductibility and into the arena of surplus stripping, but all of this was unleashed by a pure interest deductibility play. Arguably, with the proposed advent of the new interest stripping rule, the FAD rules should be repealed.

Disproportionate Debt in a Multinational Group

Probably the most complex aspect of the proposals will turn out to be the one ensuring that a Canadian member of a multinational group does not bear a disproportionate amount of a multinational group's third-party borrowing.

As noted above, the new anti-stripping rules will apply to both related-party and arm's-length debt in a clear departure from Canada's existing tax rules and, honestly, from common sense. Budget 2021, however, proposes to include a group ratio concept, which would allow a taxpayer to deduct net interest in excess of the statutory fixed ratio if the taxpayer can demonstrate that the ratio of net third-party interest to the book EBITDA of its consolidated group implies that a higher deduction limit is appropriate.

Presumably, the following situation exemplifies the government's concern. Suppose a foreign multinational establishes Canadian operations and makes a substantial initial investment in the share capital of a Canadian corporation. Several years later, when the Canadian business is already well established and highly profitable, the Canadian subsidiary borrows from a financial institution and uses the funds to return capital to its foreign parent, which deploys the funds outside Canada. The foreign parent is itself unleveraged.

While this situation may be seen as problematic, there are other significant concerns with the government's approach. First, it is arguable that arm's-length debt should a priori be fully deductible unless the government (and not the taxpayer) can demonstrate that the taxpayer is engaging in behavior that is specifically problematic. Hallmarks of nefarious planning can be adopted as guidelines, but in our view, the starting point should be clear: Arm's-length interest should remain fully deductible as a true and legitimate business expense.

Arguably, any restriction on third-party interest of a Canadian corporation that is part of an international group and is not guaranteed by any member of the group or by ultimate shareholders should be inapplicable even if the debt ratio of the Canadian subsidiary is higher than the group ratio in order to guard against the following scenario: The hypothetical foreign corporation has no debt owing and has cash from a divestiture. It uses its cash to acquire a Canadian target that has preexisting third-party debt (not shareholder guaranteed) that remains owing after the acquisition. It would appear there is no reason here for interest deduction restrictions.

Second, the logic of the government's proposal breaks down outside the context of multinational enterprises. Much will depend on what is included or excluded in the consolidated group comprising the tested Canadian taxpayer. For example, unless this rule is carefully scoped, Canadian portfolio companies of private equity funds, sovereign wealth funds, or pension plans could be hit.[18] Also, real estate ventures could be severely affected by the proposal. In this regard, when the United States adopted the new IRC section 163(j) as part of the TCJA, a carveout for real estate ventures, regulated utilities, and farms was adopted. While a real estate tycoon in the White House may have helped to enact the optional real estate exception, the rule recognizes an undeniable business reality: Real estate ventures are heavily leveraged with both external and internal loans. It is expected that there will be lobbying to include a similar exception in Canada.

Budget 2021 materials indicate that, consistent with these relieving rules, it is expected that stand-alone Canadian corporations or members

[18] *See, e.g.*, Kevin Orland, "Private Equity Risks a Hit From Trudeau's Interest-Deduction Cap," Bloomberg Law News, Apr. 19, 2021.

of a group that do not include nonresidents would typically not have their interest expense deductions limited under the proposed rules.

Notably, the U.S. Treasury's green book, issued May 28, indicates that the administration wants to augment the action 4-based restrictions in section 163(j) with rules focused on "excessive interest of members of financial reporting groups for disproportionate borrowing in the United States." Canada's Budget 2021 did not indicate any intention to make similar additions.

Scoping Considerations

Generally, small businesses will be excluded from the application of the rules, particularly Canadian-controlled private corporations that together with their associated group have less than C $15 million of taxable capital employed in Canada and groups of corporations and trusts with less than C $250,000 in net interest payments.

Generally, the deductibility of interest on debts owing between Canadian members of a corporate group (including under a loss-shifting arrangement) would not be restricted under the new rules.

As noted above, the proposed rules would not address other specific industries, such as farming businesses, real estate ventures, and regulated utilities, that have been subject to special rules in the United States.

Conclusion

Budget 2021's proposals to implement the OECD's recommendations under BEPS actions 2 and 4 were not accompanied by a specific statutory draft; hence our comments are, of necessity, general and high-level in nature. Nonetheless, based on the policy direction adopted by the Canadian government, we are concerned about the expected proliferation of very complex rules that we expect would be overlapping in their practical application among themselves and with existing rules. It seems to us that — to avoid legislative overkill — if the new interest stripping rules are ultimately enacted, the existing Canadian thin capitalization and FAD rules should be repealed. Moreover, the scope and actual benefits of the proposed anti-hybrid rules should be evaluated against any risks of overreach and increased administrative complexity. ■