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by Nathan Boidman, Héléna Gagné, and Michael Kandev

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SPECIAL REPORT

Interest Deductibility in Canada: What's the Fuss?

by Nathan Boidman, Héléna Gagné, and Michael Kandev

Nathan Boidman Héléna Gagné Michael Kandev

Nathan Boidman, Héléna Gagné, and Michael Kandev are with Davies Ward Phillips & Vineberg LLP in Montreal.

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This article deals with the manner in which Canada has complicated, and rendered controversial, what in most other countries is straightforward — the deductibility of business-related interest expense. The reasons to write about it are threefold: the almost-concurrent issuance of the Canada Revenue Agency's administrative views on the matter and the judgment by the Tax Court of Canada in a Canada-U.S. cross-border matter and, separately, the OECD's base erosion and profit-shifting initiative.

Interest deductibility rules are among the most basic features of an income tax system, so an outside observer would tend to think that there should be no fuss about them. Nothing is further from the truth though. Interest deductibility is a highly controversial topic both from a theoretical perspective[1] and in its practical application. This is especially true in Canada where the persistent difficulties encountered in everyday interest deductibility situations are highlighted by recent developments: the Tax Court of Canada decision in *TDL Group Co. v. Canada*[2] and the new Canada Revenue Agency Income Tax Folio S3-F6-C1.

This article critically examines these items and their relevance to cross-border situations. It argues that, at least in part, Canada's struggle with interest deductibility is due to the fact that Canada does not follow the international norm in this area, and this, in turn, has given rise to the need for special statutory rules, a massive body of litigation, and continuous efforts by the CRA to administer this morass.

Canada: Exception to the Norm

For an expenditure to be deductible under Canada's Income Tax Act,[3] it must be incurred for the purpose of gaining or producing income from a business or property[4] and must not be on capital account (that is, the expenditure gives rise to an enduring asset or benefit).[5] If an outlay is on capital account — and interest has been held to be on capital account, as explained below — special rules are provided to permit deductions in certain cases, including in respect of interest; otherwise the expense is not deductible. Hence, in Canada, the deduction of interest is generally prohibited unless specifically allowed by rules in the ITA. This basic feature of Canada's income tax system diverges from the international norm. We next review

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[1] *See* "Briefing: Ending the Debt Addiction, a Senseless Subsidy," *The Economist,* May 16-22, 2015, at 9 and 19-22, in which it is argued that interest deductibility should be eliminated as a general matter.

(Footnote continued in next column.)

[2] 2015 TCC 2015 (hereinafter *TDL*).

[3] RSC 1985, c. 1 (5th Supp.) (ITA).

[4] Section 18(1)(a).

[5] Section 18(1)(b).

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examples of this international norm in several countries and then set out in greater detail the exceptional Canadian approach.

The International Norm

The basic matter we examine here is whether the deductibility of interest on business-related debt is generally allowed under the same tax rules that apply to ongoing and current expenses or instead is generally prohibited but regulated by specific statutory rules (other than restrictive rules such as antiavoidance or cross-border limitation rules, for example).

The norm on interest deductibility in the continental European tax systems of civil law countries generally diverges from the Canadian approach. They do not have a general prohibition against deducting interest on the basis that it is a capital expenditure and therefore they view interest as generally deductible, subject to specific prohibitive and restrictive rules. For example, in Italy, interest expenses are generally deductible under the basic deductibility rules. Interest expenses, other than capitalized interest expenses, are deductible up to an amount equal to interest income accrued in the same tax period.

Any excess over that amount is deductible up to 30 percent of earnings before interest, taxes, depreciation, and amortization derived through the core business of the company. In Belgium, interest deductibility falls under the general trade and business expense deduction provisions. Similarly, in the Netherlands, interest is generally deductible under general principles. Also, in Germany, interest is subject to the general rules of deduction but, as in Italy, with a 30 percent of EBITDA cap as well. In France, it appears that interest expense on business-related debt, namely a debt to acquire a fixed asset, is deductible like a general ongoing or current expense.

A specific rule only applies when a period of 12 months is necessary before the relevant asset may be used and, in such event, it is possible to either deduct the interest expense under the current rule or to include the interest expense in the acquisition cost to be depreciated.

