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Interest Deductibility Restrictions and Inbound Direct Investment

Tim Edgar

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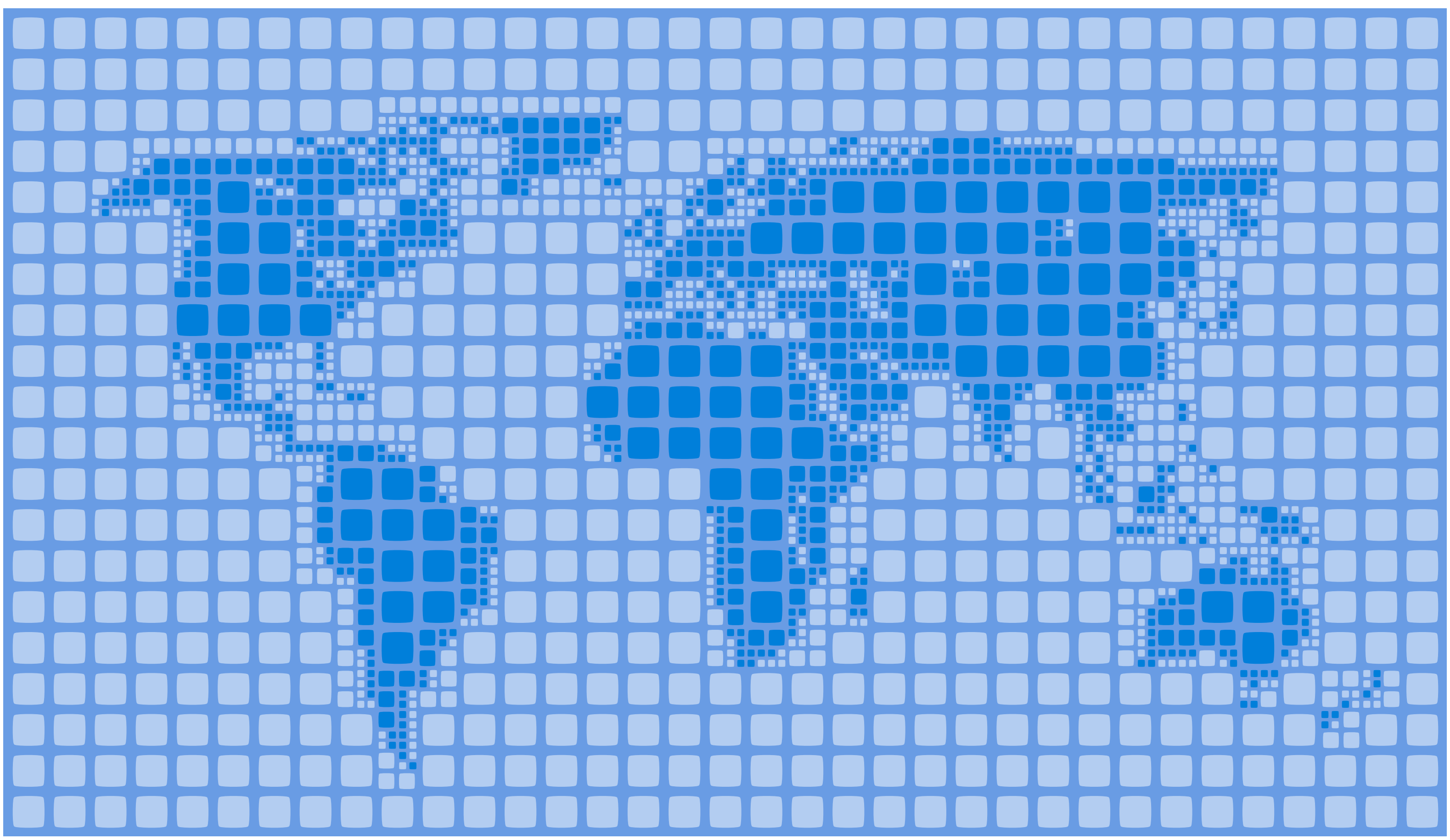

Interest Deductibility Restrictions and Inbound Direct Investment

Tim Edgar
Professor, Faculty of Law, The University of Western Ontario, London, Ontario

Senior Research Fellow, Taxation Law and Policy Research Institute, Monash University, Melbourne, Australia

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Address for correspondence:
Tim Edgar, Faculty of Law, The University of Western Ontario,
1151 Richmond Street, Suite 2, London, Ontario, Canada N6A 5B8

Email: tedgar@uwo.ca

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1. Introduction

With the enactment in 1972 of the thin capitalization rules, currently in subsections 18(4) to (6) of the Income Tax Act,[1] Canada was the first country of the Organisation for Economic Co-operation and Development (OECD) to adopt specific legislation designed to protect its corporate income tax base by limiting the deduction of interest expense in the context of inbound direct investment. Several countries have since enacted legislation intended to address the same potential base erosion. In some important respects, Canada's rules have not kept pace with these legislative developments elsewhere. Reforms have been suggested in the literature,[2] and were proposed in the 2000 budget[3] in an apparent response to recommendations of the Technical Committee on Business Taxation[4] ("the Mintz committee"). Despite adoption of some of these reform proposals, the basic structure of the thin capitalization rules has remained largely unchanged. Maintenance of the legislative status quo is arguably untenable, however, in the face of the federal government's elimination of interest withholding tax generally in the context of inbound portfolio investment,[5] as well as in the context of inbound direct investment from the United States.[6] By lowering the tax rate on corporate income repatriated as interest, this trend to lower interest withholding taxes further deepens the tax incentive to substitute debt for equity finance in the context of inbound direct investment. It is not clear that the thin capitalization rules, in their current form, can adequately serve their role as a limitation on this tax-driven substitution. Although reduction of the statutory corporate tax rate at the federal government level will help to mute the tax incentive to locate deductible interest expense in Canada, this effect is offset somewhat by the increasing use of sophisticated tax-planning structures that also avoid residence-country tax on income repatriated as tax-deductible interest expense.[7] In this structured finance environment, Canada's corporate tax

1 RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act"). Unless otherwise indicated, all statutory references are to the Act. Former subsection 18(7) ensured that the rule of non-deductibility applied equally to interest expense that a corporation elected to capitalize as part of the cost of depreciable property or its exploration and development expense pool. This priority rule was repealed for taxation years commencing after 1984 on the basis that the wording "otherwise deductible" extended to such capitalized interest expense. Former subsection 18(8) provided an exception for Canadian corporations whose principal business was the development or manufacture of airplanes or airplane components. This exception was repealed for taxation years beginning after 2000.

2 See, for example, W. G. Williamson and R.A. Garland, *Taxation of Inbound Investment* (Ottawa: Department of Finance, Working Paper 96-12, Technical Committee on Business Taxation, December 1996), at 2-3 and 15-33. See also Tim Edgar, "The Thin Capitalization Rules: Role and Reform" (1992) vol. 40, no. 1 *Canadian Tax Journal* 1-54.

3 Canada, Department of Finance, *2000 Budget, Budget Plan*, Tax Measures: Supplementary Information, annex 7, at 246-49 and Notice of Ways and Means Motion to Amend the Income Tax Act, February 28, 2000, resolution (26).

4 Canada, *Report of the Technical Committee on Business Taxation* ("Mintz report") (Ottawa: Department of Finance, 1997), at 6.26-6.30.

5 See Canada, Department of Finance, *2007 Budget, Budget Plan*, Supplementary Information, annex 5, March 19, 2007 (statement of the government's intention to eliminate withholding tax on all arm's-length interest payments made to non-residents once an exemption from withholding tax on both arm's-length and non-arm's-length interest is implemented in the Canada-U.S. tax treaty). Effective January 1, 2008, paragraph 212(1)(b) has been amended to eliminate non-resident withholding tax on non-contingent interest paid to an arm's-length person.

6 Fifth Protocol to the Canada-United States Income Tax Convention, September 21, 2007, article XI(1) (elimination of withholding tax on: (i) arm's-length interest as of the first calendar year following the entry into force of the treaty changes; and (ii) non-arm's-length interest for the third and subsequent calendar years after the entry into force of the treaty changes). The protocol has now been ratified by Canada and the United States.

7 It is also offset, of course, by any increases in provincial corporate tax rates. Despite the reductions already made, the statutory corporate income tax rate (combined federal-provincial) for 2008 remains the fifth highest of OECD countries — almost seven percentage points higher than the OECD average. See Scott A Hodge, "U.S. Corporate Taxes Now 50 percent Higher than OECD Average", *Fiscal Fact No. 136*, Tax Foundation, August 13, 2008.

on income from location-specific inbound direct investment is often the only amount of tax at stake, which places considerable pressure on the thin capitalization rules as a base-maintenance instrument.

This report reviews the following four possible options for reform of Canada's existing thin capitalization rules:

- a generalized rule of non-deductibility for interest on related-party debt;
- earnings-stripping legislation that restricts the deduction of interest expense on related-party debt;
- extension of a deductibility restriction to interest on arm's-length debt; and
- incremental reform of the existing rules.

These options are examined generally in terms of the policy issue (or issues) that the thin capitalization rules can be seen to address. Legislation in other countries is highlighted selectively to illustrate the feasibility, strengths, and weaknesses of certain of these reform options.[8] Broader reform initiatives intended to realize consistent treatment of dividends and corporate interest expense generally are not considered.[9] The rationale for these kinds of approaches extends well beyond a focus on inbound direct investment and, as a result, implicates issues beyond the mandate of the Advisory Panel.

The most important current policy issue in the development of interest deductibility restrictions in the context of inbound direct investment is probably their extension to corporate debt held by arm's-length creditors. Indeed, a failure to account for such debt of a foreign-controlled corporation is the most glaring shortcoming of the existing thin capitalization rules,[10] at least to the extent that they are perceived to be unduly weak as a mechanism to protect the Canadian corporate income tax base. An obvious alternative to a thin capitalization approach is a U.S.-style earnings-stripping limitation applicable to related-party debt. Yet the differences in approach are, in many respects, those of form only, and it is not clear that any differences in result warrant abandonment of the thin capitalization approach that has long been the defining

8 The principal countries are Australia, Denmark, Germany, Italy, the Netherlands, New Zealand, the United Kingdom, and the United States. Legislative and administrative practice in these countries is used for comparative purposes because, in general, they are the most detailed and most advanced as representative examples of the various reform alternatives. Summaries of the core features are provided in Appendix 1 and are based on: Ernst & Young LLP, *Thin Capitalization Regimes in Selected Countries*, report prepared for the Advisory Panel on Canada's System of International Taxation (May 2008); Ana Paula Dourado and Rita de la Feria, "Thin Capitalization Rules in the Context of the CCCTB", Oxford University Centre for Business Taxation, *Working Paper Series WP 08/04*; and Bruno Gouthiere et al., "A Comparative Study of the Thin Capitalization Rules in the Member States of the European Union and Certain other Countries" (2005) vol. 45, no. 9/10 *European Taxation* 367-451.

9 See, for example, the cost of capital allowance system described in Edward D. Kleinbard, *Rehabilitating the Business Income Tax* (Washington: The Brookings Institution, The Hamilton Project, Discussion Paper 2007-09, June 2007). See also United States, *Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once* (Washington, DC: Department of the Treasury, USGPO, 1992) (describing a Comprehensive Business Income Tax (CBIT) with a general rule of non-deductibility for corporate interest expense consistent with the treatment of dividends).

10 See, for example, Williamson and Garland, supra note 2, at 2 (suggesting that an arm's-length lender would base a decision on the creditworthiness of a debtor corporation as a whole, and thin capitalization provisions should reflect this reality by accounting for all debt and equity).

feature of Canada's rules. Although holding some intuitive appeal, the option of a generalized rule of non-deductibility for interest expense on related-party debt is arguably over-inclusive and thereby overly restrictive. The choice of structural reform may defensibly be limited to:

- a thin capitalization approach that constrains the use of both arm's-length and related-party debt; and
- an earnings-stripping approach that similarly constrains the use of arm's-length and related-party debt.

Extension of a rule of non-deductibility to both arm's-length and related-party debt is the most significant recent trend in country legislative practice. This kind of fundamental structural reform would fundamentally alter the policy rationale underlying the thin capitalization rules. Even so, a credible tax policy case can be made in support of such an extension in the limited context of inbound direct investment.[11] Moreover, to the extent that leveraged acquisitions of Canadian corporations by foreign-based multinationals are perceived to give rise to public policy concerns,[12] a comprehensive thin capitalization limitation, applied to arm's-length and related-party debt, addresses such transactions by providing a systemic response that is focused broadly on the identification of the tax-driven location of debt in Canada.

A failure to adopt a comprehensive interest deductibility restriction in the context of inbound direct investment leaves, as a default position, maintenance of a thin capitalization approach that limits a rule of non-deductibility in the same context to interest on related-party debt — albeit with the possibility of incremental reforms affecting various design features of the existing rules.[13] In this respect, the two most prominent issues, which have been considered in the past, are: (i) the extension of Canada's thin capitalization rules to arm's-length debt that is guaranteed by a related party; and (ii) the extension of the rules to Canadian branches, resident partnerships, and resident trusts. There is also some discussion in the report of other design issues, including:

- the specification of a permissible leverage ratio;
- the use of debt substitutes and the limitations of interest deductibility restrictions as a means to ensure source-country taxation of location-specific profits; and
- the incorporation of debt-creation rules as a response to "debt-dumping" and similar transactions.

11 The policy case for comprehensive interest deductibility restrictions that apply equally in the domestic context, which is the case with the Danish, German, and Italian earnings-stripping legislation, is fundamentally different, and is beyond the mandate of the Advisory Panel in any event.

12 See Canada, Competition Policy Review Panel, *Compete to Win: Final Report* (Ottawa: Public Works and Government Services Canada, June 2008), at 66 (recommending that the Advisory Panel "give particular attention to an assessment of tax provisions disadvantaging Canadian companies relative to non-Canadian companies in Canadian acquisitions, with the objective of recommending ways to allow Canadian-based companies to compete on an equal footing").

13 A number of the suggested reforms are considered in Williamson and Garland, supra note 2; and Edgar, supra note 2.

Because of its significance for the targeting of thin capitalization legislation, the specification of a permissible leverage ratio is discussed separately from, and before the discussion of, the other design issues. It is suggested that the very different policy rationales underlying thin capitalization legislation that applies to all debt, and legislation that limits a rule of non-deductibility to related-party debt, should be reflected in different approaches to the specification of the permissible leverage ratio. But even if it is decided to continue to limit a rule of non-deductibility to interest on related-party debt, the ratio should be computed taking into account all debt and equity of a Canadian corporation.

The report concludes with a consideration of:

- the constraint presented by the non-discrimination principle; and
- the interaction with interest deductibility restrictions in the context of outbound direct investment.

These two broader issues are common to legislation that restricts the deduction of interest expense on related-party debt and legislation that restricts the deduction of interest expense on all debt issued by foreign-controlled corporations. In fact, many of the possible incremental reforms of the existing thin capitalization rules reviewed in the report are common to these structurally different approaches. Because extension of a rule of non-deductibility to arm's-length debt would significantly increase the restrictiveness of the rules, the imperative to seriously consider some of these incremental reforms would be that much more compelling.

2. Source-country taxation of location-specific profits and the interest expense deduction

Interest deductibility restrictions increase the effective tax rate on the associated income. Restrictions that are targeted to inbound direct investment can cause a range of such investment that is tax-sensitive to locate elsewhere.[14] Tax policymakers must somehow strike a balance between protection of the revenue base and the ability to attract desirable inbound direct investment. Many countries have struck this balance with legislation that lies somewhere between a rule of non-deductibility for all interest expense and an unrestricted interest expense deduction.[15] It is suggested in this part that the empirical and the theoretical literature does not yet provide sufficiently sophisticated tools to calibrate precisely the inevitable trade-off between revenue targets and a desired level of inbound direct investment.[16] In this state of policymaking ignorance, the relative restrictiveness of a country's interest deductibility restrictions is an important qualitative property that must continue to be assessed qualitatively.[17]

The tax treatment of interest expense payable by a resident corporation to a non-resident debt holder is one aspect of a more general issue: the allocation of tax revenue from cross-border investment as between source countries (capital importers) and residence countries (capital exporters). Standard country practice reflects a compromise division of the income tax base, which allocates the principal jurisdictional right to tax portfolio income to the country in which an investor is resident. Countries in which the income is considered to be sourced are granted a limited ability to impose gross withholding taxes on the income streams, and the country

14 See Theiss Buettner, Michael Overesch, Ulrich Schreiber, and Georg Wamser, "The Impact of Thin Capitalization Rules on Multinationals' Financing and Investment Decisions", *Deutsche Bundesbank Discussion Paper No. 03/2008*, Frankfurt (finding for a sample of 24 OECD countries that thin capitalization rules reduce leverage ratios but increase the sensitivity of investment to increases in statutory tax rates). See also Vijay Jog and Jianmin Tang, "Tax Reforms, Debt Shifting and Tax Revenues: Multinational Corporations in Canada" (2001) vol. 8, no. 1 *International Tax and Public Finance* 5-26 (finding a 1.06 percent increase in the level of debt of U.S.-controlled Canadian subsidiaries for a one percentage point increase in the Canadian statutory corporate income tax rate); and Michael Overesch and Georg Wamser, "German Inbound Investment, Corporate Tax Planning, and Thin Capitalization Rules — A Differences-in-Differences Approach", *ZEW Discussion Paper No. 06-075*, 2006 (results from German inbound investment data for the period 1996-2004 suggesting: (i) a significant correlation between the use of related-party debt and tax-rate differences; and (ii) a significant reduction in the use of related-party debt in response to tightening of the German thin capitalization rules).

15 See, in this respect, Buettner et al., supra note 14, at 26 ("… there seem to be good reasons to impose restrictions on interest deductions … an optimal tax policy should combine a restriction on tax-planning by means of debt finance with a reduction in the overall tax burden on corporate profits").

16 But see, however, Bev Dahlby, *Taxation of Inbound Direct Investment: Economic Principles and Tax Policy Considerations* (Ottawa: research report prepared for the Advisory Panel on Canada's System of International Taxation, October 2008) (modelling effective source-country tax rates under simplified assumptions regarding alternative finance structures, residence-country tax regimes, and thin capitalization regimes).

17 See Andreas Haufler and Marco Runkel, "Firms' Financial Choices and Thin Capitalization Rules under Corporate Tax Competition", Oxford University Centre for Business Taxation, *Working Paper Series WP 08/15* (in the context of a two-country model with competition for mobile direct investment, thin capitalization rules that are limited to related-party debt should be set optimally by either: (i) coordinating a tightening of the rules to intensify tax competition through statutory tax rates and realize mutual gains when both countries have a comparable number of domestic firms; or (ii) defecting and lowering effective tax rates on inbound direct investment by relaxing the application of the rules when a country has a relatively larger number of domestic firms). See also Clemens Fuest and Thomas Hemmelgarn, "Corporate Tax Policy, Foreign Firm Ownership and Thin Capitalization" (2005) vol. 35, no. 5 *Regional Science and Urban Economics* 508-26 (debt shifting causes countries to reduce corporate tax rates below personal tax rates, while broadening the tax base, with countries gaining from a coordinated response to setting tax rates or defining the tax base in the presence of foreign firm ownership).

of residence is required to credit such source-country taxes. In contrast with the treatment of portfolio income, the principal right to tax income from direct investment is allocated to source countries, with the country of residence of the investor required to provide recognition of source-country taxation either by exempting the income from residence-country tax or crediting source-country tax.

This accepted division of the jurisdiction to tax is reflected in the general approach to the taxation of income earned by non-residents through a corporation resident in a source country. For income tax purposes, both the source country and the country of residence of the investors generally treat the corporation as an entity separate from the investors. The capital-importing country, on the basis of the residence of the corporation, retains the right to tax any income earned by the corporation. On distribution as a dividend, the capital-importing country, as the country of source, retains the right to tax the non-resident shareholders, with that right exercised through the levy of a dividend withholding tax. The country of residence of the shareholders generally does not tax the income earned by the corporation until it is distributed as a dividend, with relief provided either in the form of exemption or credit for source-country tax (either or both of dividend withholding tax and corporate tax on the underlying income). In contrast to the taxation of dividends, interest payable by a resident corporation to a non-resident may generally be deducted by the payer in computing its income and is subject only to withholding tax levied by the source country on the interest payment. The country of residence of the debt holder usually taxes the interest income as earned and provides some form of relief for the withholding tax of the source country.

The revenue exposure of source countries attributable to this different treatment of interest and dividends, and the resulting incentive to substitute debt for equity financing, is obvious and has long been recognized. The deduction of corporate interest payments eliminates the source-country corporate income tax, which is replaced by source-country withholding tax and residence-country tax on the interest income. Conceptually, this debt-for-equity substitution occurs where there are minimal differences in the non-tax attributes associated with the different legal forms. In the extreme, it permits the replacement of source-country taxation with a low-tax or a no-tax regime by routing taxable profits to a corporate group member in a country with such a regime. To the extent that the choice of related-party financing is responsive to source and residence country tax rates, payment of source-country tax is largely elective for multinational corporate groups in the absence of some type of interest deductibility restriction and only modest levels of interest withholding tax.

Although the incentives presented by differences in country tax rates, along with the direction of potential revenue loss, is conceptually clear, the precise dimensions of the revenue and efficiency effects of the interest expense deduction in the context of inbound direct investment using sophisticated tax-planning structures are complex, and are only beginning to be explored empirically.[18] The complicated nature of the inquiry is attributable to the fact that these effects depend not just on the choice of related-party debt or related-party equity financing. Two other behavioural margins are also implicated. One is the choice of location of arm's-length debt by a multinational corporate group. Another is the choice of investment location.[19] The choice of related-party debt or equity, as well as the choice of location of arm's-length debt, lowers the effective tax rate on foreign direct investment, which can affect the choice of investment location.[20]

As a general proposition, it is probably fair to say that the empirical literature is beginning to confirm what has always been known anecdotally about behaviour along two of these margins.[21] In particular, there is a growing body of evidence suggesting a high degree of

18 Recent empirical work by Grubert and Altshuler, using U.S. data, indicates growing use of sophisticated financing structures using the interest expense deduction and/or hybrid financial instruments (that is, financial instruments that are treated as debt by one country and equity by another) and/or hybrid entities (that is, entities that are treated as taxable by one country and as a flow through or conduit by another). See Rosanne Altshuler and Harry Grubert, "Governments and Multinational Corporations in the Race to the Bottom" (2006) vol. 45, no. 5 *Tax Notes International* 459-74 (finding that the adoption of the check-the-box entity classification rules in the United States: (i) weakened the link between source-country statutory tax rates and the effective tax rates of U.S. corporations; (ii) motivated a large increase in inter-corporate payments and income of holding corporations abroad; and (iii) resulted in tax savings of $7 billion per year by 2002, representing four percent of foreign direct investment and 15 percent of source-country tax burdens); and Rosanne Altshuler and Harry Grubert, "Taxpayer Responses to Competitive Tax Policies and Tax Policy Responses to Competitive Taxpayers: Recent Evidence" (2004) vol. 34, no. 13 *Tax Notes International* 1349-62 (concluding that the evolution of effective tax rates between 1998 and 2000 was driven more by the aggressive tax planning of U.S. corporations than tax competition among source countries). See also, Mihir A. Desai, Fritz Foley, and James R. Hines, Jr., "The Demand for Tax Haven Operations" (2006) vol. 90, no. 3 *Journal of Public Economics* 513-31 (finding that 59 percent of U.S. corporations with significant foreign operations had affiliates in tax havens in 1999, with their principal use being the shifting of income out of source countries). Martin Sullivan has tracked U.S. data suggesting: (i) lower effective tax rates on outbound direct investment by U.S. multinationals through profit-shifting transactions; and (ii) migration of real investment activities to low-tax jurisdictions in response to lower effective tax rates. See, for example, Martin A. Sullivan, "Why Reported Effective Corporate Tax Rates Are Falling" (2008) vol. 118, no. 10 *Tax Notes* 977-85; Martin A. Sullivan, "A Challenge to Conventional International Tax Wisdom" (2006) vol. 44, no. 11 *Tax Notes International* 813-25; Martin A. Sullivan, "Large U.S. Banks Keeping More Profits in Tax Havens" (2004) vol. 34, no. 13 *Tax Notes International* 1379-86; Martin A. Sullivan, "U.S. Multinationals Move More Profits to Tax Havens" (2004) vol. 102, no. 6 *Tax Notes* 690-93; Martin A. Sullivan, "Data Show Big Shift in Income to Tax Havens" (2002) vol. 97, no. 7 *Tax Notes* 880-82; and Martin A. Sullivan, "U.S. Firms Invest Heavily in Low-Tax Countries" (2000) vol. 21, no. 25 *Tax Notes International* 2756-59. The same trends are identified in a recent U.S. GAO study, United States, *U.S. Multinational Corporations: Effective Tax Rates Are Correlated with Where Income Is Reported* (Washington, DC: U.S. Government Accountability Office, Report to the Committee on Finance, U.S. Senate, August 2008). For some similar evidence in the Canadian context, see Canada, *Canadian Direct Investment in "Offshore Financial Centers"* (Ottawa: Statistics Canada, March 2005).

19 Interest deductibility restrictions implicate a fourth behavioural margin: that is, the substitution of tax-deductible payments other than interest, such as royalty payments, lease payments, and payments for goods and services generally, for otherwise restricted interest expense. This issue is discussed in Part 8.A.4.

20 It remains uncertain to what extent the location of foreign direct investment responds to the use of tax-effective financing structures. See, for example, OECD, *Tax Effects on Foreign Direct Investment: Recent Evidence and Analysis* (Paris: OECD Policy Study Series, No. 17, 2007), at 144-46. See also United States, *Report to the Congress on Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties* (Washington, DC: Department of the Treasury, November 2007), at 24 ("… existing empirical work does not address the question of whether income shifting raises or lowers the level of investment in high-tax countries"). For a simple two-country model comparing the cost of capital using a direct financing structure versus an indirect financing structure, see Jack Mintz, "Conduit Entities: Implications of Indirect Tax-Efficient Financing Structures for Real Investment" (2004) vol. 11, no. 4 *International Tax and Public Finance* 419-34.

21 For a detailed review of much of this literature, referred to in the footnotes below, see Dahlby, supra note 16.

tax-driven substitution of related-party debt and related-party equity, as well as the choice of location of arm's-length debt.[22] There is also a substantial, and related, empirical literature confirming the intuition that there is a high degree of substitutability of interest, dividends, and royalty payments as repatriation strategies in the context of foreign direct investment.[23] Taken together, this evidence confirms the intuition that related-party debt or related-party equity financing is largely substitutable in response to differences in statutory tax rates. Although there is less evidence bearing directly on the ability of a multinational group to locate arm's-length debt, the evidence that does exist confirms again the intuition that, to a large extent, realization of the most tax-effective sourcing of interest payments to arm's-length lenders

22 See, for example, Lillian F. Mills and Kaye J. Newberry, "Do Foreign Multinationals' Tax Incentives Influence Their U.S. Income Reporting and Debt Policy" (2004) vol. 57, no. 1 *National Tax Journal* 89-107 (comparing a matched sample of foreign multinationals and U.S. foreign-controlled corporations, and finding that foreign multinationals with relatively low foreign tax rates report less taxable income and use more debt in their foreign-controlled corporations than those with relatively high average foreign tax rates); and Dan S. Dhaliwal, Kaye J. Newberry, and Connie D. Weaver, "Corporate Taxes and Financing Methods for Taxable Acquisitions" (2005) vol. 22, no. 1 *Contemporary Accounting Research* 1-30 (finding for the 1987-97 period that the use of debt by U.S. firms to fund acquisitions significantly declined as foreign tax credit limitations became binding, thereby reducing the marginal tax benefit of borrowing). See also Rosanne Altshuler and Jack M. Mintz, "U.S. Interest Allocation Rules: Effects and Policy" (1995) vol. 2, no. 1 *International Tax and Public Finance* 7-35; Julie H. Collins and Douglas A. Shackelford, "Foreign Tax Credit Limitations and Preferred Stock Issuances" (1992) vol. 30, suppl., *Journal of Accounting Research* 103-24; Kenneth A. Froot and James R. Hines, Jr., "Interest Allocation Rules, Financing Patterns, and the Operations of U.S. Multinationals", in Martin Feldstein, James R. Hines, Jr., and R. Glenn Hubbard, eds., *The Effects of Taxation on Multinational Corporations* (Chicago: University of Chicago Press, 1995), 277-312; Harry Huizinga, Luc Laeven, and Gaëtan Nicodème, "Capital Structure and International Debt Shifting", *IMF Working Paper 07/39*, Washington; Jog and Tang, supra note 14; and Fred Ramb and Alfons J. Weichenrieder, "Taxes and the Financial Structure of German Inward FDI" (2005) vol. 141, no. 4 *Review of World Economics* 670-92.

