

DRAFT**THE RELATIONSHIP BETWEEN RESTRICTIONS ON THE DEDUCTION OF
INTEREST UNDER CANADIAN LAW AND CANADIAN TAX TREATIES****Brian J. Arnold****Introduction**

During his unfortunately brief academic career, Professor Tim Edgar wrote extensively about interest deductibility;¹ during the early part of his career, we co-authored several articles on interest deductibility in Canada.² As a result, I thought that an article on the topic of interest deductibility

¹ See, for example, Tim Edgar, “Outbound Direct Investment and the Sourcing of Interest Expense for Deductibility Purposes,” in Arthur J. Cockfield, ed., *Globalization and Its Tax Discontents: Tax Policy and International Investments* (Toronto: University of Toronto Press, 2010) 60-83; Tim Edgar, Jonathon Farrar, and Amin Mawani, “Foreign Direct Investment, Thin Capitalization, and the Interest Expense Deduction: A Policy Analysis” (2008) 56:4 *Canadian Tax Journal* 803-69; Tim Edgar, “The Thin Capitalization Rules: Role and Reform” (1992) 40:1 *Canadian Tax Journal* 1-54; Tim Edgar, “The Classification of Corporate Securities for Income Tax Purposes” (1990) 38:5 *Canadian Tax Journal* 1141-88.

² See, for example, Brian J. Arnold and Tim Edgar, “Reflections on the Submission of the CBA-CICA Joint Committee on Taxation Concerning the Deductibility of Interest” (1990) 38:4 *Canadian Tax Journal* 847-885; Brian J. Arnold and Tim Edgar, “Interest Deductibility,” in Roy D. Hogg and Jack M. Mintz, eds., *Tax Effects on the Financing of Medium and Small Public Corporations* (Kingston: John Deutsch Institute for the Study of Economic Policy, 1991), 59-78; Brian J. Arnold and Tim Edgar, “The Draft Legislation on Interest Deductibility: A Technical and Policy Analysis” (1992) 40:2 *Canadian Tax Journal* 267-303; Brian J. Arnold and Tim Edgar, “Deductibility of Interest Expense” (1995) 43:5 *Canadian Tax Journal* 1216-44 (1995).

would be suitable for a symposium in Tim's honour. I have chosen to explore the relationship between restrictions on the deduction of interest under Canadian domestic law and the provisions of Canadian tax treaties.

Following this introduction, the article describes restrictions on the deduction of interest under the Canadian Income Tax Act (the Act).³ Because most of these restrictions apply to interest paid to both residents and non-residents, they do not raise any concerns with respect to the provisions of tax treaties. However, treaty issues do arise with respect to Canada's thin capitalization rules since those rules apply only to interest paid to substantial nonresident shareholders of Canadian resident corporations and nonresident beneficiaries of Canadian resident trusts, and certain Canadian tax rules dealing with the deduction of interest by non-residents in computing their Canadian source income.

The central focus of the article is the relationship between the provisions of Canada's tax treaties and the restrictions on the deduction of interest under the Act. To provide a comparative perspective, it also examines the relationship between the provisions of the OECD and United Nations Model Conventions and domestic-law restrictions on the deduction of interest. The article endeavours to answer this question: to what extent do the provisions of Canada's tax treaties – and by way of comparison, the provisions of the OECD and UN Model Conventions – limit the application of restrictions on the deduction of interest, and, in, particular, the application of the thin capitalization rules? The article concludes that Canada's tax treaties have been negotiated and designed to ensure they do not prevent the application of the thin capitalization rules and rules that deem interest to be dividends.

Restrictions on the Deduction of Interest under Canadian Domestic Law

³ Income Tax Act, Statutes of Canada, RSC 1985, c. I-4 as amended.

As a result of some questionable court decisions, the deduction of interest under the Canadian income tax system has been based on the assumption that interest is a non-deductible capital expense.⁴ As a result, in general, interest is deductible only in accordance with the provisions of paragraph 20(1)(c), which allows the deduction of interest only on borrowed money or the unpaid purchase price of property that is used for the purpose of earning income from a business or property. Under paragraph 20(1)(d), compound interest is deductible if it meets the conditions of paragraph 20(1)(c) and is paid in the year. Thus, as in many countries, Canada does not allow the deduction of interest on funds that are used to earn exempt income⁵ or finance personal consumption. The definition of “exempt income” does not include dividends from Canadian or foreign corporations even though such dividends are not subject to any Canadian tax.⁶ Tracing is the basic method used to determine whether borrowed funds are used for a qualifying income-earning purpose; however, other methods, such as positive ordering and apportionment, are used where tracing is impossible.⁷ The extensive case law under paragraph 20(1)(c) is overly generous to taxpayers, allowing them to deduct interest even where their purpose is to earn gross

⁴ The proposition that interest is a non-deductible capital expense has been reiterated many times by the Supreme Court of Canada. See, for example, *The Queen v. Bronfman Trust* [1987] 1SCR 32 (SCC) and *Tennant v. MNR* [1996] 1 SCR 305 (SCC). Interest is deductible under subsection 9(1) as an ordinary business expense for financial institutions and in certain special circumstances as a matter of the Canada Revenue Agency’s (CRA) administrative discretion (see CRA, Income Tax Folio S2-C4-F1, March 18, 2016, paragraph 1.7).