Similar to continental European countries, in Australia, interest is treated like other expenses and is deductible under the general deduction provision if incurred for the purpose of producing assessable income or incurred in the course of carrying on a business for the purpose of producing assessable income. Although Australia's general deduction provision is subject to overriding limitations, including a prohibition on the deduction of an expense of a capital nature, private or domestic, Australian tax law does not view interest as a capital outlay.[6]

In the U.S., an interest expense is deductible when incurred by a corporation in carrying out its business activities, subject to some limitations. The U.S. analysis starts from the point of a very broad statutory allowance, in section 163(a) of the Internal Revenue Code, that states: ''There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.''

Interestingly, even the tax law of the U.K., which has inspired the structure of the ITA,[7] does not always follow an approach that is consistent with Canada's. In the U.K., for the purpose of corporate tax, all interest expenses are deductible in principle, subject to various specific limitations, while for the purpose of income tax (applicable to all persons other than corporations), interest expenses are deductible only in circumstances specified in the legislation. This latter approach seems to be somewhat in line with the Canadian approach as discussed below.

The Exceptional Canadian Approach

Generally, in Canada, interest expense is considered to be a capital expenditure and is not deductible unless it meets the specific requirements of the ITA. The capital nature of interest was implied in 1923 as described below and then confirmed by the Supreme Court of Canada (SCC) in 1957 in the leading *Canada Safeway* decision: ''It is important to remember that in the absence of an express statutory allowance, interest payable on capital indebtedness is not deductible as an income expense.''[8]

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[6]Thus, in general terms, interest on debt to finance the acquisition of a capital asset is considered to satisfy the deductibility test if the capital asset (for example, plant and equipment, or a building from which business is conducted) was acquired for the purpose of producing assessable income or acquired in the course of carrying on a business for the purpose of producing assessable income.

[7]In fact, early Canadian case law on interest deductibility refers to British case law and statutory provisions: *Montreal Light, Heat & Power Consolidated and Montreal Coke & Mfg. Co. v. Minister of National Revenue*, [1942] C.T.C. 1 (SCC).

[8][1957] SCR 717, 57 DTC 1239. The case involved a claim to deduct interest expense incurred in 1947, 1948, and 1949. The appellant, which operated grocery stores, borrowed money with which to acquire the shares of a distributor of grocery products with which it had business dealings. It sought to deduct the interest incurred in 1947 and 1948 under paragraph 5(1)(b) of the Income War Tax Act as interest on ''borrowed capital used in the business to earn the income.'' Its claim for 1949 was based on paragraph 11(1)(c) of the ITA, S.C. 1947-8 c. 52. The contention was that the ownership of the shares of the distributor would in some way enhance the income-earning potential of the appellant's own business. It was not suggested that the use was merely the acquisition of shares that produced dividends. In 1947 and 1948 intercorporate dividends were, under section 4 of the Income War Tax Act, ''not liable to taxation'' and expenses to earn such ''non-taxable income'' were, under subsection 6(5), not allowed as a deduction. That situation continued into 1949 when paragraph 11(1)(c) of the ITA (now 20(1)(c)) superseded paragraph 5(1)(b) of the Income War Tax Act. Paragraph 11(1)(c), as does current paragraph 20(1)(c), denied a deduction

(Footnote continued on next page.)

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With these few words, the SCC confirmed that interest paid on money borrowed to finance a business by funding the purchase of an asset is of a capital nature. This position may be seen as surprising[9] but has remained as a cornerstone of Canadian tax law.[10] It has been reaffirmed time and again by the SCC in more recent cases.[11]

In 1923, contrary to the existing statutory scheme originally enacted six years earlier,[12] a general prohibition on the deduction of capital outlays was legislated into Canadian tax law and, concurrently, to counter the apparent applicability thereof to interest, there was enacted a specific provision for the deduction of interest. This statutory structure has been preserved ever since.

Current section 18(1)(a) ITA limits the right to deduct expenditures to those made or incurred for the purpose of earning income from a business or property, and section 18(1)(b) provides that no deduction may be made for ''capital'' expenditures unless they are expressly permitted under other provisions of the ITA. Section 20(1)(c) is the specific provision that allows a deduction for interest despite the prohibition in section 18(1)(b).

In light of this, Canadian tax law diverges from the international norm because the analysis under the ITA always starts from a point of nondeductibility and proceeds on the basis of the specific statutory requirements of the ITA, such as those contained in section 20(1)(c).