23 See, for example, Rosanne Altshuler and Harry Grubert, "Repatriation Taxes, Repatriation Strategies and Multinational Financial Policy" (2002) vol. 87, no. 1 *Journal of Public Economics* 73-107 (finding that the leverage of controlled foreign corporations (CFCs) is a highly correlated function of source-country tax rates). See also Rosanne Altshuler and Harry Grubert, "Where Will They Go if We Go Territorial? Dividend Exemption and The Location of U.S. Multinational Corporations" (2001) vol. 54, no. 4 *National Tax Journal* 787-809; Rosanne Altshuler and T. Scott Newlon, "The Effects of U.S. Tax Policy on the Income Repatriation Patterns of U.S. Multinational Corporations", in Alberto Giovannini, R. Glenn Hubbard, and Joel Slemrod, eds., *Studies in International Taxation* (Chicago: University of Chicago Press, 1993), 77-115; Julie H. Collins and Douglas A. Shackelford, "Global Organization and Taxes: An Analysis of the Dividend, Interest, Royalty, and Management Fee Payments Between U.S. Multinationals' Foreign Affiliates" (1998) vol. 24, no. 2 *Journal of Accounting and Economics* 151-73; Harry Grubert, "Tax Planning by Companies and Tax Competition by Governments: Is There Evidence of Changes in Behavior?" in James R. Hines, Jr., ed., *International Taxation and Multinational Activity* (Chicago: University of Chicago Press, 2001), 113-39; Harry Grubert, "Enacting Dividend Exemption and Tax Revenue" (2001) vol. 54, no. 4 *National Tax Journal* 811-27; Harry Grubert, "Taxes and the Division of Foreign Operating Income Among Royalties, Interest, Dividends and Retained Earnings" (1998) vol. 68, no. 2 *Journal of Public Economics* 269-90; James R. Hines, Jr., "Lessons from Behavioral Responses to International Taxation" (1999) vol. 52, no. 2 *National Tax Journal* 305-22; and James R. Hines, Jr. and R. Glenn Hubbard, "Coming Home to America: Dividend Repatriations by U.S. Multinationals," in Assaf Razin and Joel Slemrod, eds., *Taxation in the Global Economy* (Chicago: University of Chicago Press, 1990), 167-207. See also Commission of the European Communities, *Report of the Committee of Independent Experts of Company Taxation* (Luxembourg: Office for Official Publications of the European Communities, 1992) ("Ruding report"), at 104-06 (reporting the results of survey evidence suggesting that national tax differences are an important factor determining the legal form of profit repatriations from foreign direct investment in the European Union).

is unconstrained by non-tax factors;[24] yet the choice is not entirely unconstrained. In other words, the sourcing of arm's-length debt would seem to be relatively unconstrained by non-tax factors, although probably not to the same extent as the choice of related-party debt or related-party equity finance.[25]

The available empirical evidence suggests, therefore, that the substitution of related-party debt and related-party equity, as well as the location of a range of arm's-length debt, occurs in instances of perfect or near-perfect substitution. In these circumstances, the financing choices implicated by an interest expense deduction in the context of inbound direct investment give rise largely to revenue effects, with little in the way of efficiency effects following directly from the substitution. The latter effects would be attributable primarily to the responsiveness of the location of investment to differences in effective country tax rates produced by an unrestricted interest expense deduction.[26] Efficiency losses attributable to distortion of the choice of investment location depend on:

- the responsiveness of this choice to differences in effective tax rates that are attributable, in part, to the deductibility of interest expense; and

- the nature of the particular locations as perfect or imperfect substitutes in terms of their non-tax attributes, such as public infrastructure and access to markets.

24 There is a considerable body of literature emphasizing the effect on the cost of capital of differences in the non-tax attributes of local capital markets. These differences can constrain the ability of a multinational group to borrow directly in the market in which a group member operates. See, for example, United States, *Approaches to Improve the Competitiveness of the U.S. Business Income Tax System for the 21st Century* (Washington, DC: Office of Tax Policy, Treasury Department, December 2007), at 56 (noting that capital-import neutrality and capital-ownership neutrality, as welfare benchmarks, assume that capital is supplied at a fixed rate by an integrated world market, yet there is very little empirical evidence supporting this assumption). The most comprehensive empirical study of the substitution of related-party debt for arm's-length debt by multinational groups in the face of differences in the non-tax attributes of local capital markets is Mihir A. Desai, Fritz Foley, and James R. Hines, Jr., "A Multinational Perspective on Capital Structure Choice and Internal Capital Markets" (2004) vol. 59, no. 6 *Journal of Finance* 2451-87 (finding for a panel of U.S. multinationals that: (i) 10 percent higher tax rates are associated with 2.8 percent greater affiliate debt as a fraction of assets; (ii) the tax elasticity of related-party debt (0.35) is greater than that of arm's-length debt (0.19); and (iii) one percent higher interest rates in local capital markets are associated with a decline of direct borrowing from arm's-length lenders by affiliates of 1.3 percent of assets, while borrowing from parent corporations increased by 0.8 percent of assets). See also Buettner et al., supra note 14 (obtaining similar results for a panel of German multinationals); Huizinga et al., supra note 22 (finding a tax elasticity of related-party debt of 0.27 for a sample of European corporations); Ramb and Weichenrieder, supra note 22 (finding for a panel of foreign-controlled German subsidiaries that taxation does not fully explain the level of intra-group debt); and Jack Mintz and Alfons Weichenrieder, "The Indirect Side of Direct Investment: Multinational Company Finance and Taxation", *CESifo Working Paper Series No. 1612*, 2005 (finding that the level of debt, both arm's-length and related-party, of foreign subsidiaries of German parent corporations was unaffected by the use of third-country conduit-financing structures, but finding a strong relationship between the substitution of arm's-length debt for related-party debt in the subsidiaries where such structures were unavailable).

25 But see Theiss Buettner, Michael Overesch, Ulrich Schreiber, and Georg Wamser, "Taxation and Capital Structure Choice — Evidence from a Panel of German Multinationals", *ZEW Discussion Paper No. 06-067*, 2006 (finding comparable tax elasticities of related-party and arm's-length debt for a sample of German multinationals). The use of related-party guarantees or other security provides a broad range of substitutability of related-party and arm's-length debt. See Buettner et al., id (finding a mean ratio of related-party to arm's-length debt of 0.68 for a panel of German multinationals); and Desai et al., supra note 24 (finding that arm's-length debt comprises the majority of debt for a panel of U.S. multinationals). The status of guaranteed debt for the purpose of interest deductibility restrictions is discussed in Part 8.B.1.

26 Efficiency effects can also arise indirectly in the presence of a budget constraint, which requires the use of other taxes, with behavioural responses, to compensate for the revenue loss.

There is now a substantial body of empirical evidence of the responsiveness to taxation of the location of a range of foreign direct investment.[27] There is also a growing body of empirical evidence supporting a characterization of outbound direct investment as a complement to domestic investment,[28] although it remains difficult to disentangle the effects of general economic conditions on the level of both outbound direct investment and domestic investment and thereby isolate the relationship between the two.[29] These two separate bodies of empirical evidence support the proposition that there is a range of foreign direct investment that responds to differences in taxation in the choice of location among source countries other than the home jurisdiction of the capital exporter. An interest expense deduction lowers the effective tax rate on foreign direct investment, with possible effects on the location of investment. In fact, in a non-cooperative setting in which countries behave strategically, tax competition for mobile investment is not limited to statutory rate reductions, but can take the form of effective rate reductions through looseness in deductibility rules such as those for interest expense. The result may be both revenue and efficiency losses where the chosen location is sub-optimal in terms of its non-tax attributes (that is, it is an imperfect substitute for an otherwise preferred higher-taxed location). The theoretical, as well as the empirical, literature has only begun, however, to account for tax competition in this particular form;[30] nor is there sufficient empirical evidence bearing directly on the dimensions of any revenue and efficiency effects attributable to changes in effective tax rates realized through an interest expense deduction.[31] In this state

27 This literature is comprehensively reviewed in OECD, *Tax Effects on Foreign Direct Investment*, supra note 20, at 46-66. The review reports the findings of a META analysis undertaken by de Mooij and Ederveen of 31 empirical studies of the effect of tax rates on the level of foreign direct investment. See Ruud A. deMooij, "Explaining the Variation in Empirical Estimates of Tax Elasticities of Foreign Direct Investment", *Tinbergen Institute Discussion Paper* 108/3, 2005 (finding a mean semi-elasticity value of -3.72, indicating that a one percent decrease in the source-country tax rate results in a 3.72 percent increase in the level of inbound direct investment). See also Ruud A. deMooij and Sjef Ederveen, "Taxation and Foreign Direct Investment: A Synthesis of Empirical Research" (2003) vol. 10, no. 6 *International Tax and Public Finance* 673-93 (finding, from an analysis of 25 studies, a median elasticity of foreign direct investment to the source-country tax rate of -3.3). See also Dana Hajkova, Giuseppe Nicoletti, Laura Vartia, and Kwang-Yeol Yoo, *Taxation, Business Environment and FDI Location in OECD Countries* (Paris: OECD Economic Studies Paper, 2006).

28 For a brief review of this literature, see James R. Hines, Jr., "Reconsidering the Taxation of Foreign Income", working paper, November 2007, at 19-20 (2008) *Tax Law Review* (forthcoming). See also Mihir Desai, C. Fritz Foley, and James R. Hines, Jr., "Foreign Direct Investment and Domestic Economic Activity", *NBER Working Paper No. 11717*, 2005 (using foreign GDP growth rates, interacted with lagged firm-specific geographic distributions of foreign investments, to suggest that 10 percent greater foreign capital investment is associated with a 2.2 percent greater domestic investment, while 10 percent greater foreign employee compensation is associated with a four percent greater domestic employee compensation).

29 Hines, supra note 28, at 20; *Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties*, supra note 20, at 25 (noting that domestic employment levels depend more on domestic factors, such as labour and product-market flexibility and workforce composition, than the level of inbound direct investment, since any increase (decrease) in the latter tends to be offset with a decrease (increase) in domestic investment); and OECD, *Tax Effects on Foreign Direct Investment*, supra note 20, at 68 ("If FDI crowds out domestic investment through a process of product competition or competition for scarce resources, there may be little positive effect on the domestic aggregate capital stock and employment, at least in the short-run").

30 See, for example, Altshuler and Grubert, "Governments and Multinational Corporations", supra note 18; and Qing Hong and Michael Smart, "In Praise of Tax Havens and Foreign Direct Investment", *CESifo Working Paper Series No. 1942*, March 2007 (allowance for some income shifting using related-party debt can permit an increase in statutory tax rates and a redistribution of the tax burden to domestic firms, with some restrictions being socially optimal in the presence of deadweight costs associated with tax planning).

31 A sense of the dimensions of these effects is suggested by a growing body of empirical literature using German data. See the sources cited, supra notes 14, 22, 24, and 25.

of empirical ignorance, tax policymakers are left with only two broad propositions in which they can have some confidence:

- The choice of related-party debt or related-party equity, and to a lesser extent the choice of location of arm's-length debt, is highly responsive to differences in tax rates.

- The choice of investment location is highly responsive to differences in tax rates for a range of foreign direct investment.

For both residence and source countries, revenue and efficiency effects are plausibly associated with both types of substitutions. In a non-cooperative setting with imperfectly mobile capital, the direction of the substitution of the location of direct investment is probably an unacknowledged, but significant, factor in the choice of deductibility rules for interest expense. From the perspective of capital-importing/source countries, a significant empirical issue is whether inbound direct investment is associated with the realization of location-specific profits.[32] Foreign direct investment that is not associated with the realization of such profits is much closer in its mobility properties to portfolio investment which, although subject to an indeterminate "home-country bias for longer-term investment",[33] is generally characterized as highly mobile and sensitive to changes in short-term after-tax rates of return. With respect to this type of investment, the standard policy prescription in a non-cooperative setting for a capital-importing country, whose economy is small and open, is the non-taxation of income from capital imports, except to the extent that residence countries provide a credit for source-country taxes. In the absence of a credit, any tax on capital imports imposes a wedge between pre- and after-tax returns. Because the tax can be avoided by investing elsewhere, pre-tax returns in the capital-importing country must rise to equate after-tax returns, with the incidence of the tax ultimately falling on immobile factors, such as labour. The inequality in pre-tax returns means that capital is misallocated in the sense that a re-allocation could increase world income. A direct tax on labour is preferable, since it avoids the distortion of the location of investment.[34]

This standard policy prescription of an exclusively residence-based system in the presence of mobile capital is derived by focusing on inbound capital flows from the perspective of a source country that is small and open. Much the same prescription emerges, nonetheless, under a more realistic assumption of simultaneous bi-directional capital flows. For example, Slemrod, Hansen and Proctor[35] derive a "seesaw" principle for the establishment of optimal source-country and residence-country tax rates. Under this principle, an increase in the tax

32 See, in this respect, Dahlby, supra note 16 (reviewing the relevant economics literature articulating two policy propositions: (i) the government of a small open economy should not impose source taxation on capital income if it can set other taxes at their optimal values; and (ii) the government of a small open economy should impose a positive source tax on capital income if it cannot otherwise impose a 100 percent tax on pure profits).

33 For an examination of the integration of capital markets and a continuing home-country bias, see Roger Gordon and Vitor Gaspar, "Home Bias in Portfolios and Taxation of Asset Income", *NBER Working Paper No. 8193*, 2001.

34 See Mark Gersovitz, "The Effect of Domestic Taxes on Foreign Private Investment", in David M.G. Newbury and Nicholas H. Stern, eds., *The Theory of Taxation for Developing Countries* (New York: Oxford University Press, 1987), 615-33; Roger Gordon, "Can Capital Income Taxes Survive in Open Economies?" (1992) vol. 47, no. 3 *The Journal of Finance* 1159-80; and Roger Gordon, "Taxation of Investment and Savings in a World Economy" (1986) vol. 76, no. 5 *American Economic Review* 1086-1102.

35 Joel Slemrod, Carl Hansen, and Roger Proctor, "The Seesaw Principle in International Tax Policy" (1997) vol. 65, no. 2 *Journal of Public Economics* 163-67.

rate on capital imports implies a reduction in the tax rate on capital exports and vice versa. An exclusively residence-based system also emerges in the tax competition literature as a standard policy prescription for mobile direct investment which migrates in response to differences in tax levels. In a non-cooperative setting, tax rates on capital under these conditions will be driven down to very low levels which, in the extreme, approach zero where the marginal costs associated with the presence of additional investment in a jurisdiction are zero. Where maximization of national welfare is the goal, tax policymakers have two principal policy responses: they can either agree to cooperate to set source-country tax rates at an invariant level (or within a defined range), or they can eliminate source-country taxes in favour of residence taxation consistent with the treatment of income from portfolio investment.

For the range of foreign direct investment that is associated with the realization of location-specific profits, an exclusively residence-based system does not emerge, however, as the standard policy prescription.[36] With this category of investment, source-country taxation can be imposed without distorting the choice of investment location; nor should the tax necessarily be shifted backwards, in which case it would not necessarily be borne by immobile factors of production in the source country. In effect, until a broad range of direct investment becomes perfectly mobile, jurisdictions are not, in fact, substitutable, and the assumptions on which much of the tax competition literature is based do not hold.[37] In this context, there is no obvious reason why tax policymakers should allow the repatriation of income free of source-country taxation. National welfare — defined as the sum of taxes and the income of nationals — can be maximized by imposing some level of source-country taxation.

As a significant factor in the determination of the effective tax rate, an interest deductibility restriction should ideally be limited to inbound direct investment that is relatively immobile. The effective tax rate on such investment can be increased by limiting the deductibility of interest while avoiding efficiency losses attributable to the tax-driven migration of mobile direct investment. The principal barrier to implementation of this approach is the need for a legislative proxy for this particular characteristic. Direct investment is mobile where the cost structure across a broad range of jurisdictions is comparable so that barriers to entry are low and competitive forces drive out profits in excess of the opportunity cost of capital.[38] Immobile direct investment is, by derivation, investment without these characteristics. There is surprisingly little, however, in the way of systematic empirical evidence suggesting proxies for the identification of the mobility characteristics of foreign direct investment.[39] In this respect, the extension of controlled foreign corporation (CFC) regimes to income from a range of businesses may provide a starting point for exclusion from interest deductibility restrictions that are targeted to immobile foreign direct investment. For instance, income from foreign base company sales and services and income from some financial services are already subject to some CFC regimes. Other obvious candidates for inclusion are income from offshore financial services generally and income of headquarters corporations and coordination centres, which

36 See, for example, OECD, *Tax Effects on Foreign Direct Investment*, supra note 20, at 77-79.

37 Id, at 25-44 (reviewing different models of the determinants of foreign direct investment).

38 Id, at 30-31.

39 Id, at 72 ("… empirical work that pools FDI across sectors may generate misleading results"). See also Dahlby, supra note 16 (noting identification difficulties that make 100 percent taxation of pure profits impractical).

serve as vehicles for the tax-effective repatriation of earnings from active business operations of affiliated entities. Perhaps most importantly, the extent to which a definition of mobile foreign direct investment should extend to income from a broad range of services and manufacturing or production activities is an empirical issue which requires further study. A range of investment in these sectors is, in fact, location-dependent in the sense that some jurisdictions offer the availability of profits in excess of the opportunity cost of capital because of unique attributes that provide uniquely lower cost structures. Direct investment in these circumstances can appear to be mobile, although not necessarily in response to tax differences. Interest deductibility restrictions should apply to this range of direct investment to ensure source-country taxation of location-specific profits in much the same way as those profits that are available in other sectors, such as natural resources, where costs and barriers to entry are high.

An inability to resolve this necessary identification issue with any legislative precision leaves tax policymakers with the option of applying some form of non-deductibility rule for interest expense equally in the context of mobile and immobile inbound direct investment. Although difficult to calibrate precisely, the resulting increase in the effective source-country tax rate for mobile direct investment could, in principle at least, be moderated by reducing the statutory rate equally for inbound direct investment and domestic investment.[40] It is not clear, however, that this calibration is undertaken in practice, with revenue loss on immobile investment offset by a corresponding or greater increase in the income of nationals from an increased level of mobile investment. Nor is it clear that sufficient empirical, as well as sufficiently nuanced, theoretical tools exist to undertake the necessary calibration, even if its realization were an explicit policy goal.[41] Tax policymakers appear instead, and of necessity, to exercise rough judgment in trading off the need to protect the source-country revenue base from location-specific profits against the possible loss of direct investment that is responsive to the increase in effective tax rates attributable to the adoption of interest deductibility restrictions. For countries, such as Canada, with a range of direct investment opportunities providing location-specific profits, any reduction in national welfare attributable to the migration of mobile investment may be tolerable, because of an offsetting revenue gain attributable to an increase in effective tax rates on immobile investment.[42]

In fact, with only incomplete or, at best, coarse-grained empirical evidence of the mobility properties of the entire range of foreign direct investment, tax policymakers have understandably focused on the use of related-party debt as a transfer-pricing technique consistent with a focus on the potential erosion of source-country taxation from transfer-pricing techniques generally.

40 See, for example, OECD, *Tax Effects on Foreign Direct Investment*, supra note 20, at 134-44 (reviewing the effects of tax planning on the computation of forward-looking effective tax rates in estimating the impact of corporate tax reforms on foreign direct investment flows); and Haufler and Runkel, supra note 17 (describing a simple two-country model of the relationship between increases in effective tax rates attributable to thin capitalization rules and welfare gains or losses from competition for mobile investment). See also Dahlby, supra note 16; and Hong and Smart, supra note 30.

41 OECD, *Tax Effects on Foreign Direct Investment*, supra note 20, at 125-33 (noting the need for more empirical evidence of the effect of tax-planning techniques, such as the use of hybrid financial instruments, hybrid entities, and third-country financing affiliates, on effective tax rates).

42 See, for example, *Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties*, supra note 20, at 24-25 (noting the lack of empirical evidence on the relationship between reduction of the effective corporate tax rate through earnings stripping and the level of inbound direct investment, as well as the negligible impact on aggregate employment unless there is unemployment in the markets for labour that is required for the type of investment).

The apparent empirical assumption is that any change in effective tax rates associated with a transfer-pricing response does not cause tax-sensitive investment to migrate or, if it does, any loss of such investment is compensated for by an increase in tax revenue from location-specific profits associated with relatively immobile investment. This rough empirical assumption seems to underlie the conventional focus of interest deductibility restrictions, such as Canada's thin capitalization rules, on the use of related-party debt as a transfer-pricing technique. As a particular type of transfer-pricing response, the contentious issue with thin capitalization regimes has been the use of a specified leverage ratio[43] as the determinative factor in the application of the arm's-length standard to related-party debt.

43 Unless otherwise indicated, the term "leverage ratio" is used to include either a debt-to-assets ratio or a debt-to-equity ratio, as well as to indicate such ratios in relation to related-party debt and related-party equity or in relation to all debt and all equity of a corporation.

3. Identifying the use of related-party debt as a transfer-pricing technique

Related-party debt can be used in either of two ways to alter the capital structure of a group member and locate deductible interest expense among source countries. One way is to have a group member borrow funds from an arm's-length lender and lend them to another member. The related-party loan effectively moves the interest expense on the arm's-length borrowing to another member of the group, with the borrowing sometimes done in this indirect way to access a lower cost of capital available to the on-lending group member. Another way involves the creation of interest expense within the multinational group by having one group member lend arm's-length equity to another group member. The interest payments on the related-party debt, deductible for the payer in the source country, serve to shift the income back to the related lender, thereby avoiding the corporate tax in the source country. Where this internal financing function is performed by a group member resident in a low-tax jurisdiction, residence-country tax on repatriated earnings can be deferred and even eliminated.

Consistent with transfer-pricing practices generally, tax authorities attempt to protect the source-country tax base by ensuring that the amount of interest expense charged on related-party debt is reasonable. It has long been recognized, however, that such debt differs from other related-party transactions in that altering the form of the transaction alters the tax consequences. Accordingly, tax authorities must also be sure that what appears to be debt in form is also debt in substance. The determination that the amount of interest on related-party debt is reasonable does not differ in kind from the determination of the reasonableness of the amount of the transfer price in other related-party transactions. In general, tax authorities tend to look to arm's-length comparables (or more commonly proxies for such comparables) as the basis for necessary adjustments to the amount of the return. Interest payments that are excessive in amount are denied deductibility and are commonly treated as dividends. The more difficult issue has tended to be the characterization of related-party debt as disguised equity. With related-party debt, the controlling status of a non-resident investor means that the rights and obligations specified in a debt contract are not the outcome of negotiations between parties with opposing economic interests. In short, it cannot be assumed that the particular rights and obligations will be enforced in the same manner as an arm's-length creditor, and it may be assumed instead that the form of the investment as debt deviates from its substance as fixed-payment equity.

Historically at least, country practice has reflected one of two principal approaches to the characterization issue presented by related-party debt: (i) a multifactor inquiry;[44] and (ii) a thin capitalization inquiry.[45] Articulation of the arm's-length standard for the purpose of the characterization of related-party debt is perhaps most closely associated with a multifactor inquiry designed to determine its perceived "economic substance." The OECD, for example,

44 A multifactor approach is sometimes referred to as a "subjective" approach, presumably because no single factor is determinative of the characterization of related-party debt as disguised equity. See Mintz report, supra note 4, at 6.28.

45 Earnings-stripping legislation is a later development. Although there are important differences between this approach and that of thin capitalization legislation, they are both single-factor expressions of the arm's-length standard as applied to related-party debt.

has consistently taken the position that a multifactor assessment of the character of related-party debt as disguised equity is the first-best expression of the arm's-length standard.[46] The inquiry is intended to determine whether an independent person would have provided the debt in the same circumstances, in which case its legal form can be respected for tax purposes. Without giving any special weight to one particular factor over any other, the following kinds of factors are examined in determining whether related-party debt represents a "hidden equity capitalization":[47]

- the borrower's leverage ratio before and after the loan;
- whether the loan is designed to finance the long-term needs of the borrower;
- whether the loan is contributed proportionately to existing shareholdings or as a condition of such shareholdings;
- whether the loan is designed to improve the financial situation of the borrower resulting from losses;
- whether the interest payable is dependent on the result of the borrower's business;
- whether the loan is convertible into equity;
- whether the rate of interest exceeds a reasonable commercial return;
- whether repayment of the loan is subordinated to the rights of other creditors;
- whether repayment of the loan is dependent on the level or timing of profits; and
- whether there is no fixed provision for repayment of the loan.

The case for a multifactor approach to the characterization of related-party debt is often made by contrasting it with a thin capitalization approach,[48] which is nothing more than a particular example of a single-factor inquiry[49] as an alternative to a multifactor inquiry into the consistency of a corporate capital structure with an arm's-length structure. Under thin capitalization legislation, related-party debt in excess of a specified leverage ratio is effectively considered to fail an arm's-length test and is considered to be, in reality, disguised equity. Because it is applied to the facts and circumstances of any particular situation, taking into

46 See, for example, OECD, *Thin Capitalisation: Taxation of Entertainers, Artistes, and Sportsmen* (Paris: OECD, 1987), at 8-36. See also Nathan Boidman, "Inversion, Earnings Stripping, Thin Capitalization and Related Matters — An International Perspective" (2003) vol. 29, no. 9 *Tax Notes International* 879-904, at 897 ("Some countries have no mechanical rules or formula, but can challenge the manner in which a domestic subsidiary is capitalized under that country's approach to the arm's-length principle … or perhaps under general or specific antiabuse or anti-avoidance law"); and General Report, "International Aspects of Thin Capitalization", *Cahiers de Droit Fiscal International*, Vol. LXXXIb (Amsterdam: Kluwer, 1996), 83-139, at 102-04.

47 OECD, *Thin Capitalisation*, supra note 46, at 30. Another example of a multifactor approach is the debt-equity classification regulations that were proposed, and subsequently withdrawn, by the U.S. Treasury department in the early 1980s. United States, Treasury Department, *Notice of Proposed Rulemaking*, 45 Fed. Reg. 18,957 (1980), Prop. Treas. Reg. section 1.385-6 (setting out factors indicating an equity classification of debt that is held proportionally by a shareholder).

48 OECD, *Thin Capitalisation*, supra note 46, at 31.

49 Single-factor approaches are sometimes referred to as "objective" approaches, presumably because of the focus on a single factor as determinative of the characterization of related-party debt as disguised equity. See Williamson and Garland, supra note 2, at 19-21 (labelling single-factor thin capitalization approaches in Canada, Australia and Germany as "objective").

account a number of different factors, a multifactor assessment is generally much more flexible in its application than a thin capitalization provision. At least in theory, reliance on a single-factor as determinative of the characterization issue can result in the denial of an interest deduction on related-party debt that arguably would be considered debt by an independent creditor. This may occur if, for example, the relevant leverage ratio is set too low. If the ratio is set too high, the opposite may occur.

As compared to a multifactor approach to the characterization of related-party debt, a thin capitalization provision may be seen as preferable for two principal reasons. First, the flexibility of a multifactor assessment, which is its strength, is also its weakness, since it creates uncertainty for both taxpayers and tax administrators. The greater the number of factors considered to be relevant, the more difficult it tends to become to determine an arm's length comparable in a specific set of circumstances. Failure to assign relative weight to the various factors compounds the difficulty, particularly if the unique financial or economic circumstances of a creditor and a debtor are to be considered. The uncertainty imposes a compliance burden, which can entail significant costs for both taxpayers and tax administrators.[50] Furthermore, inconsistency of result is unavoidable. The uncertainty of application can also provide multinational groups with room to finesse the boundaries of the standard or, alternatively, may make the standard too restrictive, again depending on how the tax authorities actually apply it. Problems of this kind have always been apparent, for example, in the U.S. experience with the classification of shareholder-held debt in the context of closely-held corporations, where U.S. courts have developed a multifactor assessment of the character of such debt. The sheer volume of the case law, and its focus on any number of factors in no particular manner, appear to have created an enormous degree of uncertainty and associated compliance costs for taxpayers and the Internal Revenue Service ("the IRS").

