OECD'S BASE EROSION AND PROFIT SHIFTING ACTION PLAN 4: LIMITING INTEREST DEDUCTIONS AND OTHER FINANCIAL PAYMENTS

On October 5, 2015, the OECD released fifteen Final Reports on its project entitled, Base Erosion and Profit Shifting ("**BEPS**"), intended to "restore confidence in the system (of international taxation) and ensure that profits are taxed where economic activities take place and value is created" (a statement that is present in the foreword to each Report). As a general comment of the focus on "where economic activities take place and value is created", I suggest that it is an economic fallacy to prioritize the *labour* factor of production, and devalue the classically-recognized contributions of other factors, namely *capital* and *property*, including *intellectual property*, especially if associated with a company's *brand*, as well as the modern contribution of *risk*, and the disruptive impact of the *digital economy*. The logical shift resulting from this policy would maximize taxable profits in jurisdictions with high labour content, thus encouraging multi-national enterprises ("**MNE's**") in high-tax jurisdictions to shift jobs to low-tax jurisdictions, which would be an unintended negative consequence of this new paradigm, and an inversion of the policy concerns of countries in North America to address "offshoring of jobs" today.

I have chosen to examine the Report which may have the most impact on Canada, namely *Action Plan 4*, *Limiting Interest Deductions and Other Financial Payments*. Before examining the Report, it is worth keeping in mind the current rules for interest deductibility on inbound investments to Canada. Generally, interest is deductible if the borrowed funds are used to produce income from a business or property, pursuant to a legal obligation to pay such interest.[1] If interest is paid to a non-resident that owns at least 25% of the shares of the borrower, and the debt to equity ratio of the borrower is greater than 1.5 to 1.0 (in relation to such a lender/borrower relationship), any interest paid on the excess portion of the debt will be disallowed as an expense subject, therefore, to regular tax on the borrower, and treated as a dividend paid to the non-resident, subject to withholding tax of 25%, unless reduced by an applicable tax treaty.[2] If interest is paid to a non-resident lender that does not deal at arm's length with the Canadian borrower, withholding tax of 25% will apply to the interest, unless reduced by an applicable tax treaty.[3]

Following are the perceived BEPS risks as outlined in the Report on Action Plan 4 in relation to interest expenses:

1. <u>Groups placing higher levels of third-party debt in high tax countries</u>

<u>Comment</u>: While the debtor may be able to deduct, say, 40% of the cost against high-tax income, the MNE Group is losing 60% of the cost to an unrelated third party. Accordingly, this is a specious risk. A company borrows interest-bearing debt from third parties for the purpose of earning income from its business or property, whether in the current year or in the reasonably foreseeable future. It would be a mistake to assume that companies borrow from third parties solely for the purpose of reducing their taxes payable, when such a borrowing would be uneconomic if there were not an income-earning purpose, given the inevitable cash cost of doing so.

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[1] Paragraph 20(1)(c) of the *Income Tax Act* (Canada) (the "**Act**").
[2] Subsections 18(4) to (8) of the Act.
[3] Paragraph 212(1)(b) of the Act.

2. Groups using intragroup loans to generate interest deductions in excess of the Group's third-party interest expense

Comment: This statement contains several questionable assumptions. First, why is the standard for measurement the Group's third-party debt when there may be multiple borrowers, with or without Group guarantees, in different countries, perhaps in different industries, all of which factors militate against choosing the aggregate interest cost as an appropriate standard against which to measure the interest expense of a particular borrower in the Group. Second, it ignores the reality that each Group's borrower may have different capital needs and different ability to service the intra-group debt. The economically stronger the borrower, the more leverage it can and, some would say, should incur to maximize growth and profit potential. Third, it contradicts the OECD's transfer pricing standard: What would an arm's length borrower in a similar position to the Group's particular borrower pay in similar circumstances ?