⁵ ITA, para. 18(1)(c).

⁶ ITA, subsection 248(1), the definition of “exempt income,” provides that exempt income is any property received or acquired that is not included in a person’s income under Part I of the Act “but does not include a dividend on a share.” Dividends from Canadian-resident corporations and foreign corporations are included income under subsections 82(1) and 90(1) respectively, but such dividends received by a Canadian-resident corporation are deductible in computing taxable income under subsection 112(1) and subsection 113(1) respectively.

⁷ See CRA, Income Tax Folio S4-F2-C1, paragraph 1.28 – 1.58.

revenue rather than net income and even where they have only an ancillary purpose of earning gross revenue.⁸

The deduction of interest under paragraph 20(1)(c) is limited to the amount of interest paid in the year or payable in respect of the year,⁹ or a reasonable amount, whichever is the lesser. The purpose of the limitation of the amount of deductible interest to a reasonable amount is unclear, since section 67 prohibits the deduction of all expenses except to the extent that they are reasonable in the circumstances.

In addition to these general rules with respect to the deduction of interest, the Act contains many specific rules that deny or limit the deduction of interest. These rules may take the form of limitations or prohibitions on the deduction of interest or alternative or additional conditions to the general conditions in paragraph 20(1)(c) for the deduction of interest. For example, interest expenses that would otherwise be deductible under paragraph 20(1)(c) are restricted in the following circumstances:

- No deduction is allowed for interest expenses incurred to acquire vacant land;¹⁰
- No deduction is allowed for interest expenses during the construction or renovation of a building;¹¹

⁸ See, for example, *Ludco Enterprises Ltd. v. The Queen* [2001] SCC 62 and most recently, *TDL Group v. The Queen* [2016] FCA 67.

⁹ However, the CRA allows interest to be deducted on an accrual basis by taxpayers that use the accrual method of accounting for income tax purposes. See CRA, Income Tax Folio S4-F2-C1, paragraph 1.13.

¹⁰ ITA subsection 18(2).

¹¹ ITA subsection 18(3.1).

- No deduction is allowed for interest paid by a resident corporation or trust to specified non-residents (thin capitalization rules);¹²
- The deduction of prepaid interest is limited to the amount that reasonably relates to the particular year;¹³
- The amount of interest payable on certain long-term debt obligations is limited to the reasonable amount attributable to the particular year;¹⁴
- No deduction of interest is allowed with respect to borrowed funds used to make contributions to deferred savings plans, such as registered retirement savings plans and tax deferred savings plans;¹⁵
- The deduction of interest with respect to certain weak-currency borrowings is limited to the amount of interest that would have been incurred if the taxpayer had borrowed an equivalent amount on the same terms in the currency that was ultimately used to earn income;¹⁶ and
- The deduction of interest paid by a Canadian-resident to a non-arm's-length non-resident may be disallowed to the extent that the interest exceeds the amount that would be paid if the parties were dealing at arm's length.¹⁷

¹² ITA subsection 18(4).

¹³ ITA subsection 18(9).

¹⁴ ITA subsection 18(9.2 – 9.8).

¹⁵ ITA subsection 18(11).

¹⁶ ITA section 20.3.

¹⁷ ITA section 247(2).

The only restrictions on the deduction of interest in the above list that apply solely to payments of interest to non-residents are Canada's transfer pricing and thin capitalization rules. The transfer pricing rules apply to transactions or series of transactions between "a taxpayer or partnership and a non-resident person with whom the taxpayer or the partnership, or a member of the partnership, does not deal at arm's length" where the terms or conditions differ from the terms or conditions that persons dealing at arm's length would have agreed to.¹⁸ The rules also apply where persons dealing at arm's length would not have entered into the transaction or series of transactions and the transaction or series was entered into primarily to obtain a tax benefit.¹⁹ The transfer pricing rules do not apply to transactions between residents of Canada.

The thin capitalization rules apply for the purposes of the computation of the income of a corporation or trust from a business or property (other than the Canadian banking business of an authorized foreign bank). Therefore, the rules apply to both resident and non-resident corporations and trusts. However, the rules apply only to deductible interest paid or payable on outstanding debts owed to "specified non-residents" to the extent that those debts exceed 1.5 times the equity of the corporation or trust. "Specified non-residents" are defined to be:

- non-resident beneficiaries of a trust that own, alone or together with non-arm's-length persons, an interest in the trust with a fair market value of 25 percent or more of the value of all the interests in the trust, and
- non-resident shareholders of a corporation that own, alone or together with non-arm's-length persons, shares with 25 percent or more of the votes or the fair market value of all the shares of the corporation.