The need for flexibility in the approach to the characterization of related-party debt may also be somewhat overstated. Corporate finance has become increasingly flexible and complex in the design of securities that combine formal terms and conditions normally associated with debt and equity. An approach to the characterization of these kinds of hybrid securities as debt or equity may have to be similarly flexible to be effective from the perspective of both taxpayers and tax administrators. The characterization of related-party debt as disguised equity is similar to the characterization of shareholder-held debt, which differs notably from the characterization of debt-equity hybrids. Specifically, with shareholder-held debt, it is assumed that the formal terms and conditions of the debt obligation support its characterization as debt. The issue is whether the parties to the apparent debt intend it to serve as equity for non-tax purposes, despite the evidence of the formal terms. Where taxpayers are likely to be involved in an attempt to disguise their intention for tax purposes, the characterization of their relationship on the basis of one particular factor does not seem as unreasonable as it might otherwise. Knowing with some certainty where the boundary lies between debt and equity in the use of

50 See, for example, Mintz report, supra note 4, at 6.28 (characterizing subjective approaches as tending to increase uncertainty, with associated administrative and compliance costs). See also Williamson and Garland, supra note 2, at 19-21 (labelling as "subjective" the multifactor approach used in the United Kingdom, as well as the approach articulated in the U.S. debt-equity case law).

related-party debt, the parties may be left to govern themselves accordingly. Tax policymakers can also much more readily set a single determinative factor at a level that is perceived to realize an acceptable trade-off between protection of the source-country tax base and the ability to attract inbound direct investment.

Moreover, although conventionally framed as a choice between the certainty of a single-factor approach and the flexibility of a multifactor approach, the choice may be largely a false one because of country practice, which has tended to moderate significantly the otherwise stark differences, in both process and result, between a multifactor inquiry and a single-factor, thin capitalization inquiry. In particular, a number of countries that use a fixed leverage ratio as the singular expression of the arm's-length standard moderate the discontinuities in result by providing an exception for foreign-controlled corporations with debt in excess of the specified ratio if it can be demonstrated that their capital structures are consistent with a multifactor approach to the articulation of the arm's-length standard. In effect, purported rigidity of result that is associated with reliance on a single factor, such as a specified leverage ratio, is avoided by limiting a thin capitalization rule to a safe-harbour rule and providing a foreign-controlled corporation with the option to demonstrate that its leverage ratio constitutes an arm's-length ratio in the particular circumstances (for example, by showing that its ratio is in line with those of competitors in the same sector in the same country). Conversely, the compliance and administrative costs associated with the uncertainty of application of a multifactor inquiry as the expression of the arm's-length standard can be moderated by providing a legislative safe-harbour for foreign-controlled corporations whose capital structures are within a specified leverage ratio.[51] Under either approach, the certainty property of a single-factor approach can be captured without sacrificing entirely the flexibility provided by a multifactor inquiry. Differences in both process and result are minimized, therefore, by adopting either:

- a thin capitalization approach with an arm's-length exception based on a multifactor inquiry for foreign-controlled corporations with a leverage ratio in excess of the specified ratio; or
- a multifactor inquiry as the expression of the arm's-length standard with a safe-harbour for foreign-controlled corporations whose leverage ratios are within a specified ratio.

Canada's existing thin capitalization rules are notable in their use of a fixed ratio approach without provision for capital structures that are consistent with the arm's-length standard expressed as a multifactor inquiry. The latter is conventionally seen as necessary to ensure compliance with non-discrimination treaty articles that follow the OECD model. As discussed in more detail in Part 9, the Canadian approach has been to provide a specific treaty exception from the procedural constraint of the non-discrimination principle for the thin capitalization rules. If Canada's rules were to be modified to follow the lead of some countries and account

51 The most developed multifactor approach is probably found in UK administrative practice, where a 1:1 leverage ratio and a 3:1 interest-coverage ratio are used as safe harbours. Austria, as well as the Nordic countries, other than Denmark, use much less formally developed multifactor approaches.

for the tax-driven sourcing of arm's-length debt, as well as the use of related-party debt as a transfer-pricing technique, adoption of an arm's-length exception might prove necessary. In any event, it is arguable that this kind of exception, expressed as a multifactor inquiry into the capital structure of a foreign-controlled corporation whose leverage ratio exceeds the specified ratio, becomes an important substantive element of thin capitalization legislation independent of the procedural constraint imposed by the non-discrimination principle. In particular, an explicit exception for leverage ratios in excess of a specified ratio may be seen as a way to account for inter-sectoral differences that is preferable to the use of tailored ratios for sectors other than the financial sector. Indeed, an important recent trend in country practice is the use of the consolidated leverage ratio of a multinational group as a tighter proxy for an arm's-length exception. This approach has desirable certainty properties, and can be designed to provide some accommodation for the unique circumstances of particular group members. These points are returned to in Parts 7 and 9.

4. Canada's thin capitalization rules

Because dividend payments are non-deductible for the payer, Canadian tax is payable at the general corporate rate to the extent that a foreign-controlled corporation is capitalized with equity, while dividends paid to a non-resident are also subject to Part XIII withholding tax (reduced by treaty)[52] without any credit for corporate tax on the underlying income for non-resident shareholders. Subject to the thin capitalization rules, interest paid or payable to a non-resident debt holder is generally deductible for the payer and is subject only to withholding tax at a statutory rate of 25 percent (reduced by treaty).[53]

Consistent with practice in most countries, this different tax treatment of interest and dividends creates an obvious incentive for a non-resident to capitalize a Canadian corporation with debt. The incentive was acknowledged by the Royal Commission on Taxation[54] and by the federal government in its 1969 white paper, *Proposals for Tax Reform*:[55]

> The Canadian tax system contemplates that non-residents who earn business profits in Canada shall pay income tax to Canada at the rates that apply to Canadians. If a foreign individual carries on business in Canada, he is taxed on the profits in accordance with the normal table of progressive rates. If a foreign corporation carries on business here, it is taxed on the profits at the corporate rate of 50 per cent. If the foreign corporation incorporates a Canadian subsidiary, the Canadian corporation is taxed on the profits at 50 per cent, provided the foreign corporation makes its investment in the form of shares. If, however, the foreign corporation makes its investment as a loan, the interest on the loan is a deduction in computing business profits. It therefore saves tax at 50 percent, but it bears Canadian tax only at the withholding rate of 15 per cent (or 25 per cent if not protected by treaty). It is a natural thing for corporations to borrow, and not unnatural for them to borrow from their shareholders, but the difference in tax rates has tempted some to create corporations with very nominal share capital (say $3) and to make virtually all of their investment as an interest-bearing loan.

In the white paper, the government proposed to address the perceived problem by restricting the "deductibility of non-arm's length interest wherever the ratio of shareholder debt to equity exceeds three to one."[56] In effect, debt held by non-resident shareholders not dealing at arm's length with a resident corporation was to be considered excessive when it exceeded the 3:1 ratio. To the extent of the excess, the corporation was to be regarded as thinly capitalized and the excessive debt more in the nature of equity.

52 The standard treaty rate for foreign portfolio dividends is 15 percent, while the rate for foreign direct dividends is five percent.

53 But see, supra note 5 (unconditional elimination of interest withholding tax on arm's-length debt); and supra note 6 (elimination of interest withholding tax on interest paid to non-arm's length creditors resident in the United States).

54 Canada, *Report of the Royal Commission on Taxation*, vol. IV ("the Carter report") (Ottawa: Queen's Printer, 1966), at 74.

55 Canada, Department of Finance, *Proposals for Tax Reform* ("the white paper") (Ottawa: Queen's Printer, 1969), at 77, paragraph 6.41.

56 Id., at 78, paragraph 6.42.

Despite criticism and some hesitation on the part of the government,[57] the white paper proposal formed the basis of the thin capitalization rules introduced in 1972. In its focus on related-party debt, subsections 18(4) to (6) of the Act reflect the conventional framing of the base erosion problem presented by an interest expense deduction in the context of inbound direct investment. As a response to the transfer-pricing problem presented by the use of such debt, the thin capitalization rules are a single-factor expression of the arm's-length standard, with a specified leverage ratio as the determinative factor. In its current form, subsection 18(4) denies a deduction for interest payable by a Canadian corporation to specified non-residents, to the extent that the amount of the related debt exceeds the equity investment of those persons by more than 2:1.[58] The portion of the non-deductible interest expense is calculated using the following formula:

$$\text{interest expense in year on outstanding debt owed to specified non-residents} \times \frac{\text{monthly average of greatest amount of debt owed to specified non-residents in year minus two times the equity}}{\text{monthly average of the greatest amount of debt owed to specified non-residents}}$$

A "specified non-resident" is defined as:

- a non-resident who, either alone or together with other non-arm's-length persons, owns shares of the capital stock of a Canadian corporation with 25 percent or more of the voting rights or value of all shares (a "specified non-resident shareholder"); or

- a non-resident who does not deal at arm's length with any shareholder who, either alone or together with other non-arm's-length persons, owns shares of the capital stock of a Canadian corporation with 25 percent or more of the voting rights or value of all shares (a "specified shareholder").

Debt capital, defined as "outstanding debts owed to specified non-residents", equals the aggregate of all amounts outstanding as, or on account of, a debt or other obligation on which an amount of otherwise deductible interest is paid or payable to a specified non-resident. As an anti-avoidance measure, subsection 18(6) extends outstanding debts owed to specified non-residents to include any loan made by a specified non-resident to another person on condition that the amount is on-lent to a Canadian corporation ("back-to-back loans").

57 In the white paper, id., the government acknowledged that the proposed thin capitalization provision "is necessarily arbitrary, difficult to administer, and may require alteration at a later date in light of experience".

58 Non-deductible interest expense is not recharacterized as a dividend for purposes of the Act, including non-resident withholding tax. *Tetrad Resources Ltd. v. The Queen*, [1996] 1 CTC 2622, 96 DTC 1808 (TCC) (excess interest expense could not be recharacterized as management fees).

Equity capital is the aggregate of a Canadian corporation's

- retained earnings at the beginning of the year (except to the extent that those earnings include retained earnings of another corporation);
- the monthly average of contributed surplus to the extent that it was contributed by a specified non-resident shareholder; and
- the monthly average paid up capital in respect of shares of any class owned by a specified non-resident shareholder.

For the most part, the thin capitalization rules have remained fundamentally unchanged from their original form enacted in 1972. In its 1998 report, the Mintz committee characterized the rules "as working well",[59] presumably in its function of protecting Canada's source jurisdiction to tax without unduly affecting business operations. The committee offered three recommendations for reform:

- adoption of a 2:1 leverage ratio rather than the 3:1 ratio in effect at the time;
- application of the rules to branches, trusts, and partnerships; and
- tightening of the back-to-back loan rule to extend to comparable arrangements, such as amounts left on deposit, where the relevant indebtedness is back-to-back.[60]

In the February 2000 budget, the government accepted the first recommendation on the apparent basis that some countries had adopted lower debt-equity ratios of 2:1. In addition, the budget papers stated that, "the permitted 3:1 debt-equity ratio is high compared to actual industry ratios in the Canadian economy, suggesting that the 3:1 ratio permits inappropriately high debt levels";[61] and "the new ratio (2:1) provides a better measurement of excessive reliance on related-party debt financing in the context of actual Canadian industry debt-equity ratios".[62] The 2000 budget also proposed the move to monthly averages of debt, contributed surplus and paid up capital instead of the greatest amount of each in a particular taxation year.[63] The compliance and administrative burden attributable to the need to maintain adequate records to support the necessary calculations was apparently seen to be justified in light of:

- the overly restrictive results that could occur because of the use of the greatest amount of debt outstanding to specified non-residents in a taxation year as the determinative amount of such indebtedness in the computation of the leverage ratio; and

59 Mintz report, supra note 4, at 6.29.

60 Id., at 6.30.

61 2000 budget, supra note 3, at 247.

62 Id., at 248.

63 The use of a weighted average to measure the amount of indebtedness is suggested in Williamson and Garland, supra note 2, at 28. The use of approaches that avoid spikes in the measurement of both debt and equity is suggested in Edgar, supra note 2, at 44-46 and 48-49.

- the overly generous results that could occur because of the use of contributed surplus at the beginning of a taxation year and the greater of paid-up capital at the beginning or end of the year as variables in the amount of equity in the computation of the leverage ratio.

More controversially, the 2000 budget also proposed to extend the category of affected indebtedness to include any debt of a Canadian corporation that is guaranteed by a specified non-resident. This particular extension, premised on an assumption that guaranteed debt can be considered equivalent to the provision of debt capital from a specified non-resident, was rejected by the Mintz committee[64] and was never enacted, presumably on the basis that it would unduly interfere with commercial uses of guarantee arrangements. But picking up on another recommendation of the Mintz committee, the 2000 budget also proposed consultation on an extension of the rules to branches, trusts, and partnerships. This proposed consultation, as well as a proposal to similarly consult on an extension of the rules to certain debt substitutes such as leases,[65] was shelved.

At least in terms of their basic structural features, Canada's existing thin capitalization rules are broadly consistent with similarly-focused interest deductibility restrictions in other countries. The Mintz committee's general characterization of Canada's rules is therefore unsurprising. The most significant development in legislative practice since the committee's report has been the extension of interest deductibility restrictions by some countries to limit the sourcing of arm's-length debt.[66] Accounting properly for the tax-driven use of such debt in the context of inbound direct investment is arguably the single most glaring deficiency in Canada's rules.

64 Mintz report, supra note 4, at 6.29.

65 This particular proposal appeared to follow from a recommendation in a background report on the thin capitalization rules prepared for the Mintz committee. See Williamson and Garland, supra note 2, at 2 and 31.

66 At the time of the Mintz report, only the thin capitalization legislation in New Zealand applied to arm's-length debt for deductibility purposes. The U.S. earnings-stripping legislation, enacted in 1989, accounts for all debt in the application of the 1.5:1 safe-harbour leverage ratio. Arm's-length debt is also accounted for in computing the interest-coverage ratio, but non-deductibility is limited to interest expense payable to a related person.

5. Reform options one and two: Alternative approaches limited to the deductibility of interest expense on related-party debt

If it is decided to continue to limit Canada's existing thin capitalization rules to the tax-driven use of related-party debt, there are really only two reform alternatives that are decidedly structural in nature — a generalized rule of non-deductibility and an earnings-stripping approach. As suggested in this part, it is unclear that either of these alternatives would improve appreciably the target-effectiveness of the existing rules.

A. Generalized rule of non-deductibility

In the context of inbound direct investment, a generalized rule of non-deductibility maintains the source jurisdiction to tax business income by eliminating, and not just constraining, the use of related-party debt as a tax-effective form of disguised equity financing. All related-party debt is treated consistently with related-party equity on the assumption that such debt is used exclusively as a transfer-pricing technique. This underlying empirical assumption suggests that the characterization issue with related-party debt is inappropriately framed as an application of the arm's-length standard expressed as a multifactor inquiry. In fact, in the absence of a broad denial of the deduction of interest expense on related-party debt, it is argued by proponents that there is no obvious normative basis to appeal to in determining the level of permissible debt as the outcome of either a multifactor or a single-factor inquiry. The lack of any normative basis can be seen as a function of the distinction generally in the tax law between debt and equity, with an inquiry into the integrity of shareholder-held debt based on the arm's-length standard using screening devices for the tax-driven substitution of related-party debt for related-party equity. In serving the role of a screening device, the arm's-length standard, expressed as a multifactor inquiry, is no more normatively defensible than any other possible standard, albeit there are costs and benefits associated with the various alternatives.

A generalized rule of non-deductibility for related-party debt is suggested in some of the literature,[67] and there is also some limited legislative precedent. For example, under the UK *Income and Corporation Taxes Act, 1988*, interest payable by a resident corporation on debt held by a non-resident corporation was treated as a dividend where the non-resident corporation owned 75 percent or more of the shares of the resident corporation, or both corporations were

67 See, for example, Gary Clyde Hufbauer, *U.S. Taxation of International Income: Blueprint for Reform* (Washington: Institute for International Economics, 1992), at 100-04 (proposing a rule of non-deductibility for interest on related-party debt as part of a move to a territorial system with formulary apportionment of the arm's-length debt of a multinational group). See also Alex Easson, "Company Tax Reform and the Inter-Nation Allocation of Tax Jurisdiction", in John G. Head and Richard Krever, eds., *Company Tax Systems* (Melbourne: Australian Tax Research Foundation, 1997), 285-320, at 315-16 and 319 (suggesting a rule of non-deductibility for related-party interest, rent, and royalty payments, consistent with the taxation of dividends, as part of a package eliminating dividend withholding tax). A rule of non-deductibility is alluded to, but is undeveloped, in the OECD report on harmful tax competition. See OECD, *Harmful Tax Competition: An Emerging Global Issue* (Paris: OECD, 1998), at 59-60.

75-percent owned subsidiaries of another corporation.[68] It was stated in the Carter report that "the simplest solution to this problem of interest payments by a Canadian corporation to non-resident investors with whom it does not deal at arm's length would be to deem such payments to be dividends".[69] The report then went on to recommend adoption of a generalized rule of non-deductibility, "at least in a number of well-defined cases".[70] The UK example was cited in support of the recommendation.

Because of the simplicity of its underlying empirical premise, a generalized rule of non-deductibility for related-party debt appears to be much simpler than any of the alternatives. But the apparent simplicity is deceptive. Indeed, the choice of an appropriate share-ownership threshold beyond which a rule of non-deductibility would be applied is ultimately a question of how restrictive tax policymakers wish to be with the use of related-party debt as a transfer-pricing technique. The restrictiveness of this kind of a rule places considerable pressure on the definition of affected issuers. Realistically, its restrictiveness probably means that it would have to be limited to those situations involving a relatively high level of share ownership such as 75 percent or more of all shares of each class or all shares with full voting rights and share value. It may even be necessary to provide some offsetting benefit, such as dividend imputation credits, so that non-deductible interest is treated as a dividend eligible for credit. However, Canada's historical reluctance to provide the dividend tax credit to non-resident shareholders because of revenue concerns makes this type of compromise unlikely, even if only extended to those shareholders affected by a rule of non-deductibility. Moreover, there would remain a need for some other form of interest deductibility restriction for those circumstances in which share ownership is below that for the application of a non-deductibility rule but is sufficient to provide an element of influence that could facilitate the tax-driven substitution of related-party debt for related-party equity. To the extent that this type of a supporting restriction is required, a generalized rule of non-deductibility would likely fail to provide significant simplicity gains and would have to be justified on other policy grounds as a first-best response to the perceived policy problem.

In this respect, three general considerations cast considerable doubt on the feasibility and desirability of a generalized rule of non-deductibility for related-party debt. Indeed, a generalized rule of non-deductibility has undesirable properties that seriously undermine the policy case for its adoption. First, as already noted, interest deductibility restrictions increase the effective tax rate on inbound direct investment, with possible effects on the decision to locate a range of investment. A generalized rule of non-deductibility for related-party debt would have the most significant effect on effective tax rates of all the possible restrictions and, therefore, the most significant effect on the decision to locate investment. Although it is difficult to assess precisely the extent of this effect, such an assessment cannot be avoided, with any loss of investment balanced against any increase in revenue attributable to a broader rule of non-deductibility.

68 See Williamson and Garland, supra note 2, at 21 (noting that the apparent harshness of the UK rule was tempered by the practice of overriding it in tax treaties). Ireland applies a comparable rule of non-deductibility, which is limited to interest paid by a non-bank resident corporation to a 75 percent non-resident parent corporation or another 75-percent-owned non-resident subsidiary, if: (i) the payee is not resident in an EU member state or a treaty country; and (ii) the payment was made other than in the ordinary course of the trade of the payer.

69 Carter report, supra note 54, at 73.

70 Ibid.

Second, a generalized rule of non-deductibility is arguably over-inclusive in screening for the tax-driven use of related-party debt, primarily because it prohibits the tax-deductible on-lending of arm's-length debt where such a structure may be used for non-tax reasons, including access to a lower cost of capital. Multinational groups have any number of revenue and expense items that should be allocated, for tax purposes, to the jurisdictions in which they operate. Interest is simply one of those expenses. The problematic issue is how much of the interest expense on arm's-length debt of a multinational group should be allocated to source countries and on what basis. A generalized rule of non-deductibility for related-party debt would prohibit the use of such debt as an allocation mechanism. In the presence of this prohibition, a multinational group could still realize an allocation of its arm's-length interest expense by ensuring that some of this debt is sourced through direct borrowings by group members. The extent to which arm's-length debt and related-party debt are perfect or near-perfect substitutes for a multinational group is an empirical issue. As noted in Part 2, there is some evidence that the location of arm's-length debt is tax-sensitive, which would suggest a range of substitutability with related-party debt. The extent of this substitutability would mitigate the apparent over-inclusiveness of a prohibition on the sourcing of arm's-length debt through the use of related-party debt. A plausible empirical assumption, however, is that the location of arm's-length debt is not entirely unconstrained by non-tax factors.[71] Related-party debt may thus be used as a convenient, and defensible, method of effecting an appropriate allocation of arm's-length interest expense.[72] In other words, the simplifying empirical assumption underlying a generalized rule of non-deductibility for related-party debt — that the use of all such debt is tax-driven — is simply incorrect.

Given very different, and more complex, empirical assumptions as to the use of related-party and arm's-length debt, it is suggested in Part 6 below that, in the context of inbound direct investment, the principal focus of a theoretically coherent interest deductibility restriction is the sourcing of arm's-length debt. Consistent with this focus, the tax-deductible use of related-party debt should be permitted to the extent that it represents an indirect means of sourcing the arm's-length debt of a multinational group and, together with arm's-length borrowings of a foreign-controlled corporation, the permissible amount falls within a specified upper limit. Along with the excessive sourcing of arm's-length debt, the conversion of arm's-length equity of a consolidated multinational group to tax-effective related-party debt is an appropriate target of deductibility restrictions. A generalized rule of non-deductibility critically fails to make any attempt to screen for this purely tax-driven use of related-party debt.[73] In attempting to

71 See the sources cited, supra notes 24 and 25.

72 Where non-tax factors favour borrowing directly in the local capital market by a foreign-controlled corporation, the provision of guarantees by the parent corporation or another group member can provide the equivalent of the on-lending of arm's-length debt. See Part 8.B.1.

73 A generalized rule of non-deductibility for interest expense may be defensible, in the context of inbound direct investment, as a response to international tax arbitrage transactions using hybrid financial instruments. Such a rule requires, however, a parallel rule treating all entities as corporations in the same context. It also requires acceptance of non-deductibility by residence countries as a means to enhance source-country taxation. See Tim Edgar, "Corporate Income Tax Coordination as a Response to International Tax Competition and International Tax Arbitrage" (2003) vol. 51, no. 3 *Canadian Tax Journal* 1079-1158, at 1142-50. The policy implications for the international tax system extend well beyond a focus on the use of related-party debt as a transfer-pricing technique or even a limitation on the sourcing of interest expense, which is the underlying rationale for the application of a rule of non-deductibility to interest on arm's-length debt. See Part 6.

perform this function, the arm's-length standard does, in fact, have a defensible normative basis. The issue remains how to express that standard and, in addition, whether to extend it to screen for the tax-driven location of arm's-length debt.

Finally, as discussed more fully below in Part 9, the non-discrimination principle, even as weakly codified in Canada's tax treaties, most likely presents a binding constraint for a generalized rule of non-deductibility; this constraint makes it practically infeasible, even it were a first-best policy response. Because this latter characterization is problematic at best, the costs associated with surmounting the application of the non-discrimination principle should probably be avoided.

B. Earnings-stripping legislation

In terms of country practice focused on the use of related-party debt as a transfer-pricing technique, earnings-stripping legislation tends to be seen as the principal competing approach to thin capitalization legislation. To the extent that the two legislative regimes share this same focus, many of their design features are similar. The major difference is the single factor that is used as a proxy for a multifactor inquiry into the consistency of related-party debt with the arm's-length standard. Instead of the leverage ratio of a corporation, earnings-stripping legislation specifies an interest-coverage ratio. It is not clear, however, that use of this different factor generates significantly different results in the vast majority of circumstances, although there are some important differences in result in some limited circumstances.

The United States was the first country to adopt earnings-stripping legislation to limit the deductibility of interest in the context of inbound direct investment.[74] The legislation was adopted in 1989 as a response to an increasing concern that the judicially-created multifactor inquiry into the status of shareholder-held debt as disguised equity was inadequate to address revenue erosion from excessive debt financing of U.S. corporations by non-residents. Internal Revenue Code (IRC), section 163(j) denies the deduction of interest paid or payable by a U.S. corporation to the extent that: (i) the interest is "disqualified interest"; and (ii) the corporation has "excess interest expense". "Disqualified interest" is defined as all interest paid or payable to a related person to the extent that the IRC imposes no tax on the interest (either mainstream corporate income tax or non-resident withholding tax). "Excess interest expense" is defined as the excess of a corporation's "net interest expense" over the sum of 50 percent of its "adjusted taxable income". "Net interest expense" is the excess of all interest on debt (whether or not held by a related person), which is paid or payable by the corporation during the taxation year over all interest includible in its gross income for that year. "Adjusted taxable income" is the corporation's taxable income calculated without reference to any deduction allowed for net interest expense, net operating losses, and depreciation, amortization, or depletion. The concept of "excess interest expense" thus performs a function similar to the leverage ratio under Canada's thin capitalization rules.

74 France is the other major country to apply an earnings-stripping approach to limit the deduction of interest on related-party debt. But the French legislation also applies if a corporation has a leverage ratio in excess of 1.5:1, making the French approach a combination of an earnings-stripping and a thin capitalization approach.

By using a tax-based equivalent of earnings before income tax and depreciation allowance (EBITDA), the U.S. earnings-stripping legislation avoids a targeting problem of thin capitalization legislation attributable to the use of the balance sheet to screen for the tax-driven use of related-party debt. In particular, the balance-sheet approach depends generally on the historical cost of assets, whether equity is defined indirectly through asset value or directly as the sum of: (i) contributed capital; and (ii) retained earnings. Under either definitional approach, the use of historical asset cost as the baseline for borrowing capacity can be seen to be overly restrictive where a corporation has greater borrowing capacity because of the relatively higher fair market value of its assets. In these circumstances, the permissible leverage for income tax purposes lags behind actual borrowing capacity until an asset acquisition is effected, and the historical cost base is written up to correspond with fair market value. There are no empirical studies, however, of the efficiency effects that might be attributable to this bias in favour of asset acquisitions embedded in thin capitalization legislation. To some extent, any behavioural response may be muted by the specification of safe-harbour leverage ratios that are overly generous. Related-party asset acquisitions, either direct or indirect through share purchases, may also be undertaken to alleviate the effect of an asset base with a low historical cost but high fair market value. To avoid the incurrence of unnecessary transaction costs associated with transaction-based revaluations, some countries permit asset value to be written up when doing so is consistent with financial accounting practice.[75] Other countries provide specifically in the tax legislation for the revaluation of certain assets, particularly intangibles, which can have large divergence in historical cost and fair market value.[76]

Although provision for revaluation in limited circumstances can mute the effect of a thin capitalization deductibility restriction attributable to the use of historical asset cost, the independence from the balance sheet of earnings-stripping legislation realizes more completely consistency of treatment of businesses with comparable asset-value profiles. This consistency of treatment comes at the cost of an irregular impact on cyclical businesses whose revenue stream can vary without affecting borrowing capacity. This undesirable legislative property can be alleviated under earnings-stripping legislation by the provision of a legislative safe harbour, as well as carryover rules for disallowed interest expense.[77] More particularly, even if a U.S. corporation has excess interest expense in a taxation year, a deduction will not be denied if the payer's leverage ratio at the end of the year does not exceed a specified safe-harbour ratio of 1.5:1.[78] Non-deductible interest for a particular taxation year may also be carried forward indefinitely and deducted in a subsequent taxation year to the extent that the affected corporation has an "excess limitation". Similarly, to the extent that a corporation has an excess

75 The Australian and New Zealand thin capitalization rules, for example, permit assets to be revalued in accordance with the relevant accounting standards. But see, in this respect, *Interpretation Bulletin IT-59R3*: Interest on Debts Owing to Specified Non-residents, September 26, 1984, paragraph 8, where the Canada Revenue Agency ("the CRA") has stated that financial accounting principles are to be used in the computation of retained earnings and contributed surplus, but the former cannot include unrealized appraisal surpluses.