3. Groups using third party or intragroup financing to fund the generation of tax exempt income (for example, where one entity or country bears an excessive proportion of the Group's total net third party interest expense)

Comment: This statement ignores the reality of an international tax system, such as Canada's, based on capital export neutrality and capital import neutrality. In other words, Canada recognizes that if a foreign affiliate earns active business income in a tax treaty country, it has been made subject to corporate tax in the same way as any corporate resident of that jurisdiction and, accordingly, the Canadian corporate shareholder should not be subject to double taxation on the repatriation of earnings, but relief should be provided through exempt surplus dividends. Moreover, the Supreme Court of Canada has stated in *Lipson v. The Queen*,[4] that the purpose of paragraph 20(1)(c) of the Act is to permit the taxpayer to accumulate capital with the potential to produce income. When a Canadian corporate shareholder is borrowing to invest in a subsidiary carrying on an active business in a tax treaty country, this enhances the ability of the Group to accumulate capital domestically and internationally (and compete domestically and internationally), regardless of the manner in which foreign income is repatriated. In effect, Canada says to its multinationals: "Make your decision based on proper business reasons, not tax benefits, because the tax result is neutral for earning profits (capital export neutrality) and for repatriating profits (capital import neutrality), in either case to facilitate the tax-free movement of capital within the corporate sector."

The Objective of Action Plan 4

The stated objective is to develop recommendations regarding best practices in the design of rules to prevent base erosion through the use of interest expense (and economically equivalent payments), for example through the use of related-party and third-party debt to achieve excessive interest deductions, or to finance the production of exempt or deferred income. In contrast to unilateral action by countries to limit interest deductions, a consistent approach utilizing international best practices would be a more effective and efficient way of addressing concerns surrounding the use of interest in base erosion and profit shifting. This approach should encourage Groups to adopt financing 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.

Proposed Rules

Action Plan 4 recommends the adoption of a fixed-ratio rule, by limiting net deductible interest (and economically equivalent payments) to a fixed percentage of earnings before interest, tax, depreciation and amortization (EBITDA) in the range of 10% to 30%. Economically equivalent payments would include financing expenses incurred in the course of borrowing, including guarantee fees and arrangement fees.

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4 2009 DTC 5015 (S.C.C.), paragraph 29.

Comment: A company that borrows from a third party but is required to pay the financier an arrangement fee or pay a guarantor a guarantee fee is not doing so merely for tax savings – again a deduction worth 40% still means a cash loss of 60% of the payment.

A further recommendation states that this fixed ratio rule 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. If a country does not introduce a Group ratio rule, it should apply the fixed ratio rule to entities in multinational and domestic groups without improper discrimination.

Comment: The restriction of interest deductibility on domestic groups is bad tax and economic policy, driven by a distorted view of the MNE's tax minimization (avoidance) motivation, while it leaves the domestic group lacking in access to capital and, thus, impaired in its ability to grow and compete. Ironically, the Report takes account of this seeming economic distortion, but asserts that the constitution of some countries or groups of countries, such as the EU, may require that all taxpayers be treated the same when in similar circumstances, thus requiring the same measure against BEPS of an MNE group be equally applied to a domestic group.

Countries have the option to offer a fallback to a group-wide ratio of third-party net interest expense that is higher. Other options put forward include a *de minimus* limit to exclude low levels of debt and the ability to carry forward and back excess interest expense. Countries can consider an "equity escape" rule such as in Germany, e.g. if equity/total assets of an entity is equal to or higher than that of the Group.

Postscript

It is interesting to note that the proposed limitation rule in Action Plan 4 is modelled to a great extent on Germany's domestic rules. In 2015, Spain and Italy adopted similar rules. However, the German Federal Court of Finance examined the German rules as they applied to a domestic German corporation, and found them to be in breach of the German constitution, because they breached the requirement of equal treatment and consistency of application.[5] Accordingly, this statutory scheme seems to be a weak fortress to build against BEPS.

Finally, the Canadian government in the Budget of March 22, 2016 announced that Canada intended to support the OECD's BEPS initiatives, but there were no proposals to amend the tax laws in connection with Action Plan 4.

[5] IR 20/15, October 14, 2015.