¹⁸ ITA paragraph 247(2)(a).

¹⁹ ITA paragraph 247(2)(b).

The thin capitalization rules do not apply to interest paid or payable to Canadian-resident beneficiaries of a trust or Canadian-resident shareholders of a corporation. Broad anti-back-to-back rules apply for purposes of the thin capitalization rules.²⁰ Under these rules, which were revised extensively in 2016, certain amounts owing by an intermediary to a specified nonresident are deemed to be owed to the specified nonresident by the Canadian corporation or trust if there is a link between the amount owed by the Canadian corporation or trust to the intermediary and the amount owed by the intermediary to the specified nonresident.

Non-residents carrying on business in Canada (or earning rental income from real property in Canada and electing to be taxed on a net basis) are entitled to deduct interest in accordance with the same rules described above with respect to residents of Canada.²¹ A non-resident's income from business carried on in Canada is determined as if the non-resident had no other income and was entitled to any deductions reasonably applicable in whole or in part to that business.²² Other than this general reasonableness principle, there are no specific rules for allocating a non-resident's interest or other expenses to its income from business carried in Canada.²³ The basic approach used to determine whether a non-resident has used borrowed funds for the purpose of earning business income in Canada is factual tracing supplemented by apportionment where tracing is impossible; this approach also applies to the deduction of interest by residents. However, special rules apply to authorized foreign banks carrying on a branch banking business in Canada. They are allowed to deduct interest expenses directly attributable to liabilities of the business in Canada, notional interest expenses with respect to amounts advanced to or used on behalf of the Canadian branch by its foreign parent, and other funds used to operate the Canadian business; however, the

²⁰ ITA subsection 18(6 and (6.1).

²¹ Non-resident actors are also allowed to elect under section 216.1 to pay tax on a net basis.

²² ITA paragraph 4(1)(a).

²³ Except for certain special situations such as pilots and actors; see subsection 115(3) and 212(5.1).

deduction is denied to the extent of the amount of interest at the Bank of Canada rate on the amount by which 95 percent of the value of the assets of the Canadian branch exceeds its liabilities and advances to the branch.²⁴

Non-residents are subject to the same restrictions on the deduction of interest that apply to residents, as described above. In particular, non-resident corporations and trusts carrying on business in Canada or earning income from property are subject to Canadian transfer pricing rules and thin capitalization rules.

Finally, interest deductions may be disallowed under the general anti-avoidance rule (GAAR), which applies to tax benefits from avoidance transactions that are contrary to the underlying rationale of the relevant provisions of the Act.²⁵ An avoidance transaction is defined to mean a transaction, whether alone or as part of a series of transactions, whose primary purpose is obtaining a tax benefit. Since the primary purpose of most financing arrangements is to raise funds for business or investment purposes, it is often difficult for the government to show that financing transactions are avoidance transactions. In any event, the courts have refused to approve the application of the GAAR to financing transactions in the cases heard to date.²⁶

The Act also contains rules that, although they do not limit the deduction of interest, have the effect of offsetting the deduction of interest. The foreign affiliate dumping rules are intended to deal with transactions whereby a Canadian corporation controlled by a nonresident corporation incurs third party or related party debt or issues shares to acquire the shares of a foreign affiliate.²⁷ Although the interest deduction is not restricted, the corporation is deemed to have paid a dividend

²⁴ ITA section 20.2. Under paragraph 18(1)(v), the interest deduction of an authorized foreign bank is limited to the amount calculated under section 20.2.

²⁵ ITA section 245.

²⁶ See *Canadian Pacific Ltd. v. The Queen* [2002] FCA and *Hill v. MNR* [2004] TCC

²⁷ ITA section 212.3.

on which Part XIII withholding tax is imposed or, where the Canadian corporation issues shares, its paid up capital is reduced so that the corporation cannot return as much capital on a tax-free basis and cannot increase its debt owed to specified nonresidents by 1.5 times the amount by which the paid up capital was originally increased. The effect of tax treaties on these rules is beyond the scope of this article.

In general, the Canadian income tax system adheres assiduously to the legal form of transactions and financial instruments. In accordance with this basic principle, the term “interest” in the Act has a narrow private-law meaning, which does not include amounts that are economically equivalent to interest. The deductibility of such amounts is governed by specific provisions of the Act.²⁸ For example, borrowing expenses other than interest are deductible on a straight-line basis over 5 years;²⁹ the full amount of a discount is deductible, when paid, where the amount of the discount does not exceed 3 percent of the principal amount of the debt obligation, but only one-half of any larger discount is deductible.³⁰

Adherence to legal form also applies to the characterization of debt and equity securities.³¹ Thus, shares of a corporation are invariably treated as shares even where they have terms typical of debt obligations, such as a fixed term and fixed payments. Similarly, debt obligations are invariably treated as debt even where they have characteristics of equity, such as a right to participate in profits. The Act does not contain any comprehensive rules that characterize debt or equity in accordance with their terms, although it does contain complex specific rules to prevent

²⁸ See ITA paragraphs 20(1)(e), (e.1), (e.2), (f) and (l.1).