76 Proposed changes to the Australian thin capitalization legislation would allow, for example, the recognition of certain intangible assets at values higher than those used for financial accounting purposes.

77 Williamson and Garland, supra note 2, at 30.

78 For this purpose, the total of all indebtedness (that is, both related-party and arm's-length debt) is compared to the sum of all money and the book value for tax purposes of all assets less the amount of indebtedness.

limitation in a particular taxation year, the excess may be carried forward for three years and added to 50 percent of the corporation's adjusted taxable income for the subsequent year in computing excess interest expense.

Carryover rules add some complexity to earnings-stripping legislation and are arguably unnecessary under a thin capitalization approach.[79] As a supposedly defining feature of earnings-stripping legislation, legislative complexity is compounded when a specified leverage ratio is used as a safe-harbour, thereby requiring all of the same design features of thin capitalization legislation.[80] These compliance and administrative costs are offset to some extent, however, by the fact that interest-coverage ratios are concepts that derive their content from information that is available as part of the tax-compliance exercise. By comparison, balance-sheet proxies for the arm's-length standard, such as leverage ratios, tend to be based on financial accounting information which is independent of the tax system. This independence can be problematic where there is some flexibility in the relevant accounting practices, including differences in jurisdictional practices, which becomes especially problematic if, for the kinds of reasons suggested below in Part 7, the consolidated leverage ratio of a multinational group is used as a benchmark against which the leverage ratios of its members is compared.[81] Even so, the choice of an interest-coverage ratio can have an inevitable arbitrariness that may not be as pronounced with leverage ratios, assuming that a defensible case can be made for the choice of the consolidated leverage ratio of a multinational group as the conceptually correct benchmark. Although in principle, there is no reason why the consolidated interest-coverage ratio of a multinational group could not be similarly used a benchmark, EBITDA, when designed as a concept unique to the tax system, presents what are probably even more severe compliance difficulties when it comes to computation on a worldwide basis. Indeed, jurisdictional variation in tax-based EBITDA means that it would more than likely be prohibitively costly to compute it on a consolidated basis for a multinational group. Yet, the alternative of using an accounting-based concept as a safe harbour provides nothing in the way of compliance and administrative cost savings as compared to a thin capitalization approach that is grounded in the use of the consolidated leverage ratio of a multinational group.

Ultimately, deviation from the benchmark of a consolidated worldwide leverage or interest-coverage ratio for various reasons, including access to the necessary information, means that there will be an inevitable arbitrariness to the choice of either type of ratio as proxies for the arm's-length standard. The desired restrictiveness of interest deductibility restrictions is an

79 Williamson and Garland, supra note 2, at 30-31 (noting that the application of a balance sheet test, such as a leverage ratio, is not subject to cyclical fluctuations, and carryover of non-deductible expense is defensible only if the borrowing capacity of a foreign-controlled corporation is to be measured over the life of the corporation rather than annually).

80 See, for example, Mintz report, supra note 4, at 6.28 (characterizing earnings-stripping legislation as overly complex). Because the relevant computation must be made equally in the event that a leverage ratio is specified as a safe harbour, it is not obvious that requiring compliance with both an interest-coverage ratio and a leverage ratio, as is the case under the French approach, adds a further layer of complexity.

81 See, for example, Les Nethercott and Andrew M.C. Smith, "New Zealand's Thin Capitalisation Rules and the Adoption of International Financial Reporting Standards in New Zealand", Working Paper No. 41, 2007, Victoria Centre for Accounting, Governance and Taxation Research; and Andrew M.C. Smith and Les Nethercott, "Thin Capitalisation Rules and the Introduction of International Financial Reporting Standards: A New Zealand Perspective" (2006) vol. 12, no. 1 *New Zealand Journal of Taxation Law and Policy* 61-77. Ideally, inter-jurisdictional variation will be eliminated as national accounting bodies adopt International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board (IASB). IFRS will not be adopted in Canada until January 1, 2011. For the purpose of the safe harbour for leverage ratios consistent with the consolidated ratio of a worldwide group, Germany and the Netherlands, for example, permit the use of either U.S. generally accepted accounting principles (GAAP) or IFRS.

important determinant of this choice, whatever factor is used to specify the level of permissible debt. The choice of a thin capitalization or an earnings-stripping approach would seem, therefore, to come down to an assessment of the differential impact on two types of inbound direct investment: that is, (i) businesses with low asset cost but high value; and (ii) businesses with cyclical variations in revenue streams. Although compliance costs associated with legislative complexity have tended to be seen as more severe with an earnings-stripping approach, those costs have probably been overstated. Many of the same issues, such as the identification of arm's-length debt that can be considered disguised related-party debt (for example, guaranteed debt and back-to-back debt), arise equally under thin capitalization legislation that limits a rule of non-deductibility to related-party debt. Administrative and compliance costs, which are the significant consequential attribute of legislative complexity, arise equally under a rules-based approach, such as that characteristic of the U.S. earnings-stripping legislation, or a standards-based approach characteristic of practice in other countries.[82] If the use of a safe harbour specified in terms of a leverage ratio is abandoned, an earnings-stripping approach may even offer simplification gains for some of the reasons suggested here.

Because the precise dimensions of the efficiency effects attributable to the differential impact of a thin capitalization approach and an earnings-stripping approach on different types of businesses is unknown, it is unclear whether the latter offers sufficiently desirable properties to abandon the former as reflected in subsections 18(4) to (6).[83] Most importantly, it is simply not clear that an earnings-stripping approach strikes a more acceptable balance between the need to protect source-country taxation of location-specific profits and the need to attract a level of inbound direct investment. Much depends on the specification of an interest-coverage ratio in the same way that specification of the leverage ratio is critical under a thin capitalization regime. There may well be an element of path dependence in the choice of one approach or the other, where it remains focused on the use of related-party debt as a transfer-pricing technique. This path dependency does not mean that tax policymakers are necessarily locked into what is, in fact, the least desirable option. As discussed in the next part below, a more significant policy choice is the choice to extend interest deductibility restrictions — whether in the form of thin capitalization legislation or earnings-stripping legislation — to arm's-length debt.

82 Simplification gains associated with an extension of a rule of non-deductibility to arm's-length debt are highlighted in Parts 6 and 8.B.1.

83 See, in this respect, Mintz report, supra note 4, at 6.28 (suggesting that an earnings-stripping approach is desirable only if a rule of non-deductibility is extended to domestic tax-exempt investors).

6. Reform option three: Extending a deductibility restriction to interest expense on arm's-length debt

Given the over-inclusiveness of a generalized rule of non-deductibility for related-party debt, the most significant structural issue in the design of interest deductibility restrictions in the context of inbound direct investment is probably their extension to arm's-length debt. As reflected in country practice, this issue affects equally a thin capitalization or an earnings-stripping approach, leaving the kinds of differences between the two approaches described in Part 5 as the basis for choosing one or the other. Extension to arm's-length debt can take one of two forms:

- application of a rule of non-deductibility equally to arm's-length and related-party debt; or
- inclusion of arm's-length debt for the purpose of computing a specified leverage or interest-coverage ratio, but limiting the application of a rule of non-deductibility to related-party debt.

Adoption of the first approach is a relatively recent trend in country practice as a comprehensive means to protect the source-country tax base. The second approach is reflected in the U.S. earnings-stripping legislation and was recommended in a background report on the thin capitalization rules prepared for the Mintz committee.[84] It is suggested in this part that the rationale for the extension of a rule of non-deductibility to arm's-length debt is quite different from the rationale for its application to related-party debt.[85] An approach that accounts for arm's-length debt in the computation of a specified leverage or interest-coverage ratio, but limits a rule of non-deductibility to related-party debt, is broadly consistent with the conventional focus of interest deductibility restrictions on the use of related-party debt as a transfer-pricing technique in the context of inbound direct investment.

It is notable that the extension in some EU countries of interest deductibility restrictions to arm's-length debt has been motivated by the European Court of Justice's (ECJ) characterization of thin capitalization regimes that are limited to related-party debt in the context of inbound

84 Williamson and Garland, supra note 2, at 2. See also Edgar, supra note 2, at 39-40.

85 See, in this respect, Christoph Kaserer, "Restricting Interest Deductions in Corporate Tax Systems: Its Impact on Investment Decisions and Capital Markets", *European Private Equity and Venture Capital Association Special Paper*, March 2008, at 6-7 (characterizing the target of earnings-stripping legislation that applies equally to arm's-length debt as abusive corporate leverage).

direct investment as a violation of the right to freedom of establishment under the EC Treaty.[86] Nonetheless, the uniquely EU context should not obscure the more broadly-relevant rationale for such an extension as a response intended to constrain the ability of multinational corporate groups to allocate interest expense on arm's-length debt to group members carrying on business in various source countries.[87] Given the degree of substitutability of the choice of location of arm's-length debt,[88] the limitation of interest deductibility restrictions to related-party debt leaves considerable room to reduce source-country taxation. As already noted in Part 2, the increasing use of third-country and other financing structures has allowed the deferral and/or elimination of residence-country tax on income repatriated as interest on related-party debt. At the same time, source-country tax can be largely eliminated by combining the tax-deductible use of related-party debt, within legislatively-specified limits, with the unconstrained allocation of arm's-length debt. Obviously, interest deductibility restrictions that are limited to related-party debt allow arm's-length debt of a multinational group to be allocated, without limit, on a tax-deductible basis to a source country. Within the constraints of the relevant deductibility restrictions, related-party debt can be used as an alternative transactional form to allocate arm's-length group debt to a source country.[89] Perhaps not quite so obviously, these regimes also allow related-party debt to be used, within the relevant constraints, to convert arm's-length equity of a multinational group to tax-deductible debt.

The application of interest deductibility restrictions to arm's-length debt in the context of inbound direct investment is difficult to justify, however, as an expression of the arm's-length principle in executing a transfer-pricing response. Comprehensive restrictions, applicable equally to arm's-length and related-party debt, are more defensibly rationalized as a sourcing rule or, more accurately, as an outer limit on the sourcing of interest expense which otherwise would result from an acceptance of the private-law integrity of borrowing transactions, both within and external to a multinational group, as determinative. The principal function of either thin capitalization or earnings-stripping regimes is significantly altered under this different justification. Instead of serving as a transfer-pricing response to the use of related-party debt, a legislative regime that applies a rule of non-deductibility to arm's-length debt in the context of inbound direct investment serves as an overlay on the sourcing of interest expense on

86 The dismantling of thin capitalization regimes in EU countries began with the decision in *Lankhorst-Horhorst* (C-324/00) (2002) ECR I-11779 (characterizing the former German legislation as violating the right to freedom of establishment). Subsequent case law has clarified the relationship between the EC Treaty right to the free movement of capital and freedom of establishment implicated by thin capitalization legislation applicable to related-party debt held by non-residents. See *Lasertec* (C-492/04) (because it applied to a controlling or direct investment, the former German thin capitalization legislation implicated the right to freedom of establishment, which is available to EU nationals only. Any effect on the right to free movement of capital, which is available equally to non-EU nationals, was characterized as incidental only). See also *Thin Cap GLO* (C-524/04) (UK thin capitalization rules implicated primarily the right to freedom of establishment); and *Commission v. Netherlands (Golden Share)* (C-282/04 and C-283/04) (Dutch special share rules implicated primarily the right to free movement of capital, with a secondary effect on the right to freedom of establishment).

87 See, in this respect, Kaserer, supra note 85, at 5 (suggesting that the adoption of earnings-stripping legislation applicable to arm's-length, as well as related-party debt, has been motivated by concern over income shifting by multinationals and the high leverage ratios resulting from corporate acquisitions by private equity funds). Rather than adopt comprehensive interest deductibility restrictions, Portugal and Spain have responded to the ECJ jurisprudence by excluding EU-resident corporations from the application of their thin capitalization regimes.

88 Some of the relevant empirical evidence is cited, supra notes 24 and 25.

89 Appendix 2 provides a simple worked example illustrating the difference in result under a restriction that applies a rule of non-deductibility equally to related-party-debt and arm's-length debt and one that accounts for the latter in the computation of a specified ratio but limits a rule of non-deductibility to the former.

such debt by a multinational group. Under this kind of an extended deductibility restriction, the application of thin capitalization or earnings-stripping legislation to related-party debt performs the much different secondary functions of:

- screening for the tax-driven conversion of arm's-length group equity to related-party debt; and
- limiting the allocation of arm's-length group debt through the use of related-party debt.[90]

As a sourcing limitation, the application of interest deductibility restrictions to arm's-length debt recognizes that sourcing rules generally suffer from an inevitable normative arbitrariness, with interest expense being no different than revenue and expense generally. By allocating revenue and expense between residence and source countries, sourcing rules operationalize the accepted division of the jurisdiction to tax. Ideally, there should be some correspondence between the rationale for assertion of jurisdiction to tax and the specifics of sourcing rules that operationalize that rationale. But as some commentators have emphasized,[91] the notion of a geographic source of revenue and expense lacks any well-defined economic content. This feature is common to any attempt to allocate net income as a tax base among jurisdictions since, as Ault and Bradford point out,[92] it is unclear that the geographic source of income is a coherent concept. The lack of coherence can be attributed to the fact that there is no obvious connection or close correlation between the policy basis for the allocation of net income to a particular jurisdiction and the specifics of the rules, including sourcing rules, that implement the necessary allocation.[93] In other words, the factors posited by sourcing rules are rough proxies for the provision of public goods and services and, as such, they realize, at best, only a rough correlation between the allocation of the tax base and the amount of benefits realized by a taxpayer with a presence in the jurisdiction.

As a general proposition, revenue and expenses of a multinational group are sourced by a combination of the concept of corporate residence and an acceptance of the private-law integrity of transactions entered into by group members.[94] Under this separate-entity/transactional approach, revenue and expenses are attributed to taxing jurisdictions based on the transactions that a group member enters into with independent parties, as well as other group members. The sourcing of revenue and expenses (and the income allocation that results from this acceptance of the integrity of private-law transactions) is overlaid by the application of the arm's-length principle, the origin of which can be traced to the League of Nations 1935 Model Convention on Income Allocation and the background Carroll Report commissioned by

90 The choice of one of these secondary functions is effectively made through the specification of a permissible leverage ratio or interest-coverage ratio. The design of this feature of interest deductibility restrictions is discussed in Part 7.

91 See, for example, Stephen E. Shay, J. Clifton Fleming, Jr., and Robert J. Peroni, "What's Source Got to Do With It? Source Rules and U.S. International Taxation" (2002) vol. 56, no. 1 *Tax Law Review* 81-155; and Hugh J. Ault and David P. Bradford, "Taxing International Income: An Analysis of the U.S. System and Its Economic Premises", in Assaf Razin and Joel Slemrod, eds., *Taxation in the Global Economy* (Chicago: University of Chicago Press, 1990), 11-46.

92 Ault and Bradford, supra note 91, at 12.

93 Shay et al., supra note 91, at 137-39.

94 Richard J. Vann, "Reflections on Business Profits and the Arm's-Length Principle", in Brian J. Arnold, Jacques Sasseville, and Eric M. Zolt, eds., *The Taxation of Business Profits Under Tax Treaties* (Toronto: Canadian Tax Foundation, 2003), 133-69.

the Fiscal Committee.[95] Accordingly, an acceptance of the private-law integrity of transactions entered into by a corporate group member resident in a jurisdiction determines, in the first instance, the sourcing of revenue and expenses. The income allocation resulting from that acceptance can be altered, however, by altering the price associated with related-party transactions to conform to the arm's-length standard.

Interest expense is commonly sourced by physically tracing the use of borrowed funds by a taxpayer (that is, following a paper trail to a particular use). Where borrowed funds are traced to the earning of domestic-source income, the associated interest expense is characterized as domestic-source and, in principle, should be deductible against that income. Where borrowed funds are traced to foreign-source income, the interest expense is characterized as foreign source and, in principle, should be deductible against that income which, if exempt, may or may not support a deduction. The conceptual basis for tracing as a sourcing rule is nothing more than an extension to the cross-border context of a perceived, largely intuitive, appeal in a purely domestic context, where the purpose of the use of borrowed funds must be determined in characterizing interest expense as deductible (income-earning purpose) or non-deductible (personal purpose). The intuition underlying tracing is that interest expense bears a close resemblance to any other payment made for the use of an asset.[96] By analogy with these other rental payments, the deductibility of which is determined by examining the use of the relevant property, the deductibility of interest expense is determined by examining the use of the relevant borrowed funds.

In the context of inbound direct investment, tracing as a sourcing rule tends to provide results that are tantamount to an unrestricted interest expense deduction, since all or substantially all of the income of a foreign-controlled corporation will commonly be sourced in the capital-importing country. As an alternative to tracing, interest expense can be sourced on some formulary basis using factors, such as asset value or gross income. In a general sense, formulary apportionment links interest expense with domestic or foreign-source income, and thereby sources the expense, by piggybacking on the sourcing rules that are used for assets or gross revenue. To the extent that these sourcing rules are seen to be anchored in a sound economic nexus to a jurisdiction, formulary apportionment tends to be characterized in the same positive manner. In fact, the intuition underlying a favourable characterization of formulary apportionment as a sourcing rule for interest expense is the perception that it is more robust against taxpayer manipulation, primarily because it ignores borrowing and lending transactions in the context of multinational corporate groups. The intuition is a familiar one evident more generally in the literature on formulary apportionment as a method to allocate the income tax base associated with cross-border transactions generally among jurisdictions. In the more general context of the allocation of the income base, it is seen as preferable to the separate-entity/transactional method of allocation, which is seen to be susceptible to taxpayer manipulation because of its acceptance of the private-law integrity of related-party transactions, even with the overlay of the arm's-length principle.

95 Mitchell B. Carroll, *Methods of Allocating Taxable Income*, vol. 4 of League of Nations, *Taxation of Foreign and National Enterprises, Studies of the Tax Systems and the Methods of Allocation of the Profits of Enterprises Operating in More Than One Country*, League of Nations document no. C.425(b).M2176(b).1933.II.A (Geneva: League of Nations, 1933).

96 See, for example, Michael J. McIntyre, "An Inquiry into the Special Status of Interest Payments" (1981) no. 5 *Duke Law Journal* 765-810.

Indeed, in the context of inbound direct investment, it is fairly obvious that only some form of formulary apportionment can serve to effectively source offshore some of the interest expense of a foreign-controlled corporation on its arm's-length debt. But this result can be realized only if the assets or gross revenue of the worldwide group are used for allocation purposes, since again all or substantially all of the assets and revenue of a foreign-controlled resident corporation will be sourced in the capital-importing country. The need to account for the worldwide assets or gross revenue of the group presents administrative and compliance complexities that are otherwise associated with the rejection of the private-law integrity of transactions under formulary apportionment. Most importantly, it would require the provision of information to source-country tax authorities that is not otherwise available, with attendant costs. Furthermore, the lack of acceptance of formulary apportionment as a sourcing rule for interest expense means its use by a single country (or a relatively small set of countries) could result in the double counting of interest expense for deductibility purposes or its non-deductibility in both residence and source countries, with undesirable revenue or efficiency costs.

As an alternative to an unqualified application of formulary apportionment as a sourcing rule, an interest deductibility restriction, using either a thin capitalization or an earnings-stripping approach, can combine the robustness of formulary apportionment as a bulwark against revenue erosion with the simplicity gains otherwise associated with a respect for the private-law integrity of transactions and the application of tracing as determinative of the sourcing of interest expense for deductibility purposes. In effect, either type of restriction can be used to impose an outer limit on the sourcing of interest expense, either indirectly through the use of related-party debt or directly through the location of arm's-length debt, without incurring the entire range of administrative and compliance complexities associated with an unqualified application of formulary apportionment.[97] This result can be realized, for example, by using the consolidated leverage ratio of a multinational group as a proxy for an arm's-length capital structure of a foreign-controlled resident corporation. But rather than apportioning interest expense explicitly on the basis of the relative mix of domestic and foreign assets of the consolidated worldwide group, use of the group leverage ratio as determinative of an arm's-length capital structure assumes that debt of domestic members in excess of this ratio has been sourced for tax reasons; it is effectively reallocated to foreign assets by denying the deduction of the associated interest expense. As a proxy for an arm's-length capital structure, the added feature of a specified safe-harbour leverage ratio provides simplification gains for a wide range of corporate groups. In short, the private-law integrity of transactions is respected for sourcing purposes to the extent of the greater of: (i) the specified safe harbour; or (ii) the leverage ratio of the particular worldwide group.[98]

This approach is reflected generally in the New Zealand thin capitalization legislation, which was the first to extend a rule of non-deductibility to the arm's-length debt of a foreign-controlled resident corporation. At a broad level of policy principle, the Australian thin capitalization legislation follows the lead of the New Zealand legislation in the context of

97 Any negative effect on the cost of capital could be muted by limiting application of a rule of non-deductibility to the location of arm's-length debt in the context of inbound direct investment, with the consolidated group leverage ratio serving as a safe harbour. See Kaserer, supra note 85, at 21 (conceding that large multinational firms can mitigate the effect of comprehensive earnings-stripping rules by altering the location of arm's-length debt and equity).

98 The rationale for specification of the level of permissible debt in terms of the consolidated leverage ratio of a multinational group is developed in more detail in Part 7.

inbound direct investment.[99] Much the same extension of earnings-stripping legislation to arm's-length debt is reflected in the recently-adopted German and Italian legislation. Before the adoption of this legislation, both countries had typical thin capitalization regimes limited to related-party debt.[100] Under the new earnings-stripping legislation, a German-resident corporation or an Italian-resident corporation cannot deduct interest expense in excess of 30 percent of "adjusted earnings" (that is, EBITDA). For deductibility purposes, there is no limitation on the amount of the excess to interest on related-party debt. Both legislative regimes provide for an indefinite carryforward of non-deductible interest expense, while the German legislation provides a safe harbour for a corporation with a leverage ratio that is equal to or less than the consolidated ratio of the worldwide group.[101] Although, as already noted, this comprehensive earnings-stripping approach was ostensibly taken as a response to ECJ jurisprudence regarding the consistency of thin capitalization legislation with the right to freedom of establishment under the EC Treaty, an extension to arm's-length debt is not necessarily required to realize this particular goal. For example, French and UK policymakers chose instead to extend thin capitalization deductibility limitations to resident taxpayers related to resident corporate borrowers. German and Italian tax policymakers presumably took the opportunity to reconsider their interest deductibility restrictions in the face of increasing evidence of the substitutability of the location of arm's-length debt by multinational groups.[102] But as evidenced by the Australian and New Zealand thin capitalization regimes, a move to an earnings-stripping approach is not required to realize the imposition of an outer limit on the sourcing of arm's-length debt. A thin capitalization approach was presumably chosen by Australian and New Zealand tax policymakers after consideration of many of the same factors reviewed in Part 5.B.

As an alternative to a comprehensive deductibility limitation applicable equally to related-party and arm's-length debt, the latter can be accounted for in applying the arm's-length standard, but without subjecting it to a deductibility limitation. This approach is used, for example, under the U.S. earnings-stripping legislation where both the 1.5:1 safe-harbour leverage ratio and the term "excess interest expense" are applied on the basis of all outstanding indebtedness and interest expense, respectively. Non-deductibility applies, however, only to

99 New Zealand recently proposed to follow the lead of the Australian legislation in applying its thin capitalization legislation in the context of outbound direct investment. See New Zealand, *New Zealand's International Tax Review: Developing an Active Income Exemption for Controlled Foreign Companies* (Wellington: Inland Revenue, Policy Advice Division and Treasury Department, October 2007), at 57-68; New Zealand, *New Zealand's International Tax Review: A Direction for Change* (Wellington: Inland Revenue, Policy Advice Division, December 2006), at 39-51. The proposals have been carried forward in legislation that also introduces an exemption system for active business income. New Zealand, Minister of Finance and Revenue, *Press Release: Tax Reform to Help New Zealand Companies Compete Overseas* (Wellington: The Treasury, July 2008). As part of a similar move to an exemption system, the United Kingdom has also proposed using the consolidated leverage ratio of a worldwide group as a benchmark in limiting the sourcing of interest expense domestically in the context of outbound direct investment. See United Kingdom, *Taxation of the Foreign Profits of Companies: A Discussion Document* (London: HM Treasury and HM Revenue and Customs, June 2007), at 25-26.

100 Denmark has also supplemented its thin capitalization legislation, which applies to related-party debt, with an earnings-stripping limitation applicable to interest on all debt. Under two additional tests, interest expense of a Danish corporation is deductible to the extent that it does not exceed: (i) 6.5 percent of the tax value of "qualifying assets"; and (ii) 80 percent of EBITDA. A de minimis exemption is provided equal to € 2.7 million net interest expense. The tax value of qualifying assets includes only 20 percent of the tax acquisition cost of foreign subsidiaries.

101 A de minimis exemption is provided for a German-resident corporation that is not a member of a group and incurs no more than € 1 million per year.

102 The extension to arm's-length debt also applies equally in the context of outbound foreign direct investment, consistent with the thin capitalization legislation in Australia and New Zealand.

the extent that excess interest expense includes such expense owed to related persons. The result is an ordering rule whereby arm's-length debt is considered to fill first the borrowing capacity of a foreign-controlled resident corporation. Related-party debt may be used to fill the remainder of that capacity, thereby permitting arm's-length debt of the multinational group to be allocated to an affiliate through the use of related-party debt. In general, an interest deductibility restriction that takes into account all indebtedness of a resident corporation, but without applying the restriction to arm's-length debt, may be supported on the basis that it approximates the economic reality of a capital structure that includes debt held by a controlling shareholder.[103] In particular, debt held by a shareholder is often subordinated to all other debt and, accordingly, it lies somewhere in between debt and common shares in terms of the risk and return payoff profile. On the assumption that a particular corporation has some maximum borrowing capacity, a portion of the debt held by a shareholder may serve as equity to the extent that it is subordinate to all other debt, and it exceeds that maximum capacity less the amount of debt held by persons other than shareholders. The ordering assumption implicit in an interest deductibility restriction that takes into account indebtedness owed to persons other than significant shareholders seems to accord roughly with this economic reality.

Accounting for arm's-length debt for the purpose of computing the specified leverage ratio, but excepting interest expense on such debt from non-deductibility, does not address, of course, the tax-driven allocation of arm's-length debt to a source country. Thin capitalization legislation that adopts this approach remains focused, therefore, on the use of related-party debt as a transfer-pricing technique, with a specified leverage ratio used to screen for the tax-driven substitution of such debt for related-party equity. In this respect, the status of arm's-length debt of a foreign-controlled corporation that is guaranteed by a related party, or is provided on a "back-to-back" basis, remains an issue, since non-deductibility is limited to interest on related-party debt. In short, it must be determined whether there is a range of guaranteed and back-to-back debt that should be treated as the equivalent of related-party debt and thereby subject to a rule of non-deductibility. As noted above in Part 4, the status of guaranteed debt proved to be especially contentious in the context of the only prior attempt at substantial reform of Canada's thin capitalization rules. A desirable feature of thin capitalization or earnings-stripping legislation that applies non-deductibility status equally to related-party and arm's-length debt is the elimination of the need to determine the status of guaranteed and back-to-back debt as one or the other. Multinational groups can be expected to structure the location of arm's-length debt, either through direct borrowings by group members or through on-lending transactions between group members, to ensure compliance with a specified leverage ratio.

