BUDGET 2021: PROPOSED LIMITATIONS ON "EXCESSIVE" INTEREST DEDUCTIONS

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Budget 2021 proposes significant new limitations on business interest deductibility, commencing January 1, 2023. In practice, the proposed interest deductibility limits, in most cases, are not expected to apply to stand-alone Canadian corporations or Canadian corporations that are members of a group with no non-resident members.

While draft legislation is expected to be released for comment only later this year, the proposals, as outlined in Budget 2021, are significantly advanced and build on the government's previously-stated commitment to implement what it sees as "best practices" recommended by the so-called BEPS (base erosion and profit shifting) Action Plan developed by the Organisation for Economic Co-operation and Development in conjunction with the G20.

The interest deductibility proposal will apply to corporations (including a Canadian branch of a foreign corporation), partnerships and trusts. In general, the proposal will limit the entity's ability to deduct interest to no more than a fixed percentage (40% in the first year commencing January 1, 2023, and 30% in subsequent years) of EBITDA as more specifically defined for purposes of the proposal. Otherwise deductible interest denied under the proposal may, in general terms, be carried back 3 years or carried forward up to 20 years. No general grandfathering for existing borrowings is proposed.

The government has indicated that, consistent with the BEPS Action Plan, its goal is to limit what it sees as the capability of large companies, typically multinationals, to use "excessive" interest deductions to reduce Canadian tax, for example by paying interest to related non-residents in low-tax jurisdictions, using debt to finance investments that earn non-taxable income, or having Canadian businesses bear a disproportionate burden of a multinational group's third-party borrowing.

For purposes of the proposed 40% or 30%-of-EBITDA interest deductibility limitation, a more specific concept of "tax EBITDA" will be used, based on taxable income before interest expense, interest income, income tax, depreciation and amortization as defined more specifically for these purposes. "Tax EBITDA" is to be defined in a manner that will exclude most intercompany dividends, but will be structured so as to allow Canadian corporate groups to implement domestic loss utilization by using losses of one group member to offset the income of another group member. Interest will be defined to include amounts that legally constitute interest, but also certain types of payments that are "economically equivalent to interest", as well as certain other financing-related amounts. For the purposes of the proposed restrictions, interest expense will exclude interest that is not otherwise deductible, including under the current thin capitalization rules (which will remain in place). The proposal effectively envisions a limited concept of group consolidation whereby (i) Canadian members of a group that is within the 40% or 30% threshold on a group basis would be able to transfer a specific member's 'unused capacity' to another Canadian group member, and (ii) a deduction in excess of the otherwise fixed percentage may be permitted in certain circumstances if it can be demonstrated that the group's ratio of net third-party debt-to-book-EBITDA implies that a higher deduction limit would be appropriate.[1]

Banks and life insurance companies will not be permitted to transfer their 'unused capacity' (as referenced above) to other group members that are not also regulated banking or insurance entities.

The proposal contains exceptions for Canadian-controlled private corporations that, together with associated corporations, have taxable capital employed in Canada of less than $15 million, and also for groups of corporations and trusts with aggregate net interest expense among Canadian group members of $250,000 or less.

It is expected that the proposed interest deductibility restrictions will increase federal revenues by $5.3 billion over five years.

[1] For purposes of the group ratio rule, the group will comprise the parent company and subsidiaries that are fully consolidated in the parent's audited consolidated financial statements.

by Peter Botz

A Cautionary Note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.