The main requirements of section 20(1)(c) are that the subject amount be paid in the year or be payable in respect of the year under a legal obligation to pay interest and that the amount be reasonable. When money is borrowed, the use of the money must be established and the purpose of that use must be to earn business or property income.[13] When an amount is payable for property acquired, the property must have been acquired for the purpose of earning income (other than exempt income or to acquire an interest in certain life insurance policies).

The fairly vague statutory requirement that for interest to be deducted, it must be on ''borrowed money used for the purpose of earning income from a business or property'' combined with the underlying general prohibition on interest deductibility has resulted in this being one of the most frequently litigated provisions of Canadian tax law. The interpretation of the word ''purpose'' was addressed by the SCC in *Ludco Enterprises Ltd. v. The Queen*,[14] as follows:

> [T]he requisite test to determine the purpose for interest deductibility under s. 20(1)(c)(i) is whether, considering all the circumstances, the taxpayer had a reasonable expectation of income at the time the investment was made.

With regard to purpose, the court also stated:

> Absent a sham or window dressing or other vitiating circumstances, a taxpayer's ancillary purpose may be nonetheless a bona fide, actual, real and true objective of his or her investment, equally capable of providing the requisite purpose for interest deductibility in comparison with any more important or significant primary purpose.

The meaning of ''income'' was also addressed in *Ludco* as follows: ''[I]t is clear that 'income' in s. 20(1)(c)(i) refers to income generally, that is, an amount that would come into income for taxation purposes, not just net income.''

The interpretation of the term ''used,'' and in particular whether it means directly used or indirectly used and whether used means first used or currently used, has also been considered by the SCC. In *Bronfman*

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for interest on borrowed money used to earn income from property the income from which would be exempt. ''Exempt income'' as defined in section 139 included intercorporate dividends that were deductible under section 27 in computing taxable income. It was not until tax reform in 1972 that the definition of exempt income was changed specifically to exclude a dividend on a share.

[9]Why should interest on indebtedness to acquire a machine be a capital outlay when lease payments to lease such machine are a current expense?

[10]Much has been written on this specific topic and in a tax policy analysis of interest deductibility, a commentator questioned the premise of the Supreme Court that interest is a capital expense: Brian J. Arnold, ''Is Interest a Capital Expense?'' *Canadian Tax Journal* (1992), Vol. 40, No. 3, 533. His analysis provides for an interesting glimpse at the uncertain historical treatment of interest deductibility.

[11]In *The Queen v. Bronfman Trust*, 87 DTC 5059 (SCC), at para. 27, the SCC reaffirmed the position that interest is a capital expenditure:

> It is perhaps otiose to note at the outset that in the absence of a provision such as paragraph 20(1)(c) specifically authorizing the deduction from income of interest payments in certain circumstances, no such deductions could generally be taken by the taxpayer. Interest expenses on loans to augment fixed assets or working capital would fall within the prohibition against the deduction of a ''payment on account of capital'' under paragraph 18(1)(b).

Even more recently, the issue of interest deductibility was again brought before the SCC in *Gifford v. R.*, 2004 DTC 6120 (SCC). In its analysis, the SCC noted that the Canadian jurisprudence had not held that interest was always a capital expense, but had consistently found that when the proceeds of the loan add to the financial capital of the borrower, any interest paid on that loan will be considered a payment ''on account of capital.''

[12]The original Canadian federal income tax statute of 1917 did not specifically provide for the deductibility of interest; tax was imposed on income that was defined as net profit or gain, implying the deductibility of expenses such as interest.

[13]Borrowed money used to acquire a life insurance policy or property the income from which would be exempt will not qualify.

[14]2001 SCC 62, 2001 DTC 5505.

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Trust, the SCC stated that ''[t]he text of the Act requires tracing the use of borrowed funds to a specific eligible use.''

In *Shell Canada Limited v. The Queen*,[15] the SCC described the test by saying that ''[i]f a direct link can be drawn between the borrowed money and an eligible use,'' then the money was used for the purpose of earning income from a business or property. Also, ''[i]nterest is deductible only if there is a sufficiently direct link between the borrowed money and the current eligible use.'' The SCC commentary in these cases means that the test to be applied is the direct use of the borrowed money. In some circumstances, however, the courts have stated that indirect use will be accepted as an exception to the direct use test.