The inclusion of all debt of a foreign-controlled corporation in the calculation of the leverage ratio would have much the same effect as lowering the ratio and including only debt owed to specified non-residents. Either type of amendment would make the application of thin capitalization rules more restrictive. Although the case might be somewhat overstated, it is arguable that a more restrictive application realized through a lowering of the ratio in any manner would lead to a loss, at the margin, of some inbound direct investment. A compromise

103 See Williamson and Garland, supra note 2, at 2. See also Edgar, supra note 2, at 39-40.

position would be to account for all outstanding debts owed by a foreign-controlled corporation to any non-resident, with the interest deduction continuing to be denied only in respect of interest owed to related non-residents in excess of the ratio. The theoretical defensibility of this kind of compromise position is nonetheless unclear. There would appear to be no obvious reason to distinguish arm's-length debt owed to non-residents from arm's-length debt owed to residents in the computation of the leverage ratio. The fact that interest income may or may not be fully taxable has no apparent relevance to the computation of the ratio. At best, such a compromise would move the computation closer to the theoretically correct position without, perhaps, having an adverse impact on the level of inbound direct investment.

7. Specifying the level of permissible debt

Part 2 emphasized that, under thin capitalization legislation, the specified leverage ratio serves as a single-factor expression of the arm's-length standard applied to related-party debt as a transfer-pricing technique. Where such legislation extends to arm's-length debt, Part 6 suggested that a specified leverage ratio serves the much different function of providing an upper limit on the permissible sourcing of interest expense for deductibility purposes. In fact, the extension of a thin capitalization regime to arm's-length debt, with a rule of non-deductibility applying equally to such debt and related-party debt, changes the fundamental nature of the legislation in the context of inbound direct investment. Instead of screening for the use of related-party debt as a transfer-pricing technique, the legislation limits the sourcing of arm's-length debt, whether effected directly through borrowings by a resident group member or indirectly through the on-lending of arm's-length group debt. With earnings-stripping legislation, the same functions are performed by the specification of the interest-coverage ratio, although a relatively tight leverage ratio may also be used as a safe harbour. In specifying these ratios, thin capitalization regimes (as well as earnings-stripping regimes with safe-harbour leverage ratios) are far from consistent. The inconsistency may be attributable, in part at least, to a lack of clear thinking regarding the role played by the specification.

There would appear to be three, theoretically defensible, approaches to the specification of a leverage ratio.[104] One approach uses the ratio of a multinational group computed on a consolidated basis (that is, ignoring related-party debt and related-party equity) as the relevant ratio for all group members. This approach is premised on an assumption that a particular member's appropriate share of the arm's-length debt of a multinational group is the relative proportion of the arm's-length debt and equity for the group as a whole. Another approach uses either a mean or a median ratio for all resident corporations as representative of an arm's-length capital structure. A standard based on the ratios of all resident corporations is somewhat general; a standard based on particular industry ratios attempts to account for the uniquely sectoral circumstances of different corporations. A third approach is based on the premise that a leverage ratio is an admittedly blunt tool for the identification of the tax-driven sourcing of debt, and the level at which tax policymakers set the ratio is an outcome of the resolution of the question of how stringent they want to make an interest deductibility restriction relative

104 The ratio could be set entirely arbitrarily, but the theoretical basis for doing so is unclear. A fourth approach would set the ratio at a level that precisely calibrates and trades off revenue gain from an increase in effective tax rates against a loss of national income attributable to the migration of tax-sensitive foreign direct investment. Although theoretically defensible, this approach is not feasible in the absence of sufficient empirical evidence, particularly the responsiveness of the entire range of foreign direct investment. Moreover, existing modelling techniques are insufficiently nuanced in the sense that they generally fail to account for the full range of tax-planning techniques affecting effective tax rates.

to other jurisdictions.[105] A ratio in line with the most lenient standard attempts to prevent a country from being the less desirable jurisdiction for a multinational group to locate interest expense, but leaves it vulnerable in comparison with other jurisdictions. A ratio in line with the most restrictive standard attempts to make a country one of the more undesirable jurisdictions for the location of interest expense, but it can affect the decision to locate investment.

Where a thin capitalization regime applies to all debt of a foreign-controlled corporation, these approaches are not necessarily mutually exclusive and, in fact, they can be combined in an effort to capture the positive properties of each while minimizing their negative properties. A combined approach begins with the proposition that the overall capitalization of a worldwide group, ignoring related-party transactions, is a first-best baseline.[106] The rationale for the use of this identification tool is the fact that the consolidated leverage ratio of the group reflects the level of risk acceptable to shareholders, who determine the level of acceptable leverage through the share-pricing process. Use of the consolidated leverage ratio of a multinational group as the baseline for the leverage ratio of each group member permits the arm's-length debt of the group to be allocated to various source countries either directly through borrowings by affiliates from arm's-length lenders or indirectly through related-party on-lending of the same borrowings. Any allocation in excess of the consolidated group ratio is considered a conversion of arm's-length equity to related-party debt, which is effectively characterized as exclusively tax-driven and thereby the target of a rule of non-deductibility.

Use of the consolidated leverage ratio of a worldwide group as the singular expression of the arm's-length standard is tantamount, however, to asset apportionment and suffers from the kinds of problems noted in Part 6. Perhaps most importantly, it entails administrative and compliance costs associated with the need to obtain the necessary information to calculate a consolidated group ratio.[107] But these negative properties can be managed by specifying a safe-harbour ratio consistent with either the dominant practice in other countries or a general or sectoral mean or median ratio. This type of approach is evident in the New Zealand thin capitalization legislation, which specifies a 75-percent debt-to-assets ratio in an apparent effort to provide a looseness of application consistent with transfer-pricing practices generally. Foreign-controlled resident corporations that exceed this ratio can justify their particular ratios if they are within the consolidated ratio of the worldwide group to which they belong. The New Zealand legislation also provides, however, a 10-percent uplift to account for any unique circumstances that support an allocation of the arm's-length interest expense of the

105 Australia and New Zealand provide an apparent example of an approach that pegs specification of the level of permissible debt to that of other countries with similar non-tax attributes who may compete for some of the same inbound direct investment. Australia first introduced thin capitalization legislation in 1987 applicable to related-party debt only. New Zealand followed in 1995 with thin capitalization legislation applicable to both arm's-length and related-party debt. However, the level of permissible debt in the New Zealand legislation was set at the same 75 percent of domestic assets that was specified in the Australian legislation. When Australia, in 1997, subsequently lowered the level of permissible debt to 66⅔ percent, New Zealand proposed doing the same. See New Zealand, *Interest Deductions for Companies: A Government Discussion Document* (Wellington: Inland Revenue, Policy Advice Division, September 1999), at 24-26. But before the proposal was implemented, Australia introduced its current legislation in 2001, applicable to all debt of a foreign-controlled corporation, and moved back up to a 75-percent debt-to-assets ratio. In the face of this change, New Zealand abandoned its proposal to move to a 66⅔ percent debt-to-assets ratio.

106 But see, in this respect, Mintz report, supra note 4, at 6.29 (concluding that there is little merit in technical modifications of the definitions of debt and equity, including the use of a global leverage ratio).

107 See Williamson and Garland, supra note 2, at 30 (characterizing use of the consolidated worldwide group ratio as "equitable" but complex and difficult to enforce).

group in a proportion that is greater than that which would be allocated by applying the consolidated leverage ratio. For example, the magnitude of the operations of the foreign-controlled corporation measured in terms of gross revenue or wages may indicate that a different allocation is appropriate, or the corporation may be engaged in a business that is conventionally more highly leveraged than the other businesses of the group. Although the New Zealand legislation is not so limited, it is arguable that the empirical premise of an uplift provision suggests that it be made available only to the extent that a particular foreign-controlled corporation's additional borrowing capacity is filled with debt issued directly to arm's-length lenders. In essence, the uplift should be unavailable where the borrowing capacity of a particular group member, measured in terms of the consolidated group ratio, is already filled with related-party debt.[108] Such debt would be stacked first against the relevant leverage ratio, with arm's-length debt filling any balance up to the amount of the consolidated ratio plus the specified uplift.[109]

The administrative and compliance costs associated with use of the consolidated leverage ratio of a multinational group are presumably manageable because of the limited circumstances in which this ratio must be relied on as the baseline against which the allocation of arm's-length debt is measured.[110] Moreover, outside of the financial sector, where regulatory leverage ratios can be used as an expression of arm's-length ratios,[111] tailored ratios for particular industry sectors are not as obviously required under an approach that combines the use of a fixed ratio with an exception for ratios consistent with a worldwide consolidated group ratio, plus an uplift provision.[112] Provision for a leverage ratio that is in line with the consolidated ratio of a worldwide group leaves a thin capitalization deductibility restriction exposed, however, to

108 The safe harbour under the German earnings-stripping legislation for a corporation with a leverage ratio no greater than that of the worldwide group is available only if less than 10 percent of net interest expense is paid to a shareholder with a 25 percent or more holding who is not part of the group. The test must be satisfied by each member of the group.

109 For the limited purpose of this effective ordering rule, arm's-length debt of a foreign-controlled corporation that is guaranteed by a related party would have to be characterized as either arm's-length or related-party debt. See Part 8.B.1 regarding the status of guaranteed debt generally under interest deductibility provisions that are limited to interest on related-party debt.

110 The Australian legislation provides an exception for a capital structure that can be characterized as consistent with the arm's-length standard. In the context of outbound direct investment, an exception is provided for leverage ratios of resident corporations that are no greater than 120 percent of the consolidated ratio of the worldwide group. Costs associated with the acquisition of the required information for the computation of the consolidated ratio of a worldwide group were presumably considered to be manageable in the case of an Australian-based multinational. The possible application of the non-discrimination principle would appear to have also been a factor in choosing an exception for arm's-length capital structures rather than structures that are a multiple of the consolidated leverage ratio of a worldwide group. See Part 9.

111 See, for example, section 20.2 of the Act providing a 95 percent debt-to-risk-weighted-assets ratio for authorized foreign bank branches. The Australian thin capitalization legislation specifies the level of permissible debt for authorized deposit-taking institutions (ADIs) in terms of a required capital base equal to four percent of risk-weighted assets. Because of their functional equivalence with regulated banks, principal business moneylenders should probably be subject to much the same tailored ratio. This approach may be preferred to application of the same single ratio for non-financial corporations with a netting of arm's-length debt against loans made to arm's-length borrowers. In particular, this approach can provide avoidance opportunities. For example, the New Zealand legislation contains an "on-lending exception", which was apparently intended to provide for the higher leverage ratios of banks. The exception was presumably chosen instead of the use of regulatory leverage ratios because of the absence of the use of such ratios by domestic regulators. The banking sector, which is almost exclusively Australian owned, used their New Zealand capital base to leverage investment in preferred shares of foreign corporations. Dividends from the shares were treated as exempt income for New Zealand purposes, with interest expense fully deductible against New Zealand-source income. These transactions prompted the introduction of a specialized thin capitalization regime for the New Zealand banking sector consistent with the Australian legislation. See New Zealand, *Technical Development of a Thin Capitalisation Calculation for Banks* (Wellington: Inland Revenue, Policy Advice Division, June 2004).

112 Japan uses reasonable multiples for non-financial sectors. In 2002, the Bush administration proposed to replace the 1.5:1 safe-harbour leverage ratio under the U.S. earnings-stripping legislation with ratios tailored to different asset classes. Seven asset classes were proposed, with debt-to-asset ratios ranging from 0.98 to 0.50. This proposal was abandoned because of the added complexity in defining and applying the asset classes. Switzerland uses tailored ratios for 12 different asset classes.

"debt-dumping" transactions, whereby debt of a non-resident parent corporation (or another group member) is transferred to a group member resident in the particular source country. In effect, this approach allows a highly-leveraged multinational group to move a portion of its arm's-length debt entirely for tax reasons — that is, to ensure that the debt is sourced in the most tax-efficient manner. This tax-driven sourcing can be addressed by specifying a fixed leverage ratio that is relatively tight and independent of the consolidated leverage ratio of a multinational group, with the provision of tailored ratios for the financial sector and possibly other sectors such as real estate. But as noted briefly in Part 2 and discussed more fully in Part 9, the unavailability of an exception for foreign-controlled corporations with leverage ratios consistent with the arm's-length standard may expose a thin capitalization to the application of the non-discrimination principle. The point made here is that use of the consolidated leverage ratio of a worldwide group can be seen to provide the equivalent of an arm's-length exception at lower administrative and compliance costs, with possibly less revenue leakage than an exception that depends on the application of an indeterminate multifactor inquiry. Revenue leakage from debt-dumping transactions may be addressed by adopting debt-creation rules, although identification issues make their effectiveness unclear.[113]

Where a thin capitalization regime does not account for arm's-length debt of a foreign-controlled corporation, either for deductibility purposes or in the computation of a specified leverage ratio, use of the consolidated leverage ratio of a multinational group does not have an obvious theoretical basis to serve as a benchmark against which a particular capital structure can be assessed.[114] Use of this benchmark is defensible primarily as an upper limit on the allocation of arm's-length debt of a multinational group. Related-party debt is seen as nothing more than a mechanism by which arm's-length debt of the group can be allocated to a source country, with the consolidated leverage ratio of a worldwide group serving to screen for transactions that attempt to convert arm's-length equity into tax-deductible related-party debt. Thin capitalization legislation that focuses exclusively on related-party debt does not identify its tax-driven use in this same way. Indeed, because arm's-length debt of a foreign-controlled corporation is unaccounted for, related-party debt can be used to convert arm's-length equity of a multinational group into such debt on a tax-deductible basis even where the consolidated leverage of the group is used. Screening for tax-driven related-party debt should probably be done instead through an expression of the arm's-length principle either as the mean ratio of all corporations resident in a source jurisdiction or those resident corporations in the same sector. It is simply not obvious that use of the consolidated leverage ratio of a worldwide group, as a form of modified asset apportionment, serves a function that adds anything to an inquiry into the consistency of related-party debt with the arm's-length standard.

Whether or not a thin capitalization regime accounts for arm's-length debt, looseness of application realized through specification of a generous leverage ratio permits some conversion of arm's-length equity to tax-deductible related-party debt. The difference in this particular property between the two approaches is a difference of degree in the sense that the same

113 See Part 8.B.3.

114 Extension of the thin capitalization rules to arm's-length debt, even if only for the purpose of computing the leverage ratio, requires that equity include both related-party and arm's-length equity to properly measure the borrowing capacity of a foreign-controlled corporation. See, for example, Williamson and Garland, supra note 2, at 28. This approach is followed in the Australian and New Zealand thin capitalization legislation.

ratio used under both will provide greater conversion opportunities where arm's-length debt is not accounted for in any manner. Either way, the consequent reduction in the effective source-country tax rate attributable to the use of a loose ratio can be seen as an attempt to compete for a range of inbound direct investment.[115] Using both conservative and broad measures of leverage, there is some empirical evidence relevant to specification of a leverage ratio.[116] More particularly, this evidence suggests, consistent with the 2000 budget proposal, that a fixed ratio greater than 2:1 is non-binding and arguably a poor proxy for an arm's-length capital structure. The looseness in application realized through ratios in excess of this level can be seen as excessive, albeit a precise calibration of the associated costs and benefits is impossible given the existing state of the empirical evidence on the mobility of foreign direct investment. It may be the case that a more acceptable balance between revenue maintenance and competitiveness concerns can be realized by specifying a relatively tight leverage ratio, such as 1.5:1, and accounting for arm's-length debt, at a minimum, in the computation of the ratio, with an exception for ratios that are a modest multiple of a consolidated worldwide group ratio.

The thin capitalization regimes in some countries, such as Australia and New Zealand, specify a level of permissible debt as a percentage of the domestic asset base of a foreign-controlled corporation. Because a debt-to-assets ratio is similarly based on the balance sheet of a corporation prepared for financial accounting purposes, there should be no reason, in terms of substantive result, to favour this type of ratio over a leverage ratio that uses a direct measure of the equity of a corporation. A more significant issue may well be the choice of tax values or financial accounting values generally as the basis for the computation of the leverage ratio.[117] A debt-to-assets ratio may be preferred if, as under Canada's thin capitalization rules, some of the elements of equity are tax-based.[118] But if asset values are also tax-based, such as they are under the U.S. earnings-stripping legislation, there would again be no obvious reason in terms of substantive result to prefer an indirect measure of equity.[119] Otherwise, the principal reason to choose one over the other would appear to be perceived administrative and compliance

115 See, in this respect, Altshuler and Grubert, "Governments and Multinationals", supra note 18 (arguing that high-tax countries compete for direct investment by allowing tax-planning structures that reduce effective tax rates).

116 See, for example, Shee-Boon Law, "The Choice of Fixed Accounting Ratios as Safe Harbours in Thin Capitalization Rules — Some Guidance from Commercial Debt Contracts" (2006) vol. 21, no. 2 *Australian Tax Forum* 363-86 (comparing the leverage ratios under the Australian, New Zealand and U.S. legislation with accounting ratios used in debt contracts). See also Jen Baggs and James A. Brander, "Trade Liberalization, Profitability, and Financial Leverage" (2006) vol. 37, no. 2 *Journal of International Business Studies* 196-211 (finding, for the period 1984 to 1997, a median debt-to-assets ratio of 65 percent for a sample of Canadian corporations); Tim Edgar, Jonathan Farrar, and Amin Mawani, "Foreign Direct Investment, Thin Capitalization, and the Interest Expense Deduction: A Policy Analysis" (2008), *Canadian Tax Journal* (forthcoming) (finding, for the period 1996-2005, that a 2:1 debt-equity ratio is non-binding for most non-financial sectors in Canada other than real estate); and Andrew M. C. Smith and Paul V. Dunmore, "Double Tax Agreements and the Arm's Length Principle: The Safe Harbour Ratio in New Zealand's Thin Capitalisation Rules", Working Paper No. 14, 2005, Victoria University Centre for Accounting, Governance and Taxation Research (finding that: (i) only about five percent of foreign-controlled New Zealand corporations had debt percentages in excess of the 75 percent debt-to-assets safe harbour ratio under the New Zealand thin capitalization legislation for the period 1983-92 before the enactment of the rules in 1995; and (ii) foreign-controlled corporations in excess of the specified debt percentage do not tend to carry as much interest-bearing debt as New Zealand-owned corporations).

117 For a review of various technical issues attributable to the use of tax values in the computation of equity, see Williamson and Garland, supra note 2, at 25-28. See also IT-59R3, supra note 75, paragraph 8 (financial accounting principles are to be used in the computation of retained earnings and contributed surplus, but the former cannot be a negative amount).

118 See, for example, Williamson and Garland, supra note 2, at 25 (noting that the concept of paid-up capital in the definition of share capital is a tax-based concept that is not adjusted on a secondary-market share purchase).

119 Use of the consolidated leverage ratio of a worldwide group as a proxy for the arm's-length principle ideally requires the use of financial accounting values in the measurement of debt and equity to ensure consistency of measurement. An uplift provision could be used to accommodate variations in measurement because of the continued use of tax-based values in computing the leverage ratio of a foreign-controlled corporation on an unconsolidated basis.

costs. There is no available evidence that these costs are appreciably different under either measure; nor is there any evidence that the integrity of the financial accounting information that is the source of either measure is preferable.

Use of an interest-coverage ratio under earnings-stripping legislation is, of course, a much more substantively different, single-factor proxy for the arm's-length standard as applied to related-party debt; it is also a much different expression of the upper limit on the sourcing of arm's-length debt under comprehensive earnings-stripping legislation applicable to such debt. In principle at least, the same approaches that can be taken to the specification of a leverage ratio can be taken to the specification of an interest-coverage ratio. There would not appear, however, to be much in the way of systematic empirical evidence of interest-coverage ratios either generally or for particular sectors.[120] Although far from complete, the existing empirical evidence for leverage ratios seems to be more extensive. The relatively thinner empirical evidence may mean that their specification is even more explicitly a function of the need to balance revenue erosion against the level of inbound direct investment as a function of effective tax rates.[121] Furthermore, interest-coverage ratios may be even more variable on a sectoral basis, which makes the use of the consolidated ratio of a multinational group with an uplift that much more desirable. In this respect, Part 5 noted that the informational constraints attributable to jurisdictional variation in the use of tax-based EBITDA may be greater than the same constraints attributable to jurisdictional variation in the use of leverage ratios based on financial accounting practice. Where earnings-stripping legislation is extended to arm's-length debt, particularly in the application of a rule of non-deductibility, it may be necessary to follow the lead of the German legislation and provide a safe harbour specified in terms of the consolidated leverage ratio of a worldwide group.

120 See Law, supra note 116, for a summary of some of the empirical evidence of the use of leverage ratios in debt contracts. It is notable that the German and Italian earnings-stripping legislation both specify interest-coverage ratios of 2.33:1, while the U.S. legislation specifies a 1:1 coverage ratio. It is difficult to explain the difference on the basis that the German and Italian legislation apply non-deductibility to interest on all debt, since the U.S. legislation accounts for all debt in the computation of the ratio. Moreover, there would appear to be no appreciable difference in the interest-coverage ratios of U.S.-owned and foreign-controlled non-financial corporations. See Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties, supra note 20, at 11-21; and Harry Grubert, "Debt and the Profitability of Foreign-Controlled Domestic Corporations in the United States", Department of the Treasury, Office of Tax Analysis, OTA Technical Working Paper 1, July 2008. The difference in specification of the permissible level of debt may reflect greater leverage in the U.S. corporate sector and a desire to accommodate this corporate policy for tax-policy purposes. The generous interest-coverage ratio under the Danish earnings-stripping legislation appears to track the same leverage ratio under its thin capitalization legislation applicable to related-party debt.

121 Specification of a tighter interest-coverage ratio has been the focus of a number of proposals to tighten the U.S. earnings-stripping rule. See generally, *Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties*, supra note 20, at 27-28.

8. Reform option four: Incremental reform of the existing thin capitalization rules

A fourth reform option is amendment of certain design features of the existing thin capitalization rules to enhance their effectiveness in limiting the tax-driven use of related-party debt. As noted above in Part 4, some of these possible amendments were considered by the Mintz committee,[122] and some were proposed in the 2000 federal budget but never adopted. Each of these possibilities, along with some others, is reviewed briefly in this part. In general, the possible amendments would make the rules more restrictive. Each is analyzed in terms of its rationale, potential problems, and benefits. Where relevant, developments in country practice and policy thinking since the release of the Mintz report and the 2000 budget are noted.

Incremental reform possibilities are grouped into the two general categories of first-order and second-order design issues. The former consists of those core elements of interest deductibility restrictions that implement the chosen policy goal. Together, they target the restrictions by defining:

- the range of affected debt issuers;
- the range of affected debt holders;
- the level of permissible debt; and
- the range of affected payments.

Because the most significant policy issue for Canada's thin capitalization rules is the need to properly account for arm's-length debt, specification of the level of permissible debt in the form of a leverage ratio was discussed separately in Part 7. Although there is a credible case to extend a rule of non-deductibility to arm's-length debt, such an approach would constitute a fundamental policy shift. The more conservative reform option, consistent with previous recommendations,[123] would account for arm's-length debt in determining the borrowing capacity of a corporation, but would continue to exclude it from a rule of non-deductibility. Where arm's-length debt is accounted for in this way, the consolidated leverage ratio of a multinational group can be used as the equivalent of an arm's-length exception to a fixed-ratio limitation. Outside of the financial sector, a 2:1 ratio can be seen to strike an acceptable compromise between the need to maintain the revenue base and attract desirable inbound direct investment, although a tighter 1.5:1 ratio can be defended. But if the existing thin capitalization rules are not amended, at a minimum, to account for arm's-length debt in the computation of the leverage ratio, a 2:1 ratio is arguably overly generous. Indeed, in the absence of a proper accounting of arm's-length debt in the capital structure of a foreign-controlled corporation, it is simply not clear what ratio is appropriate, since the use of tax-driven debt is no longer defined in terms of the conversion of arm's-length group equity into otherwise deductible, related-party debt.

122 Mintz report, supra note 4, at 6.28-6.30. See also Williamson and Garland, supra note 2, at 25-33; and Edgar, supra note 2, at 32-54.

123 Williamson and Garland, supra note 2, at 2 and 25-26; and Edgar, supra note 2, at 39-40.

The other first-order design issues reviewed in this part are:

- extension of the thin capitalization rules to a range of unincorporated organizational forms;
- extension of the rules to a range of debt substitutes; and
- modification of the definition of direct investment for the purpose of the rules.

It is suggested that, although there is no systematic evidence of the substitution of branches, resident partnerships, and resident trusts for Canadian corporations in response to the thin capitalization rules, the necessary technical exercise required to realize consistency of treatment may be worth undertaking, especially if the rules are tightened in their application to the corporate form to account for arm's-length debt. Any attempt to extend the range of affected payments to address debt substitutes, as well as extend the range of affected debt holders to include domestic tax-exempt entities, is much more problematic. There also would appear to be no compelling reason to alter the level of share ownership, which effectively distinguishes inbound direct from portfolio investment. There may nonetheless be a case for the adoption of: (i) more complete supporting rules with respect to constructive and indirect share ownership; and (ii) a rule deeming a foreign partnership to be a person for the purpose of applying the share ownership threshold.

The second-order design issues considered in this part of the report consist generally of those issues that are secondary to the basic targeting issues; they are related to the first-order design issues, but they do not alter the basic targeting aspects of the legislation. Many, but not all, of the possible reforms in this category focus on potential avoidance techniques and are in the nature of specific anti-avoidance rules. They may be preferred to the vagaries of the judicial application of the general anti-avoidance rule (GAAR) in section 245 of the Act. The most significant second-order issue remains the status of guaranteed debt, if it is decided to continue to limit a rule of non-deductibility to related-party debt. Even if arm's-length debt is accounted for in the computation of the specified leverage ratio, it must be determined whether there is a range of guaranteed debt that can be considered a tax-driven substitute for related-party debt. The other second-order design issue that likely merits some attention is the need to account for debt and equity of the Canadian affiliates of a multinational group on a consolidated basis. Much the same effect can be realized currently by forcing all debt and equity through a Canadian holding corporation. Accounting for debt and equity of a Canadian sub-group on a consolidated basis is necessary where it is considered that the non-tax costs associated with the holding corporation structure are significant enough to warrant undertaking the necessary technical exercise of designing such rules in the absence of consolidated reporting generally under the Act.

Whether classified as first-order or second-order in nature, certain of these incremental reforms would need to be considered equally in the event that it were decided to extend a rule of non-deductibility to interest on arm's-length debt. Such an extension would eliminate, however, the need for some amendments, and this consequence is noted where relevant.

A. First-order design issues

1. Distinguishing direct from portfolio investment

The definition of a "specified shareholder" in subsection 18(5) effectively distinguishes inbound portfolio from inbound direct investment for purposes of the thin capitalization rules. The distinction is drawn through the specification of a level of share ownership that is presumably considered sufficient to enable the tax-driven substitution of related-party debt for related-party equity with little difference in non-tax attributes. There would appear to be two possible approaches to this design issue. One approach involves a comparison of different levels of share ownership used by various countries in their comparable legislation. This kind of comparative approach is based on an assumption that wherever the level of share ownership is drawn, there will be an element of normative arbitrariness. Given this unavoidable property, the definition can be drawn by focusing on the relative effect of a thin capitalization provision on the general problem that such a provision is designed to address. The principal difficulty with this kind of qualitative assessment is that differences in the relative restrictiveness of the various elements of the rules in different countries are difficult to quantify and a useful comparison is difficult outside of extreme differences. For instance, not only the relative levels of share ownership, but also the relative leverage ratios (or interest-coverage ratios used in earnings-stripping legislation), should be taken into account, along with the application of deductibility restrictions to arm's-length as well as related-party debt.[124] Although the 25-percent share ownership threshold used in the existing thin capitalization rules is, comparatively speaking, a relatively expansive concept of direct investment,[125] the associated restrictiveness in the application of the rules is offset to some extent by the failure to account for arm's-length debt in the computation of the specified leverage ratio, let alone extend a rule of non-deductibility to all debt. Indeed, it may be the case that this failure has made the relatively low share ownership threshold largely inconsequential.

The alternative to a comparative approach is to isolate some level of share ownership that can confidently be considered representative of direct investment. Any number of possibilities exists, with the principal problem being that any one alternative is, at best, only a rough approximation. The absence of a completely satisfactory approach to the specification of the level of share ownership may mean that maintenance of the status quo is the most prudent course of reform, especially if there is little or no evidence that the existing 25-percent level, applied on a votes or value basis, is inappropriately high or low. In other provisions of the Act, including the foreign affiliate rules, the line between foreign portfolio and direct investment is drawn at ownership of 10 percent or more of the shares of any class. This 10-percent level could be regarded as representative of the status quo generally in a cross-border context, as well as in certain domestic contexts. For the sake of legislative consistency, the thin capitalization

124 Even a superficially qualitative comparison is difficult in the face of a lack of transparency regarding the substantive content of the law which is characteristic of an application of the arm's-length standard expressed as a multifactor approach to the characterization of shareholder-held debt as equity. The UK approach to the application of this approach is a notable exception.