²⁹ ITA paragraph 20(1)(e).

³⁰ ITA paragraph 20(1)(f).

³¹ See, for example, Barejo

the use of certain preferred shares for tax avoidance purposes.³² In general, although the Act sometimes deems payments on debt obligations to be dividends and deems dividends to be interest,³³ it does not deem the underlying property on which payments are made to be something other than its legal character under private law. For example, under the thin capitalization rules, shareholder benefits and loans and excessive interest are deemed to be dividends for purposes of Part XIII withholding tax.³⁴

The Relevant Provisions of the OECD and UN Model Conventions

This section provides a brief overview of the effect that the provisions of the OECD and UN Model Conventions would have on the application of restrictions on the deduction of interest under Canadian law. The key provisions are Articles 9(1) (Transfer Pricing) and 24(4) and (5) (Nondiscrimination) with respect to the deduction of interest paid by Canadian residents to non-residents and Article 7 (Attribution of Profits to PEs) and 24(3) (Nondiscrimination) with respect to the deduction of interest by non-residents.

Deduction of Interest Paid by Canadian Residents to Non-residents

Article 1(3) – Saving Clause

Article 1(3), the saving clause, provides that, subject to specific exceptions, tax treaties are not intended to prevent countries from taxing their residents without any limitations imposed by the

³² ITA, Parts IV.1 and VI.1 and the definitions in subsection 248(1) of “term preferred share,” “taxable preferred share,” “short term preferred share,” “guaranteed share” and “collateralized preferred share.”

³³ For example, payments on an “income bond” or “income debenture,” which is defined in subsection 248(1) to be a bond or debenture under which interest is payable only if the issuer has profits, are not deductible (paragraph 18(1)(g)) and are deemed to be dividends (subsection 1593) and (4)).

³⁴ ITA paragraph 214(3)(a) and subsection 214(16).

treaty.³⁵ For bilateral treaties that do not contain the saving clause – which includes most treaties, given that Article 1(3) was added to the OECD and UN Model Conventions only in late 2017 – the result should be the same as for treaties that include the saving clause. The 2017 Commentary on Article 1 confirms this interpretation explicitly: “Paragraph 3 [of Article 1] confirms the general principle that the Convention does not restrict a Contracting State’s right to tax its own residents.”³⁶

Whether a tax treaty with a saving clause allows a contracting state to deny or limit the deduction of interest by residents depends on the exceptions to the saving clause. The key exception is Article 24, the nondiscrimination article, although it is notable that Article 9(1) and Article 7, dealing with transfer pricing and the attribution of profits to PEs respectively, are not listed as exceptions.

Currently, the treaty with the United States is the only Canadian tax treaty with a saving clause.³⁷ It is an open question whether Canadian courts would interpret Canadian tax treaties without a saving clause to be subject to an implicit principle that tax treaties do not limit the taxation by a country of its own residents unless they do so explicitly. Although Canada did not agree to modify its treaties to include the saving clause pursuant to the multilateral convention to

³⁵ The exceptions include Article 23, which requires residence countries to provide relief for double taxation through an exemption or foreign tax credit. For an excellent recent discussion of the saving clause see Patricia Brown, “Come on in, the Water’s . . . Choppy: The Expansion of the Saving Clause Beyond the United States,” in Brian J. Arnold, ed., *Tax Treaties after the BEPS Project: A Tribute to Jacques Sasseville* (Toronto: Canadian Tax Foundation 2018) 55 – 73.

³⁶ Paragraph 18 of the Commentary on Article 1 of the OECD Model Convention and paragraph of the Commentary on Article 1 of the UN Model Convention quoting paragraph 18 of the OECD Commentary.

³⁷ Convention Between Canada and the United States of America With Respect to Taxes on Income and on Capital Signed on September 26, 1980, as Amended by Protocols Signed on June 14, 1983, March 28, 1984, March 17, 1995, July 29, 1997 and September 21, 2007.

implement BEPS changes,³⁸ it seems likely that Canada will agree to include the saving clause on a bilateral basis.

Article 9 – Transfer Pricing

Article 9(1) of the OECD and UN Model Conventions states the arm's-length principle applicable to commercial and financial relations between associated enterprises. According to the arm's-length principle, where the prices charged in transactions between associated enterprises differ from the prices (arm's-length prices) that would be charged in similar or comparable transactions between unrelated or independent enterprises, the tax authorities can adjust the profits of the enterprises to reflect the true profits that would have been earned if the transactions had taken place at arm's length. If one contracting state applies its transfer pricing rules in accordance with the arm's-length principle in Article 9(1) to increase the profits of a resident enterprise from transactions with a related enterprise resident in the other contracting state, Article 9(2) requires the other state to provide a corresponding adjustment to the profits of the related enterprise in order to eliminate double taxation.