Despite the extensive SCC guidance on the interpretation of section 20(1)(c), this provision is a constant source of tax disputes and the long string of cases now continues with a recent decision from the Tax Court of Canada, *TDL*, which dealt with a cross-border tax plan and unfortunately adds to the rule's ambiguity.

TDL Group Co. v. R.

In *TDL*, the taxpayer appealed a reassessment denying interest deductions on loans from its U.S. parent corporation used to acquire additional common shares in its U.S. wholly owned subsidiary. The government disallowed the interest deduction because the funds borrowed were not used for the purposes of earning income from a business or property, even though borrowing to buy common shares is normally considered to meet that test.

In this case, Wendy's International Inc., the ultimate U.S. parent of the group, lent to its U.S. subsidiary, Delcan Inc., at an interest rate not to exceed 7 percent. Delcan Inc. in turn loaned the full amount to its direct subsidiary, TDL Group Co., at a rate of 7.125 percent and subsequently assigned this loan receivable to another U.S. affiliate in the group.

TDL Group Co. in turn used the full amount of the loan from Delcan Inc. to purchase additional common shares in its already wholly owned U.S. subsidiary, Tim Donut U.S. Limited, Inc., which in turn made an interest-free loan back to Wendy's the next day. So the money went from Wendy's to some group companies including the taxpayer and then back to Wendy's.

The loan to Wendy's was originally intended to be on an interest-bearing basis according to planning memorandums, although no rate was specified. Due to concerns about the effect of an interest-bearing note on U.S. state taxes and over the thin capitalization and foreign accrual property income rules under the ITA, it was decided that the loan would proceed on a non-interest basis until the matter was sorted out.

[15][1999] 3 SCR 622, 99 DTC 5669.

Thereafter, Tim Donut U.S. Limited, Inc. incorporated a new U.S. subsidiary, Buzz Co. Tim Donut U.S. Limited assigned the note to Buzz Co. as payment for its shares in Buzz Co., and Buzz Co. then issued a demand for payment on the note to Wendy's that repaid the note in full by issuing a new promissory note to Buzz Co. for the same full amount bearing an interest rate of 4.75 percent, thus effectively replacing the non-interest-bearing loan with a new interest-bearing one. The delay in effecting these plan changes was explained by the preoccupation of the parties of the group in purchasing the interests of one of the group's founders.

The CRA denied the deduction of interest paid on TDL Group Co.'s loan from Delcan Inc. during the period when TDL Group Co.'s U.S. subsidiary loaned the money back to Wendy's on an interest-free basis. Once the loan to Wendy's was effectively repaid and replaced with an interest-bearing loan evidenced by the new note, the CRA allowed interest deductibility from that date onward.

In determining what borrowed money has been used for, the onus is on a taxpayer to trace or link the borrowed money to a specific eligible use. TDL Group Co. argued that the purchase of common shares in Tim's U.S., the property it acquired from the proceeds of its borrowings from Delcan Inc., satisfied the test in subparagraph 20(1)(c)(i) and that the use by TDL Group Co. as borrower is what must be looked at, not the use made by a party in which the borrower has invested (that is, the use made by Tim's U.S., the subsidiary of the funds invested in it).

In essence, TDL Group Co.'s position was that the act of purchasing shares that capitalized its subsidiary to allow it to acquire capital assets and operate its business for the appellant's ultimate benefit and payment of future dividends is sufficient, regardless of whether Tim's U.S. actually immediately earned income from the new capital injection. TDL Group Co. argued that Tim's U.S. had a 10-year plan to significantly expand its U.S. operations for income-earning reasons and in fact ultimately did result in substantial future dividends later paid to TDL Group Co., thus demonstrating an income-earning purpose to the purchase of the shares.

The government's position was that the transactions undertaken were nothing more than a series of predetermined steps of a tax plan to create a deductible interest expense in TDL Group Co. and that TDL Group Co. did not have a purpose of earning income from investing in Tim's U.S. shares at the time of the initial loan. In other words, the government took issue with the apparent earnings stripping that was taking place.