125 A number of countries use a higher threshold of "control", with Australia tracking its definition of a CFC in the context of outbound investment for the purpose of its thin capitalization legislation applicable to "inward investment entities". See Dourado and de la Feria, supra note 8, at 30-31 (noting the wide range of share ownership thresholds used by EU member states); and Kaserer, supra note 85, at 6 (observing that the distinction between direct and portfolio investment tends to be drawn under thin capitalization legislation on the basis of a voting rights threshold of 50 percent, with 25 percent at the lower end).

rules could be amended to accord with this lower standard. It is not clear, however, that such consistency is necessary where a definition of direct investment is applied for different policy purposes.

The 25-percent threshold could perhaps be tightened somewhat by introducing an alternative test based on de facto control of a resident corporation (as defined in subsection 256(5.1)) or returning to the former definition of a specified non-resident shareholder, which referred to ownership of 25 percent or more of any class of shares, rather than the existing votes or value test. In this respect, the definition of a "specified non-resident" effectively incorporates a notion of group ownership, which is defined in terms of the non-arm's-length concept (as defined in subsection 251(1)). This approach to share ownership prevents avoidance of the thin capitalization rules through the payment of interest to a non-resident who does not directly own shares of the payer corporation equal to, or in excess of, the share ownership threshold of 25 percent. Two general amendments, which would alter the concept of share ownership, could make the existing thin capitalization rules more restrictive. One amendment would alter the concept of a group for share ownership purposes to include, for example, two or more persons where the linkage between them is as low as the 25-percent share ownership threshold used in the definition of a "specified non-resident shareholder". Another amendment would provide a set of indirect share ownership rules that would look through one or more holding corporations, partnerships, or trusts to the ultimate owner.[126] These rules could be patterned on the indirect share ownership rules in subsection 256(1.2), which applies for the purpose of determining whether two corporations are associated.

As with the basic level of share ownership, the concept of share ownership should presumably be altered only if there is some evidence that the existing provisions fail to include what may be considered inbound direct investment; or they affect what may be considered inbound portfolio investment. But there would appear to be no systematic evidence that the existing concept of share ownership is, in fact, under-inclusive or over-inclusive. With respect to the latter, the concept of relationship, depending on a voting share ownership link of more than 50 percent, is arguably a relatively narrow concept of a corporate group. It seems unlikely, therefore, that the aggregation of shares owned by related persons results in the application of the thin capitalization rules to what might otherwise be considered inbound portfolio investment.[127] On the other hand, the emergence of private equity funds structured as foreign partnerships raises the possibility that the definition of a specified non-resident is under-inclusive. In particular, where such funds are structured with a majority of non-resident partners as investors, it may be necessary to deem a foreign partnership to be a person for the purposes of the thin capitalization rules. This clarifying legislative amendment[128] would ensure that leveraged acquisitions of Canadian corporations by non-residents are treated

126 Paragraph 18(5)(c) provides a constructive share ownership rule which deems a non-resident to own shares in certain circumstances. Paragraph 18(5)(d) deems shares to have been redeemed in certain circumstances for the purpose of the 25 percent votes or value test.

127 Because the concept of non-arm's length in fact is applied infrequently, the incorporation of that test into the non-arm's-length concept would probably have only a slight effect on the concept of a group for thin capitalization purposes.

128 Paragraph 96(1)(a) requires the income or loss of a partner to be computed as if the partnership were a separate person resident in Canada. Otherwise, a partnership is not a "person" within the definition in subsection 248(1) because it is not a person as a matter of private law. Although there is a concept of partnership assets distinct from the interest of partners in a partnership, it appears necessary to deem a partnership to be a person where such status is required for purposes other than the computation of income or loss at the partnership level.

as direct investments where the relevant 25-percent shareholding is pooled in corporate or non-corporate form, while leaving undisturbed the flow-through treatment of a foreign partnership for income computation and liability purposes generally.[129] Application of the concept of direct investment to private equity funds structured as foreign partnerships would be especially significant in the event that the thin capitalization rules were reformed to extend a rule of non-deductibility to arm's-length debt.[130] In that event, the rules would apply consistently to leveraged acquisitions, whether structured to locate arm's-length debt in Canada through a direct borrowing by a target corporation or through an indirect borrowing with related-party debt owed to an acquiring foreign partnership. Continued limitation of a rule of non-deductibility to related-party debt would affect only the latter structure if the existing rules were amended to deem a foreign partnership, as an acquisition vehicle, to be a non-resident person.

Extension of an interest deductibility restriction to arm's-length debt would eliminate the need to define related-party debt as the category of affected debt. More particularly, if Canada's thin capitalization rules were extended to limit the deduction of interest on all debt, the definition of a specified non-resident could be eliminated. The definition of a specified non-resident shareholder would remain necessary, however, to identify inbound direct investment as the fact pattern in which both related-party debt and arm's-length debt may be sourced to eliminate Canadian tax on Canadian-source income. Consideration could be given to an increase in the level of share ownership indicative of direct investment as a consequence of the increased restrictiveness that would result.[131] A control test, defined in terms of ownership of more than 50 percent of the voting shares of a Canadian corporation, would be consistent generally with the specification of inbound direct investment in the legislation of other countries that accounts for arm's-length debt either in the application of a rule of non-deductibility or in the computation of the level of permissible debt. To address avoidance, the concept would probably require support in the form of an extension to a concept of de facto control. It nonetheless remains unclear empirically that a 25-percent share ownership threshold would affect a range of inbound investment that could be considered to have no influence or control over the choice of location of arm's-length debt, whether effected directly through borrowings by a Canadian corporation from an arm's-length lender or indirectly through on-lending transactions between a non-resident shareholder and a Canadian corporation.

129 In the context of the use of a control test to distinguish inbound direct from portfolio investment, Denmark, for example, amended its thin capitalization legislation to account for share ownership at the level of a foreign partnership as if it were a separate entity. See Arne Mollin Ottosen and Michael Norremark, "Private Equity Funds — Amendments to Denmark's Anti-Avoidance Legislation" (2006) vol. 60, no. 10 *Bulletin for International Fiscal Documentation* 402-10. The amendment was intended to ensure that private equity funds structured as foreign partnerships were within the thin capitalization rules when acquiring a controlling interest in a Danish-resident corporation. The Danish thin capitalization legislation limits, however, a rule of non-deductibility to related-party debt. Recently enacted earnings-stripping legislation applies a rule of non-deductibility to both related-party and arm's-length debt.

130 See Kaserer, supra note 85, at 23-24 (noting that highly-leveraged corporations, which are the result of acquisitions by private equity funds, are impacted significantly by the extension of interest deductibility restrictions to arm's-length debt).

131 For example, when Australia extended its thin capitalization legislation to outbound direct investment and arm's-length debt, the share ownership threshold in the context of inbound direct investment was changed from a 15 percent votes or dividend entitlement/share capital test to a control test.

2. *Extension to Canadian branches, resident partnerships, and resident trusts*

Where a non-resident carries on a Canadian business as a branch or contributes equity to a resident partnership or resident trust, the associated Canadian-source income is taxed generally:

- in the case of a branch, under Part I of the Act as earned and also under Part XIV on the portion of earnings that are not reinvested in Canada;
- in the case of a partnership, under Part I of the Act in the hands of non-resident partners; and
- in the case of a trust, under Part I or Part XII.2 of the Act as earned in the trust but also under Part XIII (non-resident withholding tax) on distribution to a non-resident beneficiary.

By comparison, where a non-resident contributes debt to a resident partnership or resident trust, interest expense is generally deductible in computing income at the level of the partnership or trust and is subject only to Part XIII withholding tax when paid to the non-resident debt holder.[132] The same difference in treatment holds with a Canadian branch to the extent that a related-party loan is provided by a legally-distinct corporate group member to the member carrying on business in branch form, or a notional loan is permitted to be constructed by a non-resident corporation and its Canadian branch.[133]

This bias in favour of debt, along with the non-application of the thin capitalization rules to branches, partnerships, or trusts, can induce the substitution of these organizational forms for Canadian corporations. As already noted, consistency of treatment of these potentially substitutable organizational forms for thin capitalization purposes has been considered before. Conceptually at least, it is a relatively easy matter to realize such consistency by applying the thin capitalization rules at the level of a resident partnership, resident trust, or a Canadian branch. But at the level of important legislative detail, it has also been recognized that some complex technical amendments would be required.[134] For example, the definition of a specified non-resident would have to be extended to include non-resident partners entitled to 25 percent or more of the profits or capital. The definition would have to be similarly extended to include non-resident beneficiaries entitled to 25 percent or more of the income or capital of a resident

132 See "Revenue Canada Round Table", in *Report of Proceedings of the Forty-Fourth Tax Conference*, 1992 Conference Report (Toronto: Canadian Tax Foundation, 1993), 54:1-75, question 12, at 54:8-9 (the requirement to compute income of a partnership as if it were a separate person resident in Canada does not require an assumption that the partnership is a corporation subject to the thin capitalization rules, even where all of the partners are Canadian corporations). The CRA has stated that this position applies only if the partnership is a bona fide partnership and the partners are jointly and severally liable for the partnership debts. See, for example, *Income Tax Technical News* No. 16, March 8, 1999.

133 The recognition of notional transactions, in particular, between a branch and its headquarters and the application of the arm's-length principle generally in the attribution of income to a permanent establishment is the focus of a recent OECD project. See OECD, *The Attribution of Profits to Permanent Establishments — Part I General Considerations* (Paris: OECD 2006).

134 See, for example, Mintz report, supra note 4, at 6.28 (noting some of the legislative complexities involved in extending the thin capitalization rules to branches, partnerships, and trusts, including the income allocation and controlling status issues that are commonly encountered with discretionary trusts). See also Williamson and Garland, supra note 2, at 31 (suggesting that the necessary legislation would be complex and consideration should be given to whether there is sufficient non-corporate investment to warrant the extension of the thin capitalization rules).

trust. Those non-residents who do not deal at arm's length with such persons would also have to be included. The same debt bias in the case of a branch could be addressed by applying the thin capitalization rules to a non-resident who earns Canadian-source income, other than as a partner in a partnership or a beneficiary in a trust. Otherwise deductible interest expense on debt in excess of the relevant leverage ratio would not be deductible to the extent that it is attributable to the earning of Canadian-source income and is owed to a specified non-resident. The definition of equity for the purposes of the leverage ratio would similarly have to be altered because certain amounts, such as stated capital and contributed surplus, are unique to the corporate context. For partnerships and trusts, equity could be defined generally as the amount of partnership or trust capital. For a Canadian branch, equity could be defined as the amount that would be shown on a balance sheet as equity having regard to the activities that produce assessable income from sources in Canada. This particular definitional issue is avoided, of course, if a debt-to-assets ratio is used.

Consistency of application of the thin capitalization rules to otherwise substitutable organizational forms has an obvious intuitive appeal which is confirmed by such application under comparable interest deductibility restrictions in other countries. Nonetheless, the choice to undertake the costs associated with the necessary legislative project to extend the thin capitalization rules to Canadian branches, resident partnerships, and resident trusts depends critically on an assessment of the substitutability of these organizational forms as a means to avoid the application of the thin capitalization rules. In the presence of differences in non-tax attributes that constrain their tax-driven substitution in the context of inbound direct investment, consistency of application is nothing more than a matter of empty legislative form.[135] It is a matter of some significance, therefore, that there is no systematic empirical evidence of the substitutability of these organizational forms in response to the limited application of the existing thin capitalization rules to Canadian corporations.[136] The recent income trust phenomenon has highlighted, however, their tax-driven substitutability, albeit in a predominantly domestic context.[137] Moreover, anecdotal evidence and indirect empirical evidence of the growing tax-driven use of entities that are treated inconsistently by residence and source countries ("hybrid entities") would suggest a greater degree of substitutability than may have been the case in the past.[138] Even if the substitution is driven by other differences

135 But see Williamson and Garland, supra note 2, at 31 (favouring consistency of treatment of branches and corporations but not partnerships, trusts, and corporations in the absence of significant use of these non-corporate forms, presumably as substitutes for the corporate form in the context of inbound direct investment).

136 See, for example, Roger Gordon and Jeffrey MacKie-Mason, "Tax Distortions to the Choice of Organizational Form" (1994) vol. 55, no. 2 *Journal of Public Economics* 279-306. See also Ruding report, supra note 23, at 104-06 (reporting the results of survey evidence that tax considerations play a significant role in the legal structure of foreign direct investment).

137 Entity substitution, as well as the substitution of high-yield, subordinated junk debt for equity, was also the focus of the income-trust structure as a vehicle for the acquisition of U.S. businesses. For a review of some of these structures and an analysis of the Canadian and U.S. income tax consequences, see Andrew W. Dunn and Dennis M. Metzler, "Cross-Border Income Trusts", in *Report of Proceedings of the Fifty-Fifth Tax Conference*, 2003 Conference Report (Toronto: Canadian Tax Foundation, 2004), 28:1-45.

138 See, for example, the sources cited supra note 18. Tax-efficient structuring of outbound direct investment, including the use of hybrid entities in "Tower structures", is a focus of the interest deductibility restriction in section 18.2. Canada, Department of Finance, *News Release* 2007-041, May 14, 2007.

in tax treatment,[139] failure to apply the thin capitalization rules equally to Canadian branches, resident partnerships, and resident trusts presents a significantly unconstrained opportunity to use related-party debt, in particular, to further erode source-country taxation.

The imperative to apply the thin capitalization rules consistently to these organizational forms may be that much more compelling in the event that the rules are extended to arm's-length debt for deductibility purposes. The increase in the effective tax rate for use of the corporate form that would result from an extension to arm's-length debt could itself induce a greater degree of substitution of Canadian branches, resident partnerships, or resident trusts as lower-taxed transactional forms. Substitutability of the latter two organizational forms, in particular, for a Canadian holding corporation in leveraged acquisitions could become especially attractive in the event that, as suggested above in Part 8.A.1, private equity funds structured as foreign partnerships were subjected to the thin capitalization rules by deeming such partnerships to be non-resident persons for the purpose of the rules.

3. *Extension to domestic tax-exempt investors*

Restrictions on the deductibility of interest expense can be used as a policy instrument to dampen any apparent bias in favour of interest rather than dividend distributions. With resident taxable investors, the inter-corporate dividend deduction and the dividend tax credit reduce the shareholder-level tax such that there may be no general bias one way or the other. But this is not the case with tax-exempt entities such as pension funds. Because dividends are not deductible for a resident corporation and the dividend tax credit is non-refundable, domestic tax-exempt shareholders are effectively subject to corporate tax in respect of the underlying income out of which dividends are paid. Because interest expense is generally deductible for a resident corporation, the return on debt held by domestic tax-exempt investors is not subject to corporate tax for the payer or any other tax for the investor.

In the context of direct investment in publicly-traded corporations, the recently-enacted specified investment flow-through (SIFT) legislation effectively treats deductible interest distributions as dividends, thereby mitigating the bias in favour of debt investments by domestic tax-exempt entities.[140] Perhaps most importantly, the legislation does not affect debt issued by private corporations, whether held directly by domestic tax-exempt entities or indirectly through private equity funds. Much the same bias also continues to hold for non-resident tax-exempt investors, such as sovereign wealth funds, with portfolio investments in Canadian corporations. This debt bias in the private-equity context could be mitigated by extending a thin capitalization restriction to interest expense payable to domestic or non-resident tax-exempt entities. A form of such an approach has been adopted under the U.S.

139 This would appear to be the case, for example, with private equity funds structured as partnerships with non-resident investors as the partners. Where a resident partnership is substituted for a resident holding corporation as an acquisition vehicle, the thin capitalization rules may be avoided when debt is pushed through the acquisition vehicle through to the target corporation. Indirect share ownership rules can be used in addition to separate-entity treatment to attribute debt and equity of a target corporation to non-resident partners. See Part 8.A.1.

140 Sections 197 and 122.1.

earnings-stripping rule, which applies to interest on debt held by domestic tax-exempt entities related to the issuer. But the rationale underlying a thin capitalization provision focused on related-party debt does not generally reflect the economic and legal aspects of the relationship between a corporate issuer and a tax-exempt investor.[141] In particular, debt of a Canadian corporation held directly by a domestic tax-exempt entity tends to be in the form of what may be considered portfolio investment. In the context of deductibility restrictions focused on related-party debt, a tax-exempt entity will rarely be within the concept of a related party (defined in terms of a specified level of share ownership). Indeed, it may be presumed that what appears to be debt is, in fact, debt.[142]

As already noted, Germany and Italy, as well as Denmark, have enacted earnings-stripping legislation applicable to interest on all debt of resident corporations, whether or not they are foreign controlled. However, where an interest deductibility restriction is extended to arm's-length debt to prevent its tax-driven sourcing, the rationale for this extension is limited to inbound direct investment. As suggested in Part 8.A.1, it is arguable that the acquisition of a direct investment in a Canadian corporation by a foreign partnership should be treated consistently with a leveraged acquisition effected through a non-resident holding corporation. Realization of this result, which can be accomplished by deeming a foreign partnership to be a person for the purpose of the definitions of a "specified non-resident" and a "specified non-resident shareholder", can be seen as broadly consistent with a focus on inbound direct investment. As such, it can be characterized as an incremental reform, even though it would affect investment by tax-exempt entities through a private equity fund. Extension of a comparable reform to the domestic context — that is, investment by domestic tax-exempt entities in private corporations through domestic private equity funds — implicates very different policy considerations. In short, the rationale for the application of a deductibility restriction generally in the context of domestic investment by domestic tax-exempt entities, whether direct or indirect and whether controlling or non-controlling, implicates all forms of investment affected by a tax bias in favour of debt.[143] As such, this type of fundamental reform initiative is beyond the mandate of the Advisory Panel.

141 Application of the U.S. earnings-stripping legislation to debt held by domestic tax-exempt entities related to the issuer was apparently adopted in an attempt to realize consistent treatment of residents and non-residents in similar circumstances and thereby avoid application of the non-discrimination principle in U.S. tax treaties. See, for example, Mary C. Bennett, "Nondiscrimination in International Tax Law: A Concept in Search of a Principle" (2006) vol. 59, no. 4 *Tax Law Review* 439-85, at 453. The legislative history of IRC, section 163(j) also indicates that this position is in addition to the argument that the non-discrimination principle would not be violated because of the potential judicial recharacterization of shareholder-held debt as equity for both residents and non-residents. See, for example, Shay et al., supra note 91, at 114-15. The constraint for reform of the Canadian thin capitalization rules presented by the non-discrimination principle, as it is incorporated in Canada's tax treaty network, is reviewed in Part 9.

142 But see supra note 129 regarding the extension of the Danish thin capitalization legislation to private equity funds structured as foreign partnerships even though non-deductibility is limited under the legislation to interest on related-party debt. By treating the foreign partnership as a separate entity, the acquisition of a controlling interest in a Danish-resident corporation is treated as inbound direct investment.

143 See, for example, Kaserer, supra note 85, at 21 (emphasizing the negative effect on the cost of capital for small and medium enterprises of the extension of a comprehensive earnings-stripping restriction to arm's-length domestic investors).

4. *Debt substitutes*

Capital income consists generally of:

- the normal return to waiting or, alternatively, the price for deferring consumption (also referred to as the time-value return);[144]
- a premium for the assumption of non-diversifiable risk (referred to as the return to risk taking); and
- economic rents or, alternatively, super-normal returns realized from the exploitation of market power.

The international tax-policy literature identifies the first component, as well as an element of the second, with portfolio investment and mobile direct investment. All three components are commonly associated with immobile direct investment. Most importantly, as described in Part 2, location-specific profits in the form of super-normal returns can be subjected to source-country taxation without distorting the choice of investment location.

Interest deductibility restrictions that extend to arm's-length debt are intended to preserve source-country taxation of all three components of capital income on arm's-length equity of a multinational group invested in the country. In effect, the entire return on equity of the group can be subjected to source-country taxation, provided that the consolidated leverage ratio of the worldwide group serves as the upper limit on the allocation of interest expense on group debt, either directly through arm's-length borrowings by group members or indirectly through the use of related-party debt. Where a fixed ratio is used that is greater than the group leverage ratio, group equity may be converted into tax-deductible related-party debt, thereby avoiding source-country taxation of the associated normal return and any return to risk taking. An interest deductibility restriction that is limited to related-party debt, and does not account for arm's-length debt in the computation of the leverage ratio, permits an even greater portion of these returns to be repatriated as deductible interest expense. In effect, related-party debt can be substituted for related-party equity on a tax-deductible basis within the bounds of that ratio. To the extent that a range of debt substitutes can be used to avoid the application of either form of interest deductibility restriction, an additional portion of the normal return and the return to risk on equity can also be repatriated on a tax-deductible basis. Avoidance of source-country taxation can even extend to super-normal returns, depending on the type of debt substitute.

Part 4 noted that the use of debt substitutes to avoid the application of the thin capitalization rules was identified in the 2000 budget as an area of concern, although no public consultation was ultimately undertaken, and no reforms were ever proposed. The use of debt substitutes is especially problematic under the existing thin capitalization rules because of the relatively narrow concepts of indebtedness and interest which are used to target the range of otherwise deductible payments.[145] As interpreted by the courts for the purposes of the Act generally,

144 The normal return also includes compensation for expected inflation.

145 The issue is noted in Williamson and Garland, supra note 2, at 28, with reference to leases and derivative financial instruments but without any discussion.

these concepts of "interest" and "indebtedness" are quite limited."Interest" has been interpreted consistent with its meaning for private-law purposes, requiring that an amount be computed with reference to a principal amount and that it accrue on a daily basis.[146] Similarly, the concepts of "indebtedness" and "debt" appear to be narrow ones tantamount to any transaction that is considered to give rise to a debtor-creditor relationship for private-law purposes;[147] they would not appear to extend to a transaction that could be considered a debt substitute in the sense that it gives rise to the equivalent of normal or time-value returns but does not give rise to a debtor-creditor relationship for private-law purposes. In fact, a narrow concept of "interest", as well as a narrow concept of "indebtedness", does not appear to extend to a range of financial instruments that provide these returns, including, for example:

- fixed-payment debt with embedded derivatives providing a contingent return ("contingent-payment" debt);
- derivative financial instruments, such as deep-in-the-money options and prepaid forward contracts, with an embedded debt element providing a time-value return;
- fixed-payment preferred shares; and
- finance leases providing a time-value return and repayment of an embedded loan.

At a level of general principle, an obvious approach to debt substitutes is to categorize as debt any transaction that gives rise to interest expense deductions (or their equivalent) generally under the Act. It is much more difficult, however, to translate this simple conceptual proposition into legislative form. One possible example is the New Zealand thin capitalization legislation which treats as debt, for the purpose of the legislation, all instruments that give rise to "debt deductions" under the New Zealand accrual regime. In short, all instruments that are classified as debt for the purpose of the accrual regime are treated as debt for the purpose of the thin capitalization regime. Much the same result is realized in Australia, which has adopted comprehensive legislation classifying a wide range of financial instruments as either debt or equity for all income tax purposes, including the thin capitalization legislation.[148] But in the absence of a comprehensive legislative regime that treats debt and a range of debt substitutes equivalently for income and expense recognition purposes, this example is difficult to implement. Indeed, the lack of a comprehensive approach to the characterization of financial instruments as debt or equity is an issue that extends beyond thin capitalization legislation. If classification rules are to be designed, the necessary effort should probably be made for all purposes of the Act and not just for the thin capitalization rules.

In the absence of comprehensive classification rules, the best that can feasibly be done is probably a modest extension of the relatively narrow concepts of interest and indebtedness to include, on an entirely ad hoc basis, some specifically enumerated transactions or instruments

146 See generally, Tim Edgar, "The Concept of Interest Under the Income Tax Act" (1996) vol. 44, no. 2 *Canadian Tax Journal* 277-347. In *The Queen v. Thyssen Canada Limited*, [1987] 1 CTC 112; 87 DTC 5038 (FCA), it was held that late payment charges on purchases of steel by a Canadian subsidiary from its German parent constituted interest for the purpose of subsection 18(4).

147 See, for example, *Uddelholm v. The Queen*, [1987] 2 CTC 236; 87 DTC 5431 (FCTD); and *The Queen v. Thyssen*, supra note 146.

148 *Income Tax Assessment Act 1997* (ITAA), Division 970.

that can be considered to be used commonly as debt substitutes. Adding legislative wording that would extend to amounts paid "in lieu of interest" would not seem to provide any appreciable extension of the concept of interest, even if the concept of indebtedness was similarly extended. Experience with comparable wording in other provisions of the Act suggests that any intended extension would be inconsequential at best.[149] Furthermore, although there is a range of securities and transactions that may be treated as the functional equivalent of debt under the Act for purposes other than the thin capitalization rules, they would not seem to be treated as indebtedness for the purpose of those rules absent a reclassification for all purposes of the Act. For the most part, their private-law form continues to determine their private-law substance and, therefore, their income tax classification absent a specific or generalized deeming rule for income tax purposes.[150]

Comprehensive debt-equity classification rules tend to address hybrid financial instruments: that is, the packaging of two or more financial instruments in the private-law form of a single instrument. Classification issues are also presented by synthetic financial instruments and transactions that are not normally associated with time-value returns but can be used to provide their equivalent. Thin capitalization regimes do not address in any obvious manner the use of this category of debt substitutes that give rise to the equivalent of interest expense deductions, but are not necessarily equated with debt in any manner for income tax purposes. For example, it is arguable that payments on derivative financial instruments should remain deductible where such instruments are used to hedge risk. This deductible status can be used, however, to construct a synthetic position (that is, a combination of two or more legally distinct financial instruments) that mimics the non-deductible return on another single instrument on a tax-deductible basis without being treated as a debt instrument. Similarly, where management and licensing fees (or rental payments generally) remain deductible, these payments can be substituted for profit distributions, at least to the extent of normal returns, and even a thin capitalization restriction, such as that in New Zealand or Australia, which applies to a broad range of instruments giving rise to debt deductions, will not apply. Because such payments are not normally associated with debt, only an explicit inclusion in thin capitalization legislation can subject them to a rule of non-deductibility in the context of inbound direct investment. The alternative is continued reliance on transfer-pricing rules and practices, other than thin capitalization legislation, to address the deductibility status of the entire range of non-debt deductions.

149 See, for example, paragraphs 12(1)(c) and 212(1)(b) where the legal definition of interest appears to be central to the scope of these charging provisions despite the extension to payments on account or in lieu of interest. Only rarely have these words been interpreted to extend to interest surrogates. The same restrictive approach has been taken to subsection 16(1) and its treatment of blended amounts of interest and principal. See Edgar, supra note 146.

150 An obvious example is the treatment of finance leases under the Act. Some countries recharacterize these transactions as leveraged asset acquisitions for income tax purposes consistent with financial accounting practice. But subject to indeterminate recharacterization under the case law, the same result is realized through the specified leasing rules in the Act without treating the transaction as a leveraged asset acquisition with an embedded interest element. See Regulations 1100(1.1)-(1.3) and section 16.1; and Roger D. Ashton, "Leasing: Recent Developments", in *Current Issues in Corporate Finance*, 1997 Corporate Management Tax Conference (Toronto: Canadian Tax Foundation, 1998), 11:1-45, at 11:2-17.