Article 9 of the OECD and UN Model Conventions is potentially applicable to deductible payments of interest between associated enterprises in excess of an arm's-length interest rate and to payments of interest on debt outstanding between associated enterprises in excess of an arm's-length amount of debt.³⁹ Moreover, according to the Commentary, Article 9(1) prevents the application of domestic thin capitalization rules to the extent that they result in profits of the

³⁸ Organisation for Economic Co-operation and Development, Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (“MLI”) (Paris: OECD, 2017).

³⁹ Paragraph 3 of the Commentary on Article 9 of the OECD Model Convention and paragraph 1 of the Commentary on Article 9 of the UN Model Convention, quoting paragraph 3 of the Commentary on Article 9 of the OECD Model Convention.

borrower in excess of the amount of profits that would have occurred in an arm's-length situation.⁴⁰

All Canadian tax treaties contain a provision similar to Article 9 of the OECD and UN Model Conventions.

Article 11(6) – Excessive Interest

Article 11(6) provides that the other paragraphs of Article 11 do not apply to excessive interest (interest in excess of the amount that would have been paid in the absence of a special relationship between the parties) paid by a resident of one contracting state to a related person resident in the other contracting state. The excess interest is taxable under the laws of the two countries with due regard to the other provisions of the treaty.⁴¹ Unlike Article 9, which applies where either the rate of interest or the amount of debt exceeds the arm's-length amount, Article 11(6) applies only to situations where the rate of interest is excessive.⁴²

Canadian tax treaties contain provisions similar to Article 11(6) of the OECD and UN Model Conventions.

Article 24 – Nondiscrimination

Article 24(4) of both the OECD and UN Model Conventions provides that interest, royalties, and other amounts paid by a resident of one contracting state to a resident of the other contracting state must be deductible in computing the profits of the payer under the same conditions as if they

⁴⁰ Ibid., and paragraph 74 of the Commentary on Article 24 of the OECD Model Convention.

⁴¹ The excess interest is not deemed to be a payment other than interest for purposes of the treaty, although it might be treated as a dividend under domestic law; however, Article 10 of the treaty would not apply because the excess interest is not “income from other corporate rights.” This issue is discussed below.

⁴² Paragraph 35 of the OECD Commentary on Article 11 and paragraph 22 of the UN Commentary on Article 11.

were paid to a resident of the country in which the payer is resident.⁴³ However, Article 24(4) does not apply if Article 9(1) or 11(6) applies to the payment. In effect, Article 24(4) precludes a state from discriminating against residents of the other state by denying the deduction of interest, royalties, or other amounts paid to them where a deduction is allowed for such payments to its own residents.

Article 24(5) provides that a corporation resident in one state that is owned or controlled by residents of the other contracting state should not be taxed less favourably than resident corporations owned or controlled by residents of the first state.⁴⁴ Unlike Article 24(4), Article 24(5) does not contain any exception for Article 9(1) or 11(6). However, the Commentary on Article 24 clarifies that the same exceptions to Article 24(4) should be read into Article 24(5):

Since the provisions of paragraph 1 of Article 9 or paragraph 6 of Article 11 form part of the context in which paragraph 5 must be read (as required by Article 31 of the Vienna Convention on the Law of Treaties), adjustments which are compatible with these provisions could not be considered to violate the provisions of paragraph 5.⁴⁵

Articles 24(4) and (5) do not prevent a country from imposing on non-residents additional information-reporting or other requirements for the deduction of expenses that are not imposed on

⁴³ See generally Luc Hinnekins and Philippe Hinnekins, General Report, in International Fiscal Association, *Non-discrimination at the crossroads of international taxation*, Cahiers de droit fiscal international, vol. 93a (The Netherlands: Sdu, 2008) 15-54 at 31-34.

⁴⁴ For a discussion of the potential application of Article 24(5) to thin capitalization rules see Craig Elliffe, “Unfinished Business: Domestic Thin Capitalization Rules and the Non-Discrimination Article in the OECD Model” (January 2013) 67:1 *Bulletin for International Taxation* 26-38. See also J.F. Avery Jones et al., “Art. 24(5) of the OECD Model in Relation to Intra-Group Transfers of Assets and Profits and Losses” (2011) 3 *World Tax Journal* 2.

⁴⁵ Paragraph 79 of the Commentary on Article 24 of the OECD Model Convention and paragraph 4 of the Commentary on Article 24 of the UN Model Convention, quoting paragraph 79 of the OECD Commentary.

residents, since those provisions apply only to the taxation imposed by a country and not to any connected requirements.⁴⁶

More generally, Article 24 does not apply to domestic-law measures expressly authorized by the provisions of the treaty.⁴⁷ The Commentary also provides that “It is . . . open to Contracting States to modify this provision [Article 24(4)] in bilateral conventions to avoid its use for tax avoidance purposes.”⁴⁸

As discussed in more detail below, Canadian tax treaties do not contain provisions comparable to Article 24(4) and (5) of the OECD and UN Model Convention unless they are subject to an exception for Canada’s thin capitalization rules.

