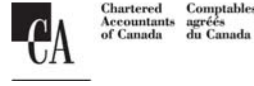

The Joint Committee on Taxation of The Canadian Bar Association and The Canadian Institute of Chartered Accountants

The Canadian Institute of Chartered Accountants 277 Wellington St. W., Toronto Ontario, M5V3H2
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May 7, 2007

The Honourable James M. Flaherty, P.C., M.P.
Minister of Finance
L'Esplanade Laurier, East Tower
140 O'Connor Street
Ottawa ON K1A 0G5

Dear Minister:

International Fair Tax Initiative

On behalf of the Joint Committee on Taxation, we are writing regarding the proposal in the 2007 Budget to restrict the deductibility of interest on debt incurred for the purpose of financing foreign affiliates.

Background on the Joint Committee

The Joint Committee on Taxation is a joint committee of the Canadian Institute of Chartered Accountants and the Canadian Bar Association and is comprised of senior income tax professionals from both organizations. The Joint Committee's primary role is to provide input to the Department of Finance and the Canada Revenue Agency with respect to income tax matters. That input includes identifying concerns with amendments to the Income Tax Act and Regulations proposed by the government, as well as making proposals for amendments to address issues of a technical nature raised by members of the tax community. For the most part, we provide our input by way of written submissions, many of which are made to the Tax Policy Branch of your Department. In addition, we meet from time to time with officials of the Department of Finance and the Canada Revenue Agency.

International Competitiveness

The proposed restriction on the deductibility of interest represents a fundamental change to the tax regime for investment in foreign affiliates. For many years, previous governments have maintained that full deductibility is necessary so that Canadian enterprises can compete internationally with enterprises based in other countries.

We find it surprising that the Budget Documents do not address this historic rationale for permitting the full deduction of interest. While we have not undertaken a study of the matter, our understanding is that the tax regimes of a significant number of other major countries continue to allow the unrestricted deduction of interest on money borrowed to invest in foreign entities, without ever taxing the profits of those entities (or taxing the profits, in whole or in part, only when distributed to the home jurisdiction).

Grandfathering

The proposal includes very limited grandfathering. Interest will be excluded from the restriction only if it is payable on debt that was either incurred before March 19, 2007 or incurred pursuant to a written agreement entered into before that day. The grandfathering applies only to such interest as is payable before 2010 (2009 in the case of non-arm's length debt) and before the expiry of the current term of the debt. The Joint Committee submits that this grandfathering falls far short of being adequate.

Our primary concern with this grandfathering is that it does not fully protect taxpayers from adverse financial consequences. Taxpayers who are not able to restructure their financing arrangements, or who are not able to do so within the permitted time frame, will have non-deductible interest. Even if they are able to restructure, taxpayers will nonetheless often be in a worse financial position. We see no reason why taxpayers should suffer financially because of a reversal of a long-standing policy—a policy that was strongly supported by prior governments.

Fairness dictates that all taxpayers who have structured their affairs in reliance on the existing rules should be able to maintain their current financing arrangements indefinitely without application of the interest restriction. The restriction should apply only with respect to new investments in foreign affiliates.

There are further reasons for extending the grandfathering. The impact of the change on each taxpayer will depend on how the taxpayer has chosen to structure the financing of its direct and indirect investment in Canadian business operations and in foreign affiliates. To date, there has been no Canadian tax reason to apply funds raised through debt financing to Canadian business operations, and to finance the investment in foreign affiliates to the maximum extent possible with equity capital and retained earnings. Some taxpayers will have relied more heavily on debt financing for their investments in foreign affiliates than will other taxpayers, and consequently will be penalized more by the proposed change. It seems unfair for the change to have such a differential impact on taxpayers, based on the fortuitous circumstance of whether they have structured their financing arrangements in a more or less favourable way. Taxpayers who have structured their financing in an unfavourable way are generally now not able to rearrange their financing so as to have more debt financing for their Canadian businesses and less debt financing for their investments in foreign affiliates.