In fact, wherever the line between deductible and non-deductible payments is drawn, there will be pressure on transfer-pricing rules and practices to maintain some constraint on the tax-driven substitution of the former for the latter.[151] But even the extreme case of an all-debt capital structure, in which related-party debt is substituted almost entirely for related-party equity, cannot strip out super-normal returns and all returns to risk-taking as deductible interest expense. In this respect, a significant problem for source-country taxation of super-normal returns and returns to risk taking remains related-party royalty payments that are used as tax-deductible substitutes for dividends.[152] Thin capitalization regimes that use leverage ratios as the expression of an arm's-length overlay on the interest expense sourcing results following from the private-law transactions of a multinational corporate group are ill-equipped to address the use of related-party royalties. In particular, it can be practically difficult to convert a royalty transaction into a notional capitalization with a time-value return, a return to risk-taking, and a super-normal return. One possible way to enhance source-country taxation would be an earnings-stripping approach extended to all forms of interest (that is, interest on both arm's-length debt and related-party debt) and related-party royalty payments. In principle at least, it is much simpler to extend the interest-coverage ratio used under this approach to related-party royalty payments, as well as interest on arm's-length and related-party debt. But the non-discrimination principle, discussed in Part 9 below, presents a potentially binding constraint on this kind of extension of interest deductibility restrictions to royalty payments and other non-debt deductions. Reliance on the principle as the basis for a vigorous assertion of the residence jurisdiction to tax royalty payments could be expected from major capital-exporting countries such as the United States.[153]

151 See, in this respect, Andrew M.C. Smith and Paul V. Dunmore, "Tax Avoidance and the Financial Structures of Non-Resident Controlled Companies in New Zealand" (1997) vol. 13, no. 3 *Australian Tax Forum* 277-309 (speculating that weak transfer-pricing rules during the period 1983-1992 provided considerable income-shifting opportunities for foreign-controlled corporations in New Zealand and, as a result, foreign-controlled corporations were financed with less equity than New Zealand-owned corporations but their debt was more likely to be provided from related-parties as non-interest-bearing current liabilities).

152 Because of non-tax constraints, the choice of location of arm's-length royalty payments would not seem to be as tax-sensitive as the choice of location of arm's-length debt. As a result, the case to extend deductibility restrictions is probably strongest with related-party royalty payments. See, for example, *Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties*, supra note 20, at 7 (distinguishing the tax-driven use of deductible interest expense on related-party debt from other deductible payments on the basis that the former "… does not require any real movement of assets or a change in the business operations of the corporation …").

153 It might be possible to support the application of the thin capitalization rules, without implicating the non-discrimination principle, by following the Italian approach and limiting a rule of non-deductibility to all royalty, management fee, and similar payments made to a resident of a tax-haven country, unless the recipient carries on an active business in the country or there is a primary business purpose for the arrangement. This kind of a supporting rule could even be linked to the anti-tax-haven initiative as a means to reinforce that initiative in the context of inbound direct investment. See 2007 budget, supra note 5, notice of ways and means motion to amend the Income Tax Act, resolutions (31)-(33) (proposing to extend the category of exempt surplus to business income earned by a foreign affiliate in a non-treaty country that has entered into an information exchange agreement and proposing to treat such income as foreign accrual property income (FAPI), subject to accrual recognition by Canadian residents, in the absence of an agreement).

B. Second-order design issues

1. Status of guaranteed debt, non-interest-bearing debt, and offsetting deposits

Interest deductibility restrictions that are limited to the use of related-party debt as a transfer-pricing technique must address the status of arm's-length debt of a foreign-controlled corporation that is guaranteed, or otherwise secured, by a group member. As noted above in Part 4, Canada's thin capitalization rules include only debt held by a specified non-resident in the calculation of the leverage ratio and do not extend to arm's-length debt, whether guaranteed or not, although the 2000 budget included a proposal to include a range of arm's-length debt that is guaranteed by a specified non-resident. The U.S. earnings-stripping legislation is notable as an interest deductibility restriction that is limited to related-party debt, but nonetheless subjects interest on guaranteed debt to possible disallowance.

The failure to include debt that is guaranteed, or otherwise secured, by a non-resident group member is presumably based on the argument that the associated interest expense does not present a revenue erosion problem for a capital-importing country. Where the arm's-length holder is a resident, the interest income is subject to tax under the mainstream income computation rules. Where the arm's-length holder is a non-resident, it may be assumed that the competing interests of the parties ensure that the terms and conditions of the debt may be respected. In other words, it may be assumed that the debt does not serve as disguised equity. Adding the guarantee of a group member would not appear to alter this basis for permitting the unrestricted deduction of interest expense. Guaranteed debt is arguably equivalent, however, to a borrowing by the guarantor and an on-lending of the relevant funds. In this particular form, the transaction would be considered related-party debt. The equivalence is all the more apparent where the borrower could not have obtained the loan on the particular terms without provision of the guarantee of another group member. Under certain conditions, therefore, guaranteed debt may be considered to serve as a tax-driven substitute for a related-party loan to a foreign-controlled corporation.

The inclusion of guaranteed debt for the purpose of interest deductibility restrictions is contentious primarily because of a perceived need to distinguish its tax-driven use from its commercial use to avoid adversely affecting the latter.[154] In the absence of an ability to make this distinction with any confidence, the preferable legislative course is an all or nothing choice of inclusion or exclusion of guaranteed debt for deductibility purposes.[155] Thin capitalization regimes that extend to arm's-length debt as an outer limit on its tax-driven sourcing resolve this choice by including all such debt on a much different basis than the conventional framing of the arguments surrounding the status of guaranteed debt under legislation focused on related-party debt as a transfer-pricing technique. Where interest deductibility restrictions remain limited to related-party debt, the exclusion of all guaranteed debt for deductibility purposes is the preferable choice only if it can be concluded with some confidence that the adverse effect

154 Williamson and Garland, supra note 2, at 29 (suggesting that guaranteed debt should not be included in computing the leverage ratio for thin capitalization purposes, with the exception of those situations in which it is clear that a foreign-controlled corporation could not have borrowed without the provision of the guarantee or where the overall leverage ratio exceeds certain defined limits).

155 Mintz report, supra note 4, at 6.28-6.29 (apparently framing the issue as the same all or nothing choice and preferring exclusion to avoid disrupting commercially-driven uses of guaranteed debt).

on the commercial use of such debt would be worse than any revenue loss attributable to its tax-driven use. There is no empirical evidence bearing on this issue, although country practice is consistent with extension to guaranteed debt where interest deductibility restrictions are limited to related-party debt.[156]

As suggested in Part 6, a compromise position between inclusion and exclusion for deductibility purposes is the inclusion of all arm's-length debt in the computation of the leverage ratio, with a non-deductibility rule applying only to interest on related-party debt. Under this approach, which remains consistent with a focus on related-party debt, guaranteed debt, as a particular type of arm's-length debt, would be excluded from a rule of non-deductibility; it would, nonetheless, be accounted for in determining the balance of any borrowing capacity of a foreign-controlled corporation available for the use of related-party debt as a mechanism to effectively allocate arm's-length debt of a multinational group to a source country. But as also pointed out in Part 6, guaranteed debt would remain available as a means to avoid a rule of non-deductibility. To the extent that it is substituted for related-party debt for this purpose, guaranteed debt should be treated as related-party debt. One possible approach to this identification issue would be to deem all guaranteed debt to be related-party debt to the extent that the leverage ratio of a group member, measured on the basis of arm's-length debt and all equity of the member, exceeds the consolidated ratio of the relevant group. This deeming rule would effectively stack guaranteed debt on top of other arm's-length debt for the purpose of applying a rule of non-deductibility. To the extent that guaranteed debt fills the balance of the permissible borrowing capacity of a group member, determined on the basis of the consolidated leverage ratio of the worldwide group, the use of guaranteed debt would be treated as non-tax driven, thereby preserving its arm's-length status for deductibility purposes.

Unlike guaranteed debt, accounting for all debt in the computation of the leverage ratio does not necessarily address appropriately the status of non-interest-bearing debt. Because such debt does not bear interest, it obviously cannot be used to shift income from the source country tax base (at least when issued on a stand-alone basis). As a result, the intuitively appealing treatment, which is reflected in the existing thin capitalization rules and the comparable rules in most other countries, is its exclusion as debt in the computation of the leverage ratio. In fact, because earnings-stripping legislation uses an interest-coverage ratio as a single-factor approach to screen for the tax-driven sourcing of interest expense, non-interest-bearing debt is automatically excluded. Under this approach, exclusion is effectively the default position, and inclusion would have to be combined with an imputed interest charge in applying the interest-coverage ratio. Under thin capitalization legislation, the status of non-interest-bearing debt as debt means that the default position is inclusion, with imputation of interest occurring automatically in the application of a rule of non-deductibility to interest expense on a proportionate basis. The limitation of thin capitalization legislation to interest-bearing debt realizes the same exclusion of non-interest-bearing debt as that under earnings-stripping legislation.

156 The status of guaranteed debt remains an issue under the U.S. earnings-stripping legislation, with some legislative proposals to modify its inclusion for non-deductibility purposes. See *Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties*, supra note 20, at 30-31.

There are, in fact, three possible treatments of non-interest-bearing debt for the purpose of computing the level of permissible debt under both thin capitalization and earnings-stripping legislation:[157]

- inclusion as debt;
- exclusion as debt and inclusion as equity; or
- exclusion as debt, but without inclusion as equity.

Although there may be some differences in administrative and compliance costs associated with each possible treatment, the choice can be framed as primarily a function of the desired level of restrictiveness (and the associated increase in effective tax rates) of a rule of non-deductibility. Inclusion of non-interest-bearing debt in the computation of the level of permissible debt is the most restrictive option. In effect, inclusion would provide much the same stacking effect as inclusion of guaranteed debt in the computation of the leverage ratio without applying disallowance to interest on such debt. But unlike guaranteed debt, which bears interest, this stacking rule for the purpose of computing the leverage ratio would be sufficient, even where a rule of non-deductibility is limited to related-party debt. By comparison, inclusion of non-interest-bearing debt as equity in the computation of the level of permissible debt is the least restrictive treatment.[158] Exclusion as debt, but without inclusion as equity, is a compromise treatment, with an admittedly intuitive appeal.[159]

Exclusion of non-interest-bearing debt results in different tax consequences for economically equivalent transactions, which means that such debt can potentially be used as an avoidance technique. For example, a single interest-bearing obligation could be split into a non-interest-bearing component and an interest-bearing component, with a higher rate on the latter providing the same risk and return as that associated with the single instrument. This different transactional form could avoid the application of the thin capitalization rules by effectively moving a portion of the principal amount of the single instrument over to a non-interest-bearing obligation that is excluded from both a rule of non-deductibility and the computation of the leverage ratio. Inclusion of all non-interest-bearing debt in the computation of the ratio could provide a systemic response to this type of transaction and comparable transactions, but perhaps at the cost of unduly affecting the commercial use of non-interest-bearing debt. The

157 See, for example, Williamson and Garland, supra note 2, at 28 (concluding that non-interest-bearing debt should be treated as equity or, at worst, excluded as debt in the computation of the leverage ratio).

158 Under thin capitalization legislation that specifies the level of permissible debt as a debt-to-assets-ratio, inclusion as equity is the result of the exclusion of non-interest-bearing debt as debt. Inclusion effectively becomes the default position and exclusion as equity requires an offsetting reduction of assets. The same treatment occurs under earnings-stripping legislation, unless revenue is imputed to non-interest-bearing debt and excluded in the application of the interest-coverage ratio. See Andrew M.C. Smith, "New Zealand's Thin Capitalization Rules" (1996) vol. 44, no. 6 *Canadian Tax Journal* 1525-51, at 1547 (noting that the treatment of non-interest-bearing debt under the New Zealand rules may be a major weakness, since such debt is relatively easy to use in a way that manipulates the leverage ratio).

159 Much the same status issue arises with instruments, such as contingent-payment debt, which may be considered debt as a matter of private law, but does not give rise to interest expense deductions. For example, debt with a participating-payment feature (that is, an amount of interest that is contingent on performance of the underlying assets of the issuer) may or may not give rise to interest expense deductions. Similarly, in the absence of comprehensive classification rules providing for the bifurcation of debt with embedded derivatives into their component parts (that is, a fixed-payment debt instrument and a separate derivative financial instrument), the same classification as either debt or equity must be made on an instrument-by-instrument basis for thin capitalization purposes. See Part 8.A.4.

alternative to inclusion as a response to potential tax-driven use is to rely on transfer-pricing rules to constrain the amount of interest on indebtedness that is issued in combination with non-interest-bearing debt as an avoidance technique. It is unclear whether a specific, purpose-based anti-avoidance rule is required in the presence of the GAAR.

The same kind of difficulty distinguishing between tax-driven and commercial uses of guaranteed debt and non-interest-bearing debt does not arise with back-to-back loans and similar arrangements. A plausible empirical assumption with these kinds of transactions is that they have no commercial use and are entirely tax-driven. Because they can confidently be assumed to serve as disguised related-party debt, interest deductibility restrictions that are limited to related-party debt should apply. In this respect, and as noted in Part 4, it has been recognized for some time now that the back-to-back loan rule in subsection 18(6) should be amended to include all indebtedness that arises between a specified non-resident and another person on condition that an amount representing all, or a portion of, the indebtedness be loaned, provided, or otherwise transferred to a Canadian corporation. This kind of amendment is apparently required because of the conventional interpretative position that offsetting deposits and other arrangements that are equivalent to back-to-back loans are outside of the current wording of subsection 18(6), because they give rise to a debtor-creditor relationship but not a lender-borrower relationship.[160] The lack of any evidence of the use of these kinds of obvious avoidance techniques may be attributable, in part at least, to the possible application of the GAAR.[161] As with guaranteed debt, an extension of a rule of non-deductibility to arm's-length debt would eliminate the need to identify back-to-back loans and comparable arrangements for deductibility purposes.

2. *Netting of indebtedness and loanbacks*

In determining the amount of outstanding debt or interest owed by a foreign-controlled corporation, the dominant country practice permits the netting of debt or interest owing to the corporation. This approach differs from the existing thin capitalization rules where the amount of debt owed to specified non-residents is calculated ignoring any amount owed by those persons to a Canadian corporation. A netting approach is presumably justified on one of two bases. One possible justification is that the inclusion of interest income owing on related-party debt (or all debt under a deductibility restriction that accounts for arm's-length debt) offsets the base erosion otherwise attributable to the deduction by a resident corporation of interest expense owed on related-party debt (or arm's-length debt where a rule of non-deductibility applies to such debt). The principal problem with this justification for a netting approach is that revenue collected on interest income may not provide a complete offset of revenue that is

160 *Minister of National Revenue v. T.E. McCool Ltd.*, [1949] CTC 39; 49 DTC 700 (SCC).

161 Although unclear, the potential application of the GAAR may be the reason that extension of the back-to-back loan rule has not been undertaken, despite the recommendation in the Mintz report, supra note 4, at 6.30. See also Williamson and Garland, supra note 2, at 28-29. The CRA has adopted a relatively restrictive interpretation of subsection 18(6), even where back-to-back loans are involved. The restrictive interpretation is based, in part, on the requirement that the first loan be made "on condition" that the funds be on-loaned to the relevant Canadian corporation. See IT-59R3, supra note 75, at paragraph 3 (indicating that subsection 18(6) will be applied only where application of the thin capitalization rules would otherwise be circumvented or frustrated); and *Income Tax Technical News No. 15*, December 18, 1998 (indicating that subsection 18(6) will not be applied to a second loan where: (i) both loans are in the same amount; (ii) interest earned on the second loan exceeds interest owing on the first loan; and (iii) a specified non-resident shareholder in respect of the first loan made to a Canadian corporation has de jure control over that corporation, as well as the Canadian corporation receiving the on-loaned funds).

forgone by permitting the deduction of interest expense. Putting aside differences in interest rates, the primary reason for the lack of a complete offset is that the tax base of a residence country in respect of foreign-source income of a taxpayer is net of any related expenses and any relief, such as a credit, for foreign taxes paid to the source country on the interest income. By comparison, the interest expense deduction results in the loss of source-country corporate tax to the extent that the expense substitutes for non-deductible dividends. As a result, a capital-importing country may suffer a net revenue loss where interest is deductible because of an effective exception from deductibility restrictions for supposedly offsetting interest income, although the loss may not be as great as it would otherwise be. In the absence of some basis to conclude that debt owed to a resident corporation affects the characterization of debt owed by the corporation to a non-resident, there would appear to be no particularly compelling reason to compute the amount of outstanding debt on a net basis.

Another possible justification for a netting approach is the need to account for the higher leverage ratios of banks and deposit-taking institutions generally. This rationale is relevant, however, primarily for a deductibility restriction that accounts for arm's-length debt.[162] A netting approach leaves the application of this type of comprehensive deductibility restriction to that portion of the capital base of a bank or deposit-taking institution that is used for purposes other than the generation of arm's-length loans. As noted in Part 7, a more narrowly-targeted approach that realizes this same result is the provision of tailored regulatory ratios for the financial sector. A difficult boundary issue with this approach is the status of principal-business moneylenders and near-banks. Although presenting some difficulties, it is not clear that resolution of this issue is sufficiently difficult to warrant the use of a netting approach as a proxy, with tolerance of the over-inclusiveness that such an approach entails.

As with the amount of outstanding debt owed to specified non-residents, the amount of equity of a Canadian corporation attributable to a specified non-resident shareholder is determined on a gross basis. That is, there is no requirement that the amount of related-party equity be reduced by any amount owing to a Canadian corporation by a specified non-resident. At least as an initial proposition, the equity of a resident corporation should be calculated on a gross basis consistent with the calculation of the amount of related-party debt. But the calculation of equity on a gross basis can allow credit for an equity contribution that is made in form only.[163] Inflation of the amount of related-party equity of a foreign-controlled corporation may occur, for example, where an equity contribution is loaned back by the corporation. Even though the particular amount of capital is, in substance, returned to a related non-resident, it remains in form as equity of the corporation. This simple arrangement may be implemented to ensure that an amount of related-party debt owed by a resident corporation remains within the specified leverage ratio.

162 The fact that the application of the thin capitalization rules is limited to related-party debt is apparently the reason that the rules do not impose any restrictions that are unique to foreign bank subsidiaries. Application of a limitation on the sourcing of arm's-length debt, like that in section 20.2 for foreign bank branches, would necessitate special provision either through an on-lending concession (netting of indebtedness) or the use of regulatory leverage ratios as suggested here and in Part 7. See also Grubert, supra note 120, at 21 (suggesting that the netting feature of IRC, section 163(j) may explain a strong association between the amount of interest income and cash flow and the greater interest expense of foreign-controlled domestic corporations).

163 See Williamson and Garland, supra note 2, at 27 (acknowledging that a reduction in the amount of equity for loanbacks "may provide a truer measure of the non-resident's equity investment", but suggesting that sections 15 and 17 would normally deter their use).

One possible way to address loanback arrangements is to require all amounts owing by a non-resident shareholder, or a person dealing at non-arm's length with such a shareholder, to be subtracted from the equity of a Canadian corporation. A more limited anti-avoidance rule would provide an exception to the calculation of equity on a gross basis where the particular facts and circumstances indicate that there is a connection between the use and sources of corporate funds, and the connection is relevant to the characterization issue. For example, a tailored anti-avoidance rule might require all amounts owed to a Canadian corporation by a specified non-resident to be subtracted from the relevant amount of equity where the indebtedness can reasonably be considered to have arisen in connection with a contribution of equity by the non-resident and not in the course of ordinary commercial dealings. This kind of anti-avoidance rule would leave in place the basic computation of equity on a gross basis, while attempting to address the use of loanbacks as a means of inflating the equity capital base. Some measure of certainty of application could be provided by defining the temporal connection between an equity contribution and a loanback, say, within two years of an addition to paid-up capital, retained earnings or contributed surplus. The alternatives to a specifically-tailored anti-avoidance rule for loanbacks are computation of equity on a gross basis with reliance on either the GAAR or a specific anti-avoidance ruled intended to address any transaction that attempts to manipulate the measurement of debt or equity.

3. Debt-creation rules

Specification of a leverage ratio as determinative of the level of permissible debt establishes a bright line within which related-party debt may be used on a tax-deductible basis. Use of a bright-line, whether determinative for characterization purposes or as a legislative safe harbour, can encourage a foreign-controlled corporation, whose debt financing is below the permitted ratio, to leverage its source-country assets to the permitted maximum. For example, a multinational group may have a group member resident in one jurisdiction borrow from a non-resident parent or other group member to acquire a group asset. The creation of the new related-group debt may be undertaken to minimize source-country taxation of the associated income. Debt-creation rules are designed to limit the use of these kinds of related-party transactions. They most obviously apply where an asset is acquired and a non-resident controlling shareholder has an interest in the vendor or the purchaser, or either of these parties is a non-resident controlling shareholder. Where they do apply, debt-creation rules take priority over the application of a thin capitalization provision to deny the deduction of interest expense based on a formula that takes into account the ownership interest of the vendor in a transferred asset and the interest of a non-resident controlling shareholder in either or both of the parties to the transaction.[164]

Although apparently targeted to what is perceived to be the artificial creation of otherwise permissible related-party debt, the premise for debt-creation rules is debatable. Once a bright line is specified, it may defensibly be left to multinational groups to structure their affairs to comply with it. In some instances, that structuring may take the form of a reduction in related-party debt or an increase in related-party equity. It is not obvious why taxpayers should be prohibited from increasing related-party debt, albeit through a related-party asset sale. In fact,

164 The former thin capitalization regime in Australia, limited to related-party debt, incorporated a debt-creation rule targeted to related-party asset sales. See *Income Tax Assessment Act, 1936*, former division 16G.

there is no obvious reason to limit debt-creation rules to related-party debt that is created through related-party asset sales. Conceivably, any transaction that is undertaken to increase the leverage of a foreign-controlled corporation and maximize the permissible interest expense deduction should be ignored.[165] Where the application of thin capitalization legislation is limited to related-party debt, the principal limitation on a broader debt-creation rule would be the creation of related-party debt. Where the application of thin capitalization legislation is extended to arm's-length debt, either in the application of a rule of non-deductibility or in the computation of the leverage ratio, debt-creation rules would similarly extend to the creation of arm's-length debt by "debt-dumping" or "push-down" transactions in which arm's-length debt is moved from one group member to another through, for example, a related-party asset sale.

This kind of broad anti-avoidance rule creates difficult identification issues associated with the need to distinguish tax-driven from non-tax-driven increases in leverage.[166] It also freezes leverage ratios at levels existing on the introduction of interest deductibility restrictions (or on a subsequent increase in the specified ratio) to the extent that any change can be considered tax-driven. A focus on related-party asset sales could be seen as an administratively manageable proxy for the identification of tax-driven increases in leverage ratios. As generally reflected in country practice, the preferable alternative to the use of such proxies is to ensure that the specification of the permissible level of leverage is sufficiently restrictive in attempting to balance revenue protection and the need to attract a desired level of inbound direct investment.[167] The integrity of this structural feature of thin capitalization legislation is enhanced by accounting for arm's-length as well as related-party debt. In effect, the sourcing of both types of debt may be tax-driven, with the specification of a leverage ratio serving to determine the upper limit against which such sourcing is tolerable.

4. Deemed dividend or carryover treatment of non-deductible interest expense

As conventionally framed, the thin capitalization concept is used in an attempt to identify when related-party debt can be considered disguised equity. Consistent with this characterization, non-deductible interest expense should be treated as a dividend for all tax purposes, including

165 A broad concept of debt-creation transactions would include leveraged acquisitions and recapitalizations. An obvious example of the latter in the United States is inversion transactions, which involved the conversion of a U.S. parent corporation to a foreign-controlled subsidiary and its refinancing to leverage it to the maximum allowed under the U.S. earnings-stripping legislation. The transactions were the reason for the Congressionally-mandated study of earnings stripping by the U.S. Treasury department. See *Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties*, supra note 20, at 7-31. See also Jim A. Sieda and William F. Wempe, "Effective Tax Rate Changes and Earnings Stripping Following Corporate Inversion" (2004) vol. 57, no. 4 *National Tax Journal* 805-828 (finding evidence of large reductions in effective tax rates and substantial income shifting out of the United States by inverted corporations); and Mihir A. Desai and James R. Hines, Jr., "Expectations and Expatriations: Tracing the Causes and Consequences of Corporate Inversions" (2002) vol. 55, no. 3 *National Tax Journal* 409-40 (suggesting that market reaction to announced expatriation decisions indicated an expectation that taxes on U.S.-source income would be reduced).

166 There has been some attempt by the CRA to use subsection 95(6) as a response to debt importation transactions in the context of outbound direct investment. See generally, Elizabeth J. Johnson, Genevieve C. Lille, and James R. Wilson, "A Reasoned Response to the CRA's Views on the Scope and Interpretation of Paragraph 95(6)(b)" (2006) vol. 54, no. 6 *Canadian Tax Journal* 571-632.

167 See, in this respect, Vann, supra note 94, at 156 ("Australia has tried to resist erosion of its tax base (with less justification) in the case where a foreign parent was subject to a junk bond buyout and tried to push the debt down to its subsidiaries"). Some countries deny the deduction of interest in the context of leveraged acquisitions. These rules are independent of more generalized thin capitalization or earnings-stripping restrictions. They can be characterized as particularized debt-creation rules. Irrespective of the contentious policy basis for such rules, they invariably present difficult identification issues that undermine their effectiveness.

non-resident withholding tax.[168] As an alternative to deemed dividend treatment, a carryover of non-deductible interest expense can be provided, with a deduction allowed in the year of carryover to the extent that the interest expense of the payer is less than the permitted maximum. This approach, which is used in the U.S. earnings-stripping legislation, as well as the Danish, German, and Italian legislation, effectively applies a thin capitalization provision over the relevant carryover period rather than in one taxation year.

A carryover mechanism is difficult to apply, however, in the context of a thin capitalization provision that depends on the amount of outstanding debt relative to the equity base of a foreign-controlled corporation. For any particular taxation year in which the leverage ratio is exceeded, a determination must be made of the amount of interest expense that is notionally attributable to the permitted maximum amount of debt less the actual amount outstanding for the year. Using the terminology of the U.S. earnings-stripping legislation, this unused amount of principal represents a resident corporation's excess limitation for a particular taxation year for carryover purposes. The unused principal amount must then be converted into an interest expense figure, since it is an amount of otherwise non-deductible interest expense that is to be carried over for deduction purposes. Because a thin capitalization provision does not have the same adverse impact on cyclical businesses as an earnings-stripping approach, based on an interest-coverage ratio, it is unclear whether carryover rules are worth the compliance and administrative costs.[169] Moreover, given convergence in non-resident withholding tax rates for interest and dividend payments, it is similarly unclear whether deemed dividend treatment of non-deductible interest expense is an especially significant consideration. If a rule of non-deductibility were extended, however, to arm's-length debt, deemed dividend treatment would have broader implications. For example, it could be used to deny exemption from withholding tax for interest on portfolio debt. It could also be used to provide tax-free inter-corporate dividend treatment for resident arm's-length lenders.

5. Application to a domestic corporate group on a consolidated basis

Interest deductibility restrictions should ideally be applied to a consolidated group of foreign-controlled resident corporations in order to ensure consistency of application across a broad range of organizational structures. But consistent with the income computation rules in the Act generally, the existing thin capitalization rules apply to resident Canadian corporations on an unconsolidated basis. Where a multinational group organizes its Canadian operations through a resident holding corporation and one or more resident operating subsidiaries, the application of the rules on an unconsolidated basis tends to force related-party debt to be invested in the subsidiaries through the holding corporation. Otherwise, debt provided directly by a specified non-resident to a subsidiary will exceed the permissible leverage ratio. In effect, because of the interposition of the holding corporation, the subsidiary will not have an amount of equity attributable to a non-resident shareholder.

168 See Lars-Erik Wenehed, "Thin Capitalization and EC Law" (2003) vol. 30, no. 4 *Tax Notes International* 1145-55 (emphasizing the additional tax burden imposed on non-deductible interest expense that is not recharacterized as a dividend by both the source country and the residence country).

169 Williamson and Garland, supra note 2, at 30 ("Concern with carry-forwards may not be as much of an issue where the legislation attacks excessive leverage and interest expense through a balance sheet test"). Elimination or restriction of carryover under the U.S. earnings-stripping legislation has been an element of some proposals to tighten the rules. See *Earnings Stripping, Transfer Pricing and U.S. Income Tax Treaties*, supra note 20, at 27-28.