Deduction of Interest by Non-residents

Article 7 deals with the taxation by one state of profits from a business carried on in that state by a resident of the other state to the extent that those profits are attributable to a PE in the first state. Under Article 7(2) of the OECD and UN Model Conventions, the PE is deemed to be a separate entity that deals independently with the rest of the enterprise. This separate-entity assumption is intended to make the arm’s-length principle of Article 9(1) and the transfer pricing guidelines applicable, by analogy, for the purpose of computing the profits attributable to a PE.⁴⁹

⁴⁶ Paragraph 75 of the Commentary on Article 24 of the OECD Model Convention and paragraph 4 of the Commentary on Article 24 of the UN Model Convention, quoting paragraph 75 of the OECD Commentary.

⁴⁷ Paragraph 4 of the Commentary on Article 24 of the OECD Model Convention and paragraph 1 of the Commentary on Article 24 of the UN Model Convention, quoting paragraph 4 of the OECD Commentary on Article 24. For example, withholding taxes on dividends, interest and other amounts authorized by the treaty would not violate Article 24.

⁴⁸ Paragraph 73 of the Commentary on Article 24 of the OECD Model Convention and paragraph 2 of the Commentary on Article 24 of the UN Model Convention, quoting paragraph 73 of the OECD Commentary on Article 24.

⁴⁹ Paragraph 16 of the OECD Commentary on Article 7 and paragraph 14 of the UN Commentary on Article 7.

Article 7 of the OECD Model Convention was substantially revised in 2010 to fully implement the separate-entity principle.⁵⁰ Thus, for example, a PE is considered to have the same amount of debt and equity that a separate entity carrying on the same activities would have, irrespective of the amount of debt and equity of the entity of which the PE is a part. Although Article 7 is not discussed in detail here, there are aspects of the Commentary on Article 7 that are relevant with respect to domestic-law restrictions on the deduction of interest.

The Commentary on Article 7 of the OECD Model Convention, as revised in 2010, indicates that Article 7(1) allocates taxing rights over profits attributable to a PE and Article 7(2) determines the profits that are so allocated. The Commentary goes on to provide expressly that the computation of the profits of a PE, including the deductibility of expenses, is determined in accordance with domestic law.⁵¹

Because Article 7(2) incorporates the arm's-length standard of Article 9, presumably the same result should apply under Article 9. Thus, the fundamental purpose of both Article 7 and Article 9 is to allocate profits between parts of an enterprise in the contracting states or related enterprises in the contracting states, but neither article deals with the computation of profits or the deductibility of expenses, which are matters for domestic law.

⁵⁰ See generally Jacques Malherbe and Philip Daenen, "Permanent Establishments Claim their Share of Profits: Does the Taxman Agree?" (July 2010) 64:7 *Bulletin for International Taxation* 359-366; Luis Nouel, "The New Article 7 of the OECD Model Tax Convention: The End of the Road?" (January 2011) 65:1 *Bulletin for International Taxation* 5-12; and Hans Pijl, "Interpretation of Article 7 of the OECD Model, Permanent Establishment Financing and Other Dealings" (June 2011) 65:6 *Bulletin for International Taxation* 294-306.

⁵¹ Paragraph 30 of the Commentary on Article 7 of the OECD Model Convention states: "Paragraph 2 does not deal with the issue of whether expenses are deductible when computing the taxable income of the enterprise in either Contracting State. The conditions for the deductibility are a matter to be determined by domestic law."

Article 7(3) of the UN Model Convention provides two specific rules with respect to the deduction of expenses in computing the profits of a PE.⁵² First, expenses incurred for the purposes of the business of the PE “shall be allowed as deductions” whether they are incurred in the PE state or elsewhere. Second, no deductions are allowed for notional royalties, fees for services, or interest paid by a PE to its head office or another part of the enterprise, except in the case of financial institutions.⁵³ These rules may seem to contradict the basic principle, identified above, that the deductibility of expenses is determined under domestic law;⁵⁴ however, the UN Commentary clarifies that, as under Article 7 of the OECD Model Convention, Article 7(3) deals with the attribution or allocation of expenses to a PE and the deductibility of those expenses is determined under domestic law.⁵⁵

Under Article 24(3) of both the OECD and UN Model Conventions, a country cannot impose tax on a PE of a resident of the other contracting state “less favourably” than it imposes tax on its own residents carrying on similar activities. Thus, if a country allows residents carrying on

⁵² Article 7(3) of the OECD Model Convention was similar before the 2010 update.