The Tax Court stated that:

> some types of income, such as capital gains or even dividend income, may often be derived from indirect uses of the money invested in shares of a

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> corporation that owns subsidiaries or has investments in other corporations like the case at hand. . . . These arguments clearly support an argument that monies borrowed for the purposes of creating wealth indirectly would fall within the purpose of the section.[16]

However, the Tax Court dismissed the appeal because TDL Group Co. did not have ''any reasonable expectation of earning nonexempt income of any kind'' on its common share investment, given Tim's U.S.'s history of losses, its policy of applying cash flow to capital expenditures rather than dividends, and a 10-year projection showing no dividends. The Tax Court added that:

> The evidence clearly and unambiguously only points to the sole purpose of the borrowed funds as being to facilitate an interest free loan to Wendy's while creating an interest deduction for the Appellant.[17]

The court made that statement even though the long-term plan was that the loan to Wendy's be interest bearing but that was delayed by business exigencies.

In other words, the Tax Court looked at the *indirect* use of the borrowed funds; namely, the direct use of them by Tim's U.S., to *disallow* the contested interest deduction. This seems to invert the principle that the indirect use of borrowed funds may be looked at in some circumstances as an exception to the direct use requirement in order to allow interest deductibility, not to disallow it.

This case is only the most recent example of the uncertainties involved in interpreting section 20(1)(c). It shows how malleable the eligible-use test in section 20(1)(c) is and how a judge dissatisfied with the overall outcome of a tax plan could rely on the statute's ambiguous wording to reach a desired outcome of denying interest deductibility although no arguments were put forward under Canada's general antiavoidance rule in section 245. Not surprisingly, the taxpayer has appealed the tax court's decision.

It is relevant to consider *TDL* in the context of the other recent development reviewed in this article — the recent CRA Income Tax Folio S3-F6-C1 — and in particular the discussion therein of the CRA's policy on interest deductibility regarding borrowings to purchase common shares and the newly incorporated reference to an old tax court decision that bears some striking similarities to *TDL, Mark Resources Inc. v. The Queen*.[18]

Income Tax Folio S3-F6-C1

As a matter of background, the CRA issues publications, formerly called interpretation bulletins and now reorganized as income tax folios, to provide its general views on various topics of income tax law.[19] The newly released Income Tax Folio S3-F6-C1 deals with interest deductibility in general and, effective as of March 6, 2015, replaces and cancels the former Interpretation Bulletin IT-533.

The folio includes several modifications or qualifications to the CRA's prior views on interest deductibility, including two of them that are relevant against the background of the foregoing discussion of *TDL*.

First, the folio expands the CRA's prior discussion on borrowing for investments in common shares. The CRA has stated that it generally ''considers interest costs in respect of funds borrowed to purchase common shares to be deductible on the basis that at the time the shares are acquired there is a reasonable expectation that the common shareholder will receive dividends.''[20] Absent from the prior Interpretation Bulletin IT-533, the folio now adds that it is, however:

> conceivable that in certain fact situations, such reasonable expectation would not be present. If a corporation has asserted that it does not pay dividends and that dividends are not expected to be paid in the foreseeable future such that shareholders are required to sell their shares in order to realize their value, the purpose test will not be met. However, if a corporation is silent with respect to its dividend policy, or its policy is that dividends will be paid when operational circumstances permit, the purpose test will likely be met.[21]

The recent *TDL* case is precisely an example of where interest deductibility was denied regarding a borrowing to fund the acquisition of common shares.

Second, the income tax folio now contains a new, somewhat nostalgic reference to an old tax court case, *Mark Resources*, that bears some striking similarities with *TDL*:

> 1.57 In assessing the facts of a specific loan arrangement, particular attention should be given, where relevant, to the international nature of a corporate organization. In *Mark Resources Inc.* . . . the Tax Court of Canada disallowed a corporation's deduction for interest on borrowed money used to make a contribution of capital to its foreign subsidiary. The Court determined that the real purpose of the borrowing was to enable the Canadian corporation to absorb into its income the losses of its foreign subsidiary.

In *Mark Resources*, in order to use the business losses of its U.S. subsidiary, the taxpayer borrowed funds in Canada from an arm's-length bank and made a capital

[16] *Id.* at para. 27.

[17] *Id.* at para. 32.

[18] [1993] 2 C.T.C. 2259 (TCC).

[19] Such publications are not legally binding.