Another reason for broader grandfathering is the substantial difficulty some taxpayers will face in determining the extent to which the proposed restriction applies with respect to their existing debt. The Budget Documents state that the determination of interest to which the restriction applies "will be achieved through an adaptation of the existing 'tracing' rules for interest". In the past, many corporations have not had to trace the use of borrowed money, since all uses have been eligible uses that have resulted in deductible interest.

For some corporations—including those that have operated centralized cash management systems pursuant to which all cash from group operations, both Canadian and foreign, has been commingled—it is virtually impossible to now determine the extent to which previously borrowed money is traceable to a use that results in the application of the interest restriction. For other corporations, this tracing requirement will impose an onerous compliance burden.

The grandfathering applies only if debt was incurred, or agreed to be incurred, before March 19, 2007. This does not provide relief in situations where taxpayers had committed to acquire shares of foreign affiliates before that date, but had not entered into financing agreements. Grandfathering should be extended to such taxpayers as well.

In case the grandfathering continues to be more limited than what we are advocating, we would like to point out two specific deficiencies in the grandfathering that is currently proposed. First, the time permitted for restructuring is too short. Some taxpayers will not be able to restructure their affairs within the permitted time frame to minimize the impact of the change. For example, a taxpayer that has borrowed money for a term that extends beyond 2009 may be unable to replace the financing before its maturity. Second, it is inappropriate to base the grandfathering period on the remaining term of existing debt. This disadvantages taxpayers who have used short-term debt for financing investments in foreign affiliates, and taxpayers whose debt will mature shortly.

We do not think that such taxpayers should be provided with a shorter grandfathering period than is provided to other taxpayers. Related to both of these deficiencies is the further point that it seems to be expected that taxpayers will take action now to restructure, notwithstanding that the proposed change is controversial and there is no certainty that it will be enacted. Whatever form the grandfathering takes, taxpayers should not be expected to take any steps before the enactment of the change.

Uncertainty

The Joint Committee is concerned that taxpayers may face significant uncertainty in determining whether the interest restriction applies in particular situations. The source of this concern is the very broad anti-avoidance rule that is included in the Budget Notice of Ways and Means Motion. This rule extends the restriction on the deductibility of interest to interest "that may reasonably be considered to be in connection with a transaction or event or series of transactions or events a main purpose of which was to avoid the application of" the interest restriction rules.

Assuming that a similarly worded anti-avoidance rule is contained in the legislation implementing the interest restriction, taxpayers frequently will not be able to determine whether particular tax planning constitutes legitimate tax planning or is offensive under the anti-avoidance rule. For example, if a taxpayer takes steps to ensure that it has cash on hand to invest in a foreign affiliate and later borrows money to invest in its Canadian business, the taxpayer will not know whether the anti-avoidance rule will apply to the interest on the borrowed money. This degree of uncertainty is inappropriate. The anti-avoidance rule should be drafted with sufficient precision that taxpayers can determine with reasonable certainty whether it applies to particular tax planning arrangements.

We are also concerned that the implementing legislation may contain other rules that are generally worded and that such rules will be a further source of uncertainty for taxpayers.

We anticipate that your officials will respond to our concerns about uncertainty by stating that the Canada Revenue Agency will provide guidance and interpretations, and that taxpayers can seek advance tax rulings in specific cases. However, this is not an acceptable alternative to legislation that is clear and specific. We appreciate, of course, that it is not possible to achieve perfection in this regard. Nonetheless, an attempt should be made to devise rules that provide taxpayers with as high a degree of certainty as is reasonably possible.

The Joint Committee intends to make submissions to the Tax Policy Branch on the more detailed aspects of this proposal once draft legislation has been released.

We would be pleased to meet you or your officials to discuss the submissions in this letter.

Yours truly,

Bruce Harris, CA
Chair, Taxation Committee
Canadian Institute of Chartered Accountants

William R. Holmes
Chair, Taxation Section
Canadian Bar Association

cc: Rob Wright
Deputy Minister

Mark Carney
Senior Associate Deputy Minister

Bob Hamilton
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Tax Policy Branch

Brian Ernewein
General Director
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