⁵³ Paragraph 18 of the UN Commentary on Article 7, quoting paragraph 41 of the 2008 Commentary on Article 7 of the OECD Model Convention. The exception for notional interest of PEs of financial institutions reflects the fact that the ordinary business of such institutions involves making and receiving advances, so that notional interest expenses are likely to approximate the actual interest expenses of the enterprise attributable to the PE.

⁵⁴ Paragraph 17 of the Commentary on Article 7 indicates that the basic objective of Article 7(3) is “to ensure that the expenditure claimed as a deduction in determining the taxable profits is relevant, referable and necessary for carrying out the business operations. There has to exist a nexus between the expenditure and the business activity so that the expenditure incurred is justified by business expediency, necessity or efficiency.”

⁵⁵ Paragraph 18 of the UN Commentary on Article 7, quoting paragraph 30 of the 2008 Commentary on Article 7 of the OECD Model Convention: “paragraph 3 only determines which expenses should be attributed to the permanent establishment for the purpose of determining the profits attributable to that permanent establishment. It does not deal with the issue of whether those expenses once attributed are deductible when computing the taxable income of the permanent establishment since the conditions for the deduction of expenses are a matter to be determined by domestic law, subject to the provisions of Article 24 on Non-discrimination (in particular paragraphs 3 and 4 of that Article).”

business to deduct interest, it must allow the residents of its treaty partners carrying on business in the country to deduct interest on the same or more favourable terms.⁵⁶ However, Article 24(3) does not prevent a country from applying its transfer pricing rules to disallow the deduction of excessive interest paid to an associated non-resident enterprise.⁵⁷

Most Canadian tax treaties contain provisions similar to Article 7 of the OECD Model as it read before 2010; a few contain a provision similar to Article 7 of the 2010 OECD Model Convention.⁵⁸ Many Canadian tax treaties also contain provisions similar to Article 24(3) of the OECD and UN Model Conventions.

Article 29(9) – The General Anti-Abuse Rule

Article 29(9) of the OECD and UN Model Conventions allows a country to deny the benefit of a treaty where one of the main purposes of a transaction is to obtain such a benefit, unless the taxpayer can establish that granting the benefit in the circumstances would be in accordance with the object and purpose of the treaty. Article 29(9) applies “[N]otwithstanding any other provision of this Convention” so that it would prevail in the event of a conflict with another provision of the treaty. It is theoretically impossible for Article 29(9) to be applied to restrict the deduction of interest because, as noted above, the deductibility of expenses, including interest, is a matter for domestic law. However, it is conceivable that Article 29(9) could result in the restriction of the deduction of interest indirectly by denying the benefit of Article 7, 9, or 24 of a treaty.

⁵⁶ Paragraph 40(a) of the Commentary on Article 24 of the OECD Model Convention and paragraph 2 of the Commentary on Article 24 of the UN Model Convention, quoting paragraph 40(a) of the OECD Commentary on Article 24.

⁵⁷ Paragraph 42 of the Commentary on Article 24 of the OECD Model Convention and paragraph 2 of the Commentary on Article 24 of the UN Model Convention, quoting paragraph 42 of the OECD Commentary on Article 24.

⁵⁸ For example, the treaties with the United Kingdom and the United States.

Many of Canada's tax treaties will contain a general anti-abuse rule identical to Article 29(9) of the OECD and UN Model Conventions once the Multilateral Convention becomes effective for those treaties. However, since Canada's general anti-avoidance rule applies in the event of any conflict with the provisions of a treaty, it is unclear what, if any, impact the addition of the treaty general anti-abuse rule to any Canadian tax treaties will have.

Summary

The effect of the provisions of the OECD and UN Model Conventions on domestic-law restrictions on the deduction of interest can be summarized as follows:

- Article 24(4) and (5) prevent a contracting state from limiting the deduction of interest (and other disbursements) paid to residents of the other contracting state where the deduction of interest paid to residents of the first state are not similarly limited, unless the limitations are covered by Article 9(1) or 11(6);
- Article 9(1) prevents the application of domestic restrictions on the deduction of interest, including thin capitalization rules, to the extent that they apply only to interest paid to non-residents and result in the taxation of profits in excess of the arm's-length profits.
- Article 24(3) prevents a contracting state from discriminating against residents of the other state carrying on business in the first state through a PE; arguably, Article 24(3) would prevent a state from limiting the deduction of interest by a non-resident in computing the profits attributable to a PE under Article 7 (for example, through the application of thin capitalization rules) where residents of the state are not subject to a similar limitation;
- With the exception of Articles 9(1) and 24, the provisions of the OECD and UN Model Conventions do not deal with or have any effect on the deductibility of interest and other expenses; and

- Restrictions on the deduction of interest under domestic anti-avoidance rules are arguably not prevented by the provisions of the OECD or UN Model Conventions.