[20] CRA, Income Tax Folio S3-F6-C1, at para. 1.69 and 1.70.

[21] *Id.* at para. 1.70.

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contribution of those funds to the U.S. subsidiary. The U.S. subsidiary purchased a term deposit from the same bank bearing a lower rate of interest than that charged on the loan to the taxpayer and pledged the deposit to the bank as security for that loan. The interest generated by the term deposit was paid as a tax-free dividend to the taxpayer. Significantly, no net attributable foreign accrual property income was generated because the interest on the term deposit was offset by past active business losses of the U.S. subsidiary.[22] Justice Bowman's singular reasoning in this case was as follows:

> 45 What, then, is the ''direct'' use to which the borrowed funds were put here? *The direct and immediate use was the injection of capital into a subsidiary with the necessary and intended consequence that the subsidiary should earn interest income from term deposits from which it could pay dividends.* The earning of dividend income cannot, however, in my opinion, be said to be the *real purpose* of the use of the borrowed funds. Theoretically one might, in a connected series of events leading to a predetermined conclusion, postulate as [to] the purpose of each event in the sequence the achievement of the result that immediately follows but in determining the ''purpose'' of the use of borrowed funds within the meaning of paragraph 20(1)(c) the court is faced with practical considerations with which the pure theorist is not concerned. *That purpose — and it is a practical and real one, and in no way remote, fanciful or indirect — is the importation of the losses from the U.S.*
>
> . . .
>
> 58 The *true purpose* for which the borrowed money was used was to implement a plan to absorb into the Canadian parent's income the losses of a foreign subsidiary. *That result is not contemplated by the Canadian income tax system and it is not consistent with the scheme of the Act which contemplates the separation for fiscal purposes of the profits and losses of separate corporate entities.*
>
> . . .
>
> 62 My conclusion is therefore that the interest paid on the bank loan was not interest on borrowed money used for the purpose of earning income from a business or property. [Emphasis added.]

The inclusion of the reference to *Mark Resources* in the recent folio is puzzling. First, the specific tax plan at issue in this case was statutorily blocked, a year later in 1994, and it is now no longer possible for FAPI to be reduced by losses from an active business. Under the current rules, the loss deductible by virtue of variable F in the computation of FAPI is prescribed by regulation 5903(1), which was amended for tax years after 1994 to the effect that losses from an active business are ring-fenced and would no longer be deductible, under F, in computing FAPI. Therefore, the interest income earned by the U.S. subsidiary in circumstances similar to those in *Mark Resources* would be attributed to, and taxed in the hands of, the Canadian parent, even if the interest income earned by the U.S. subsidiary were to be offset by business losses, for U.S. tax purposes.

Second, the main and unsuccessful challenge to the plan in *Mark Resources* was under the relatively narrow predecessor to Canada's GAAR.[23] Had the current GAAR been available, it seems likely that Judge Bowman (as he then was) would have applied it. In fact, the court's analysis (that the tax result sought by the taxpayer was not contemplated by the Canadian income tax system and was not consistent with the scheme of the act) is unfounded in the wording of section 20(1)(c), but is consistent with the type of reasoning expected under the GAAR.

Finally, *Mark Resources* is a clear outlier in terms of the application of section 20(1)(c). The repeated qualification by Bowman of the purpose test in section 20(1)(c) by the use of terms such as ''real'' and ''true'' allowed him to depart from the statutory requirements of this provision and reach a pragmatic result consistent with his obvious dislike for the tax plan that was implemented.

Why should an old and odd case like *Mark Resources* find its way into CRA's main interpretation statement on interest deductibility? Arguably, the answer seems to be found in the increased concern with base erosion and profit shifting. Notably, however, the 100-paragraph income tax folio does not deal directly with cross-border issues.

International Aspects

In an inbound context, Canada has a thin capitalization rule in section 18(4) ITA, which polices cross-border interest stripping by specified nonresident shareholders and non-arm's-length persons. Essentially, an interest deduction is denied when the average outstanding monthly debt exceeds 1.5 times the total of:

- the retained earnings of the corporation at the beginning of the year;
- the average of all amounts, each of which is the corporation's contributed surplus at the beginning of a calendar month that ends in the year; and
- the average of all amounts, each of which is the corporation's paid-up capital.