This technical problem could be addressed by extending a limited form of consolidated reporting in applying the thin capitalization rules. For example, equity at the level of a resident holding corporation could be taken into account at the level of operating subsidiaries where the holding corporation and the subsidiaries are all wholly owned. The need for such an approach has apparently been mitigated, however, by the ability to structure inbound direct investment in a manner that ensures compliance with the existing thin capitalization rules and realizes a form of self-help consolidation. It is unclear to what extent pushing all related-party debt through a Canadian holding corporation has resulted in efficiency losses. Without knowledge of the amount of such losses, it is impossible to determine whether the compliance and administrative costs associated with a stand-alone consolidation regime for the sole purpose of the thin capitalization rules are warranted.[170]

Extension of the thin capitalization rules to arm's-length debt, either for the purpose of applying a rule of non-deductibility or for the purpose of computing the specified leverage ratio, could increase efficiency losses attributable to the need to push all debt, and not just related-party debt, through a Canadian holding corporation structure. On the other hand, the use of related-party guarantees or other security can mitigate any such losses. In fact, an extension to arm's-length debt can reduce the imperative to push debt through a holding corporation structure. As has been pointed out,[171] an important implication of such an extension is the accounting for all equity, either arm's-length or related-party, in computing the leverage ratio. Provided that inter-corporate equity is accounted for only once, much the same effect as the application of the thin capitalization rules on a consolidated basis can be realized without explicit legislative provision.[172]

170 See Williamson and Garland, supra note 2, at 26 (noting that the approach under the existing Canadian thin capitalization rules favours simplicity while forcing taxpayers to structure their investments to avoid anomalies attributable to the lack of consolidated reporting on the basis of a group of foreign-controlled Canadian corporations).

171 Ibid.

172 Ibid. (suggesting that the definition of equity for the purpose of the thin capitalization rules be modified to account for all equity other than inter-corporate investments in the case of corporations affiliated with the relevant specified non-resident shareholder).

9. Non-discrimination as a constraint

Although subject to erratic application,[173] the non-discrimination principle is a substantive principle of international tax law. Some commentators have argued, however, that a close examination of the principle as it is used in tax law is surprisingly difficult to justify in terms of any recognized normative principles.[174] Superficially, it can be seen as a constraint on the incentive of capital-importing jurisdictions to engage in "tax exportation", with its perceived inefficiencies for the level and pattern of the provision of public goods and services.[175] Even when viewed in terms of this somewhat narrow rationale rather than the more expansive rationale relevant to the EU experience, the non-discrimination principle can still be seen to override the differential application of deductibility rules based on the residency of the payee. But Canada's unique approach to the codification of the principle in its bilateral tax treaties means that the associated constraint is somewhat weaker, particularly as it affects possible reform of the existing thin capitalization rules as a particular form of interest deductibility restriction in the context of inbound direct investment. Even so, it may be necessary to follow the practice in some countries of providing an exception in domestic legislation for corporations that exceed the specified ratio but can demonstrate that their capital structure is consistent with the arm's-length standard. The need for incorporation of such an exception is probably the most compelling in the event that non-deductibility is extended to interest on arm's-length debt.

Depending on its specific articulation, the non-discrimination principle can act as a binding constraint on the adoption of interest deductibility restrictions targeted to inbound direct investment. More particularly, article 24(4) of the OECD model treaty requires consistent treatment of residents and non-residents regarding the deductibility of interest, royalties, and other disbursements. That is, deductibility status is to be extended to such payments made between an enterprise of a contracting state to a resident of another contracting state under the same conditions as those applicable to payments made between residents of the same contracting state. In this respect, there is some debate as to the status of thin capitalization or earnings-stripping legislation which uses a fixed ratio as the singular and determinative expression of the arm's-length standard.[176] One view, which appears to be the official OECD position, is that this kind of legislation is not within the exception in article 9(1), which permits adjustments to be made to payments between associated enterprises resident

173 See, for example, Lara Friedlander, "The Role of Non-Discrimination Clauses in Bilateral Income Tax Treaties After GAAT 1994" (2002) no. 2 *British Tax Review* 71-118. See also Bennett, supra note 141 (contrasting the narrow interpretation of non-discrimination articles in tax treaties with the expansive interpretation by the ECJ of the non-discrimination provision of the EC treaty).

174 See, in this respect, Alvin C. Warren, Jr., "Income Tax Discrimination Against International Commerce" (2001) vol. 54, no. 2 *Tax Law Review* 131-69.

175 See, for example, Bennett, supra note 141, at 465-66 (citing the reduction of impediments to cross-border trade and investment as a possible rationale but noting the incomplete nature of non-discrimination articles in realizing this goal). See also Shay et al., supra note 91, at 112 (emphasizing reciprocal treatment and the free flow internationally of goods and services as normative bases for the non-discrimination principle).

176 For a fuller canvassing of these arguments, see Boidman, supra note 46, at 897-98; and Geerten M.M. Michielse, "Treaty Aspects of Thin Capitalization" (1997) vol. 51, no. 12 *Bulletin for International Fiscal Documentation* 565-73.

in different contracting states to conform to the arm's-length standard.[177] Without the benefit of this exception, fixed-ratio expressions of the arm's-length standard could be considered to violate the non-discrimination principle as expressed in article 24(4).[178] As noted in Part 2, some countries attempt to avoid this apparently binding constraint by providing an exception in domestic legislation for ratios that can be supported as consistent with the arm's-length standard expressed as a multifactor inquiry into the perceived economic substance of related-party debt.[179]

Consistent with article 24(1) of the OECD model treaty, Canada's tax treaties typically impose a requirement that nationals of the other contracting state receive treatment consistent with, or no more burdensome than, the treatment of nationals of Canada in the same circumstances. Also, in respect of foreign-owned or foreign-controlled enterprises, Canada sometimes agrees to provide tax treatment that is no more burdensome than that for enterprises owned or controlled by residents of a third state.[180] Canada does not generally include, however, a provision comparable to article 24(4) of the OECD model treaty. An important exception is article XXV(7) of the Canada-U.S. treaty,[181] which requires that Canada permit the deduction of interest payable by a Canadian-resident debtor to a U.S.-resident creditor on the same basis as if the interest had been payable to a Canadian resident.[182] Article XXV(8)(a) then provides a specific exception for tax laws relating to the deductibility of interest that are in force on the date of signature of the treaty, including any subsequent modifications that do not change the general nature of the particular provisions.[183]

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177 See, for example, Bennett, supra note 141, at 453 ("If one believes that the references to the arm's length principle in the deductibility paragraph (article 24(4)) are relevant to the thin capitalization issue, the controversy surrounding thin capitalization regimes tends to focus on whether the standards of the particular regime are consistent with the arm's length principle").

178 See, in this respect, *Specialty Manufacturing Ltd. v. The Queen*, [1999] 3 CTC 82; 99 DTC 5222 (FCA) where it was argued by counsel for the taxpayer that article IX(1) of the Canada-U.S. treaty ensures that the thin capitalization rules do not apply to a Canadian subsidiary of a U.S. parent corporation where its capital structure can be characterized as consistent with the arm's-length standard. This argument, along with the additional argument that the specific exception in article XXV(8)(a) for the thin capitalization rules was insufficient to preserve their application, was not considered, since the court found that the capital structure in the particular case (100,000:1 leverage ratio) was not consistent with an arm's-length structure in any event. This argument is developed in detail in Joel A. Nitikman, "The Interaction of Canada's Thin Capitalization Rule and the Canada-United States Tax Treaty" (2000) vol. 26, no. 1 *International Tax Journal* 20-64. Nitikman was counsel for the taxpayer in *Specialty Manufacturing*.

179 The position assumes that the different treatment of non-resident and resident investors cannot be justified on the basis that the two categories of investors are, in fact, not in similar circumstances as required by the standard non-discrimination article. See, for example Shay et al., supra note 91, at 114-15 (arguing that the different treatment of foreign-controlled corporations under the U.S. earnings-stripping legislation can be justified on the basis that they are in a position that is substantively different from U.S.-owned corporations if the corporation and the investors are accounted for jointly). This analytical approach would justify the application of single-factor expressions of the arm's-length principle, such as thin capitalization or earnings-stripping legislation, without the need for an explicit exception for capital structures that can be characterized as consistent with an arm's-length structure determined as the outcome of a multifactor inquiry.

180 See Brian J. Arnold, *Tax Discrimination Against Aliens, Non-Residents, and Foreign Activities: Canada, Australia, New Zealand, the United Kingdom, and the United States* (Toronto: Canadian Tax Foundation, 1991), 135-37.

181 With ratification of the fifth protocol amending the Canada-U.S. treaty, articles XXV(3) to (10) have been renumbered as a consequence of the deletion of paragraph 2. For familiarity of reference, the former paragraph numbers are used here. The text of the relevant articles has not changed.

182 There are some other treaties with provisions comparable to articles XXV(7) and (8) of the Canada-U.S. treaty. See, for example, the treaties with Denmark, Lebanon, Portugal, Slovenia, and Sweden.

183 See, in this respect, *Ramada Ontario Limited v. The Queen*, [1994] 1 CTC 2130; 94 DTC 1071 (TCC) (amendment of the thin capitalization rules to include only the paid-up capital attributable to shares held by specified non-resident shareholders was a technical amendment consistent with the general nature of the rules). New Zealand commonly includes an exception from the non-discrimination principle for "reasonably designed anti-avoidance provisions" targeted at non-residents.

It is highly unlikely that this specific treaty exception, which is apparently intended to exclude Canada's thin capitalization rules, would extend to the enactment of a generalized rule of non-deductibility for interest on related-party debt. The status of an extension of the thin capitalization rules to affect the deductibility of interest on arm's-length debt in the context of inbound direct investment is less clear. As suggested in Part 6, such an extension is intended to impose an outer limit on the sourcing of interest expense on arm's-length debt and arguably differs in kind from the rationale for the application of thin capitalization rules to related-party debt as a particular expression of the arm's-length standard. On the other hand, the ease of substitutability of the choice of location of arm's-length debt presents a revenue-erosion problem that is not unlike the problem presented by transfer-pricing generally, and the extension of a rule of non-deductibility to interest on arm's-length debt on the same conditions as related-party debt can be seen as more of a difference in degree than one of kind. In fact, under conventional deductibility restrictions that are limited to related-party debt of a foreign-controlled corporation, rejection of the legal form of such debt as determinative of its tax treatment can be seen as tolerable and broadly consistent with the arm's-length principle, given the potential revenue loss in the absence of any deductibility restrictions applicable to such debt. Extension of the same kind of limitation to arm's-length debt as a limitation on the sourcing of the associated interest expense based on the legal form of the borrowing may not be so conceptually distinct as to constitute a difference in kind. In short, framing the thin capitalization or earnings-stripping inquiry as an inquiry into the arm's-length features of related-party debt, as well as the sourcing of arm's-length debt, may be sufficiently close in kind to the alteration of related-party prices to accord with perceived arm's-length prices. It is not entirely implausible, therefore, to defend an extension of a rule of non-deductibility to arm's-length debt as a modification of Canada's existing thin capitalization rules that does not change their general nature and is thus within the exception in Article XXV(8)(a) of the Canada-U.S. treaty.[184]

This somewhat nuanced characterization of the extension of a rule of non-deductibility to arm's-length debt may not be an entirely secure basis on which to immunize such a fundamental change to the thin capitalization rules from the non-discrimination article in the Canada-U.S. tax treaty. The fall back position that either a single-factor approach to the expression of the arm's-length principle is consistent with that principle, or that there is an important functional difference in the respective positions of foreign-controlled and domestic-controlled corporations, are perhaps even less secure. The former may be especially problematic in the event that a rule of non-deductibility is extended to arm's-length debt.[185] It is arguable, however, that such an extension would ensure compliance with Article XXV(7), irrespective of the availability of the explicit exception in Article XXV(8)(a). In particular, by applying a rule of non-deductibility equally to debt held by arm's-length non-residents and residents, the deductibility status of interest expense of a Canadian-resident corporation

184 But see, *Ramada Ontario Limited*, supra note 183, at 1078 (suggesting that the impact, or the form of, the thin capitalization legislation must be substantially altered before an amendment can be characterized as changing the general nature of the legislation).

185 See, for example, Andrew M.C. Smith and Paul V. Dunmore, "New Zealand's Thin Capitalisation Rules and the Arm's Length Principle" (2003) vol. 57, no. 10 *Bulletin for International Fiscal Documentation* 503-10, at 507 ("… taxpayers facing sanctions under New Zealand's rules would have strong grounds for arguing that the rules are not consistent with the arm's length principle").

would not depend on the residency of the creditor. Although a rule of non-deductibility would be limited to foreign-controlled corporations, Article XXV(5) only requires treatment that is consistent with that provided to corporations owned or controlled by residents of a third country. It is unclear whether the status of a resident corporation as foreign-controlled constitutes the kind of differential deductibility status contemplated by Article XXV(7).

To ensure the inapplicability of the potential override of the non-discrimination principle, an explicit exception could be adopted under the thin capitalization rules for circumstances outside the specified leverage ratio that can nonetheless be characterized as consistent with the arm's-length standard expressed as a multifactor inquiry.[186] This approach would effectively jettison reliance on the specific treaty-based exception in favour of the standard reconciliation of the non-discrimination principle and thin capitalization legislation. An alternative to an explicit exception for arm's-length capital structures is the provision of an exception for leverage ratios that are consistent with the worldwide consolidated ratio of the group to which a Canadian corporation belongs. As suggested in Part 7, use of the consolidated leverage ratio of a worldwide group, with an uplift provision, can be seen as the functional equivalent of an arm's-length exception to the application of a fixed ratio;[187] yet it avoids the administrative and compliance costs attributable to the uncertainty of application of such an exception, as well as possible revenue leakage attributable to its flexibility of application. By incorporating either form of exception, compliance with the non-discrimination principle as a constraint could possibly be realized without implicating the broader policy issues associated with comprehensive deductibility restrictions applicable in both the domestic and cross-border contexts.

Extension of Canada's thin capitalization rules to arm's-length debt solely for the purpose of computing the leverage ratio of a Canadian corporation would seem to be more plausibly within the exception in Article XXV(8)(a) of the Canada-U.S. treaty. In particular, this reform alternative is consistent with the U.S. earnings-stripping rule in effectively stacking related-party debt on top of arm's-length debt for the purpose of applying a rule of non-deductibility to the former only. The fact that a rule of non-deductibility remains limited to related-party debt would seemingly support a characterization of this reform alternative as consistent with the purpose of the thin capitalization rules generally. Moreover, this characterization would not appear to be affected by an extension of a rule of non-deductibility to a limited range of guaranteed debt, as well as a broader range of back-to-back debt arrangements, that is identified as a tax-driven substitute for related-party debt and is thereby treated consistently with such debt.

186 See, for example, Australian Taxation Office (ATO), *Taxation Ruling* TR 2003/1, March 5, 2003 (describing the ATO's interpretation of the multifactor inquiry required for the purpose of the arm's-length exception in the Australian thin capitalization legislation applicable to inbound direct investment). See also, Vann, supra note 94, at 155-56 (noting that the ATO's interpretation has been "artfully constructed to try to limit problems").

187 But see Smith and Dunmore, supra note 185, at 507 (concluding that the application of New Zealand's thin capitalization legislation violates the standard non-discrimination article and questioning whether provision for leverage ratios within 110 percent of the consolidated ratio of a multinational group is a defensible proxy for a multifactor inquiry into the character of related-party debt as disguised equity).

10. Interaction with interest deductibility restrictions in the context of outbound direct investment

Interest deductibility restrictions that apply equally to related-party debt and arm's-length debt in the context of inbound direct investment can also be applied, with somewhat different justification, in the context of outbound direct investment. This kind of symmetrical application of a comprehensive interest deductibility restriction is a feature, for example, of the Australian and New Zealand thin capitalization legislation, as well as the Danish, German, and Italian earnings-stripping legislation. Complete consistency of application means that there is no need to distinguish between inbound and outbound direct investment. In effect, where no tax consequence turns on the distinction, it becomes irrelevant, and an important design detail is eliminated. If there are some secondary differences in the application of the relevant interest deductibility restrictions, the need to distinguish inbound direct investment from outbound direct investment remains.

Canada's thin capitalization rules apply exclusively in the context of inbound direct investment to limit the deduction of interest expense that is otherwise deductible under the Act. Where a foreign-controlled corporation has both Canadian and foreign assets, section 18.2 can apply to deny the deduction of interest associated with the latter. The thin capitalization rules would apply only to the extent that interest expense is not otherwise denied deductibility under this provision, which applies in the context of a limited range of outbound direct investment. The limited application of section 18.2 — it is effectively limited to interest expense of a Canadian corporation that can be traced to the earning of foreign-source income through a foreign affiliate in certain tax-effective transactions — means that it is possible for a foreign-controlled Canadian corporation to have otherwise fully deductible interest expense where it has both Canadian and foreign assets. This possibility raises an issue as to the relationship between the thin capitalization rules and section 18.2 as the very different, and more limited, restriction on the deduction of interest expense in the context of outbound direct investment.

Thin capitalization rules are intended, in the context of inbound direct investment, to limit the level of leverage that can be accessed on equity that is invested in domestic assets generating income otherwise subject to source-country taxation. Earnings-stripping legislation imposes a comparable limitation based on the ratio of interest expense to revenue of a foreign-controlled corporation. Either limitation effectively limits the stripping, using deductible interest expense, of income otherwise subject to source-country taxation.[188] To the extent that the equity of a foreign-controlled corporation can be attributed to foreign assets generating income that is not subject to taxation in the same manner as domestic-source income, the equity should arguably

188 Because thin capitalization legislation applicable in the context of outbound direct investment is designed to realize much the same result, equity allocated to shares of a foreign affiliate (or foreign assets) is similarly excluded from computation of the specified ratio.

be excluded from the base that can be leveraged on a tax-deductible basis.[189] In short, equity should be included in this base only to the extent that it can be considered to generate income that is otherwise fully subject to source-country taxation.

The equity base of a foreign-controlled corporation with both domestic and foreign assets can be allocated as between the two on some formulary basis using relative assets values, with only equity allocated to domestic assets included in the computation of the leverage ratio. Where the asset base of a foreign-controlled corporation is used instead of its equity base in the computation of the leverage ratio, foreign assets can simply be excluded from the base. For administrative and compliance reasons, however, the required allocation of equity, or the exclusion of foreign assets, can be limited to those circumstances in which the level of such assets of a foreign-controlled corporation are significant relative to its domestic asset base. For example, an allocation exercise or exclusion of foreign assets could be limited to those circumstances in which the domestic asset base is something less than "all or substantially all" of the total asset base of the corporation. An alternative, which is consistent with legislative practice in some countries, would exclude shares in CFCs or non-controlled foreign affiliates. Although the effect would be to deny the deduction of a portion of the interest expense of a foreign-controlled corporation that is considered attributable to the earning of tax-preferred foreign-source income, the exclusion of equity invested in shares of CFCs or foreign affiliates (or the exclusion of foreign assets) in the computation of the leverage ratio remains defensible as a structural component of interest deductibility restrictions applicable exclusively in the context of inbound direct investment. This effect could obviously be avoided by changing the relative mix of domestic and foreign assets or, alternatively, by avoiding status as a foreign-controlled corporation. But there may be non-tax constraints that limit the extent of the ability to alter either to access additional interest expense deductions.

189 See Williamson and Garland, supra note 2, at 27 ("If the purpose of the legislation is to prevent such practices as leveraging a Canadian company in order to invest in a foreign affiliate, then merely reducing the definition of equity by related-party loans would be insufficient and the rules would need to be expanded to include related-party equity").

Appendix 1 — Summary of selected country legislation[190]

Comprehensive thin capitalization restriction applicable to arm's-length and related-party debt

	Australia	Belgium	New Zealand
Application to unincorporated entities	yes	branches	yes
Leverage ratio	75% debt:assets	7:1 debt:equity*	75% debt:assets
Characterization rules	comprehensive debt-equity legislation	legal form	debt deductions within accrual rules
Netting	yes	no	yes
Debt-creation rules	no specific rules	no specific rules	no specific rules
Deemed dividend	no	no	no
Carryover	no	no	no
Consolidation/group relief	yes	no	yes
Arm's-length exception/ safe harbour	yes	yes	110% group average
Sectoral rules	yes — FIs	no	yes — FIs

* *The deductibility restriction, although applicable equally to arm's-length and related-party debt, is limited to interest payments "for the benefit of tax-haven corporations".*

190 The summaries are based on: Ernst & Young LLP, *Thin Capitalization Regimes in Selected Countries*, report prepared for the Advisory Panel on Canada's System of International Taxation (May 2008); Ana Paula Dourado and Rita de la Feria, "Thin Capitalization Rules in the Context of the CCCTB", Oxford University Centre for Business Taxation, *Working Paper Series WP 08/*04; and Bruno Gouthiere et al., "A Comparative Study of the Thin Capitalization Rules in the Member States of the European Union and Certain Other Countries" (2005) vol. 45, no. 9/10 *European Taxation* 367-451.

Comprehensive earnings-stripping restriction applicable to arm's-length debt and related-party debt

	Denmark	Germany	Italy
Application to unincorporated entities	no	yes	branches
Interest-coverage ratio	80% EBITDA	30% EBITDA	30% EBITDA
Characterization rules	incomplete rules	economic substance	economic substance
Netting	yes	yes	yes
Debt-creation/ anti-avoidance rules	no specific rules	no specific rules	no specific rules
Deemed dividend	no	yes	no
Carryover	yes	no	yes
Consolidation/group relief	yes	yes	yes
Arm's-length exception/ safe harbour	no	debt:equity ratio — group average	no
Sectoral rules	no	no	no

Thin capitalization restriction limited to related-party debt

	Belgium	Canada	Denmark	France
Application to unincorporated entities	branches	no	no	yes
Leverage ratio	1:1 debt:equity*	2:1 debt:equity	4:1 debt:equity	1.5:1 debt:equity
Arm's-length debt in ratio	no	no	yes	no
Characterization rules	advances	legal form	incomplete rules	economic substance
Guaranteed debt	no	no	yes	no
Netting	no	no	no	yes
Debt-creation/ anti-avoidance rules	no specific rules	no specific rules	no specific rules	no specific rules
Deemed dividend	yes	no	no	no
Carryover	no	no	unclear	yes
Consolidation/group relief	no	no	yes	no
Arm's-length exception/ safe harbour	yes	no	yes	group average
Sectoral rules	no	yes — foreign bank branches	no	FIs and near FIs excepted

* *The deductibility restriction applies to shareholders who are individuals, as well as corporate directors, both residents or non-residents and individuals or corporations other than Belgian-resident corporations that are subject to mainstream tax on the interest income. But see, in this respect,* NV Lammers & Van Cleef *(C-105/07) (right to freedom of establishment violated by the disallowance of a deduction for interest paid to a director that is a foreign company).*

Thin capitalization restriction limited to related-party debt

	Japan	Netherlands	Switzerland
Application to unincorporated entities	branches	branches	yes
Leverage ratio	3:1 debt:equity	3:1 debt:equity	tailored asset ratios
Arm's-length debt in ratio	no	yes	yes
Characterization rules	yes	finance leases	incomplete rules
Guaranteed debt	yes	yes	yes
Netting	no	yes	no
Debt-creation/anti-avoidance rules	no specific rules	yes	no specific rules
Deemed dividend	yes	no	yes
Carryover	no	no	no
Consolidation/group relief	no	yes	no
Arm's-length exception/ safe harbour	3:1 debt:equity (all) or industry average	group average	yes
Sectoral rules	no	no	yes — finance corps 85% debt:assets

Earnings-stripping restriction limited to related-party debt

	France	United States
Application to unincorporated entities	yes	branches
Interest-coverage ratio	25% EBITDA	50% EBITDA
Arm's-length debt in ratio	no	yes
Characterization rules	economic substance	debt-equity case law
Guaranteed debt	no	yes
Netting	yes	yes
Debt-creation rules	no specific rules	no specific rules
Deemed dividend	no	no
Carryover	yes	yes
Consolidation	no	yes
Arm's-length exception/safe harbour	group average	1.5:1 debt:equity
Sectoral rules	FIs and near-FIs excepted	no

Multifactor arm's-length approach

	United Kingdom
Application to unincorporated entities	partnerships and branches
Interest-coverage ratio	25% EBITDA
Leverage ratio	1:1 debt:equity
Sectoral ratios	yes
Characterization rules	legal form
Guaranteed debt	yes
Netting	no
Debt-creation/anti-avoidance rules	"unallowable purpose" test anti-hybrid legislation
Deemed dividend	no (but excepted from NRWT)
Carryover	no (but arm's-length guarantor can claim)
Consolidation	yes
Safe-harbour exception	no (but ratios used as benchmarks)

Appendix 2 — Worked example illustrating the application of a thin capitalization limitation that extends to arm's-length debt

On a worldwide consolidated basis, Foreign Parentco and Domestic Subco have assets with a carrying value of $1,500. The assets are funded with: (i) $1,125 of group debt issued to arm's-length lenders; and (ii) $375 of group equity issued to the public (that is, arm's-length shareholders). One-third of the assets are used in Country R by Foreign Parentco. Two-thirds of the assets are used by Domestic Subco in Country S.

Set out below are the income tax results for Subco in Country S under four different financing structures: (i) 100 percent equity financing provided by Foreign Parentco; (ii) 100 percent debt financing provided by Foreign Parentco; (iii) 70 percent debt financing provided by Foreign Parentco, five percent debt financing provided directly to Domestic Subco by arm's-length lenders, and 25 percent equity financing provided by Foreign Parentco; and (iv) five percent debt financing provided by Foreign Parentco, 70 percent debt financing provided directly to Domestic Subco by arm's-length lenders, and 25 percent equity financing provided by Foreign Parentco. It is assumed that: (i) all debt bears interest at six percent annually; (ii) Domestic Subco earns income on its assets of $70 before interest and taxes; and (iii) the corporate income tax rate in Country S is 30 percent.

On the assumption of an unrestricted interest expense deduction, the all-related-party equity and all-related-party debt financing structures are used as baselines for comparison of the income tax results for each of the two more realistic financing structures with a mix of debt (both related-party and arm's-length) and equity. Those results are set out under three different thin capitalization regimes: (i) a rule of non-deductibility that is limited to related-party debt in excess of a 2:1 leverage ratio but accounts for all debt in the computation of the ratio; (ii) a rule of non-deductibility that applies to all debt in excess of a 2:1 leverage ratio; and (iii) a rule of non-deductibility that applies to all debt in excess of the greater of a 2:1 leverage ratio and the consolidated ratio of the multinational group to which a foreign-controlled corporation belongs.

All-Equity Capitalization	
Subco operating income (before interest and taxes)	70
country S tax (@30%)	21
after-tax dividend	49
100% Related-Party Debt Capitalization	
Subco operating income (before interest and taxes)	70
interest expense	60
operating income after deductible interest	10
country S tax (@30 %)	3
70% Related-Party Debt/5% Arm's-Length Debt/25% Related-Party Equity	
• IF 2:1 country S thin cap leverage ratio, accounting for all debt, but with a rule of non-deductibility limited to related-party debt	
non-deductible interest i.e., interest expense at 6% on greater of: (i) 83.33 excess debt, and (ii) 700 related-party debt country S tax (@30 %)	5 1.50
• IF 2:1 country S thin cap leverage ratio with a rule of non-deductibility applicable to all debt	
non-deductible interest i.e., interest expense on 83.33 excess debt country S tax (@30 %)	5 1.50
• IF 2:1 country S thin cap leverage ratio with a rule of non-deductibility applicable to all debt but exception for leverage ratio equal to the consolidated group average	
non-deductible interest i.e., 3:1 Subco leverage ratio consistent with 3:1 group average	NIL
5% Related-Party Debt/70% Arm's-Length Debt/25% Related-Party Equity	
• IF 2:1 country S thin cap leverage ratio, accounting for all debt, but with a rule of non-deductibility limited to related-party debt	
non-deductible interest i.e., interest expense at 6% on greater of: (i) 83.33 excess debt, and (ii) 50 related-party debt country S tax (@30%)	3 0.90
• IF 2:1 country S thin cap leverage ratio with a rule of non-deductibility applicable to all debt	
non-deductible interest i.e., interest expense on 83.33 excess debt country S tax (@30%)	5 1.50
• IF 2:1 country S thin cap leverage ratio with a rule of non-deductibility applicable to all debt but exception for leverage ratio equal to the consolidated group average	
non-deductible interest expense i.e., 3:1 Subco leverage ratio consistent with 3:1 group average	NIL