[22] *See generally* sections 91 and 95 of the ITA respecting FAPI and its attribution. And see notes below on how this case led to amendment of these rules.

[23] Section 245, before the 1988 enactment of the GAAR, was a rule attacking artificial deductions and other arrangements.

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In the context of rising concerns with BEPS, Canada's thin capitalization rules have been significantly amended in the 2012, 2013, and 2014 federal budgets by:

- reducing the debt-to-equity ratio from 2 to 1 to 1.5 to 1;
- expanding the scope of the rule to trusts, partnerships, and certain nonresidents; and
- attacking back-to-back arrangements.

And though the preelectoral 2015 budget does not contain any further changes, the Canadian government may not stop at that.

As part of its BEPS initiative,[24] the OECD released its discussion paper ''BEPS Action 4: Interest Deductions and Other Financial Payments'' on December 18, 2014. It discusses different options for countries to curtail BEPS in the context of interest and other financial payments. The options include general interest limitation rules, such as an overall limit on the amount of interest expense in an entity by determining interest deductibility based on fixed ratios. The report discussed using group ratios as a secondary approach. The report seems to have a preference for looking at the ratio of interest expense to EBITDA.

The OECD BEPS action 4 proposals depart from the Canadian thin capitalization rules that are based on debt level; BEPS action 4 seems to promote limitation rules based on the level of interest expense. Canada has a thin capitalization rule that implies that it accepts a certain level of interest deductions on cross-border debt when those tax deductions may attract foreign investors. In fact, in the 2015 Canadian Federal Budget released last April, the government affirmed that it is committed to maintaining Canada's advantage as an attractive destination for business investment.

However, while not introducing any specific measures, the budget referred to BEPS and confirmed that the government will proceed in this area by balancing tax integrity and fairness with the competitiveness of Canada's tax system.

Most recently, at the International Tax Seminar of the Canadian Branch of IFA on May 28, 2015, Phil Halvorson, who was seconded from EY Canada to Canada's Department of Finance until May 1, 2015, indicated, in a nonrepresentative capacity, that of the various BEPS action items, the one that the greatest attention should be paid to by the Canadian tax community is the report on interest deductibility. Apparently, Canada's government has a ''keen'' interest in addressing the scope of the Canadian thin cap rules and, accordingly, is very interested in where the BEPS deliberations land.

Finally, in the outbound context, an important question is whether BEPS action 2[25] respecting hybrid mismatch arrangements will emerge with a recommendation, comparable to the now-repealed Canadian section 18.2 ITA, that would frustrate double dips by requiring that a choice be made of interest deductions at the level of the parent or at the level of the foreign subsidiary, but not both.

Historically, since the 1972 tax reform, Canada has had a highly permissive stance on interest deductibility regarding debt incurred to finance foreign affiliate operations that would benefit from Canada's participation exemption regime. Whether in light of BEPS the Canadian government may reconsider its policy on this account is left to be seen.

Conclusion

In situations in which businesses incur interest that involves no tax planning, there should be no greater fuss or uncertainty concerning the deductibility than for any other category of business-related expenditures. And, as explained above, that seems to be the case in a number of developed countries *except* in Canada.

For historical reasons that are not entirely clear or valid, Canada has a general prohibition on interest deductibility, which, however, is subject to the specific requirements of the interest deductibility rule of section 20(1)(c). As seen above, taxpayers and the government can, and often do, have divergent views on the meaning and applicability of this rule.

The effects of those basic Canadian tax law constraints are exacerbated in cross-border situations, not only by Canada's thin capitalization and other anti-avoidance rules but also by the inherent uncertainties raised by section 20(1)(c). And there is now the additional uncertainty caused by the ongoing BEPS crusade led by the OECD against international tax planning focused on debt financings. ◆

[24] *See generally* Nathan Boidman and Michael N. Kandev, ''BEPS: The OECD Discovers America?'' *Tax Notes Int'l*, Dec. 16, 2013, p. 1017; and Boidman and Kandev, ''The BEPS Deliverables: A Macro Critique,'' *Tax Notes Int'l*, Nov. 17, 2014, p. 611.

[25] *See generally* Boidman and Kandev, ''BEPS on Hybrids: A Canadian Perspective,'' *Tax Notes Int'l*, June 30, 2014, p. 1233.

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