The Provisions of Canadian Tax Treaties Relevant to Restrictions on the Deduction of Interest

Introduction

As noted in the previous section, the provisions of Canadian tax treaties that are potentially applicable to restrictions on the deduction of interest under the Act are significantly different from the provisions of the OECD and UN Model Conventions described above. These differences are described briefly below. In general, Canadian tax treaties follow the provisions of the OECD Model Convention, including Articles 7 and 9 dealing with the attribution of profits to PEs and the determination of profits of associated enterprises, but do not generally follow the OECD version of Article 24.

Canadian tax treaties can be expected to include the general anti-abuse rule in Article 29(9) and the saving clause in Article 1(3) of the OECD and UN Model Conventions. However, those provisions are unlikely to have any effect on restrictions on the deduction of interest under Canadian domestic law. As discussed above, Article 29(9) allows countries to deny treaty benefits in certain circumstances. Since tax treaties do not deal with the deductibility of interest except as a matter of nondiscrimination under Article 24, Article 29(9) would appear to have a very limited role with respect to restrictions on the deduction of interest under domestic law. Article 1(3) allows states to tax their residents without regard to the treaty subject to several exceptions including the nondiscrimination article; therefore, the key issue is the effect of Article 9(1) and 24 on the restrictions on the deduction of interest under Canadian law.

Canadian Tax Treaty Policy with Respect to the Nondiscrimination Article

Canadian tax treaty policy is clearly to ensure that the provisions of its tax treaties do not prevent Canada from applying its thin capitalization rules. This result is accomplished in a variety of ways, all of which appear to be effective. As noted above, the only provisions of the OECD and UN Model Conventions that could prevent the application of Canada's thin capitalization rules are provisions similar to Article 24(4) and (5) and Article 9(1), which is an exception to Article 24(4) and (5). Article 24(4) prevents a contracting state from allowing the deduction of interest and other disbursements paid by its residents to residents of the other state on terms that are less favourable than those applied to the deduction of interest paid to its own residents. Article 24(5) prevents a contracting state from treating resident corporations owned or controlled by residents of the other contracting state less favourably than resident corporations owned or controlled by its own residents. Both provisions are subject to an exception for less favourable treatment that is in accordance with Article 9(1) or 11(6), which allows countries to adjust the amount of non-arm's-length or excessive payments of interest.

The four major methods used to preserve the application of Canada's thin capitalization rules in its tax treaties are:

1. Tax Treaties without any Nondiscrimination Article

Six treaties – the treaties with Australia, Ivory Coast, Kuwait, New Zealand, Oman and Papua New Guinea – do not have any nondiscrimination article. Therefore, other than Article 9(1), there is nothing in these treaties to prevent Canada from applying its thin capitalization rules.

2. Tax Treaties without Article 24(4) and (5)

Eleven treaties – Austria, Finland, France, Jordan, Malaysia, Moldova, Russia, Singapore, Ukraine, United Kingdom, Venezuela – have nondiscrimination articles, but those articles

do not contain provisions similar to Article 24(4) and (5) of the OECD and UN Model Conventions. Since Article 24(4) and (5) are the only parts of Article 24 that could prevent the application of Canada's thin capitalization rules, there is nothing in these treaties to prevent Canada from applying its thin capitalization rules, other than Article 9(1).

3. Tax Treaties without Article 24(4) and with Article 24(5) Limited to Most-Favoured-Nation Treatment

Over 50 treaties have nondiscrimination articles without any provision similar to Article 24(4), but with a provision similar to Article 24(5) that is limited to most-favoured-nation treatment (unlike Article 24(5) of the OECD and UN Model Conventions, which provides national treatment). Article 24(5) of the OECD and UN Model Convention ensures that Canadian-resident corporations controlled by residents of the other contracting state are treated no worse than Canadian-resident corporations controlled by residents of Canada. In contrast, the most-favoured-nation treatment provided by Article 24(5) of these treaties ensures only that Canadian-resident corporations controlled by residents of the other contracting state will be treated no worse than Canadian-resident corporations controlled by the residents of any third country. Thus, Canada is not required to allow Canadian-resident corporations to deduct interest paid to the residents of one of these countries as long as interest paid to the residents of any other country with which Canada has a tax treaty is not deductible.

4. Tax Treaties with Article 24(4) Subject to an Exception for Restrictions on the Deduction of Interest and with Article 24(5) Limited to Most-Favoured-Nation Treatment

Thirteen treaties⁵⁹ contain nondiscrimination articles with provisions similar to Article 24(4) and (5) of the OECD and UN Model Convention; however, the provision equivalent to Article 24(5) is limited to most-favoured-nation treatment, as described above. All of these treaties also contain a specific exception that allows Canada to apply its thin capitalization rules. A typical exception reads as follows:

The provisions of [paragraph 4] shall not affect the operation of any provision of the taxation laws of a Contracting State:

- (a) relating to the deductibility of interest and which is in force on the date of signature of this Convention (including any subsequent modification of such provisions that does not change the general nature thereof); or
- (b) adopted after such date by a Contracting State and which is designed to ensure that a person who is not a resident of that State does not enjoy, under the laws of that State, a tax treatment that is more favourable than that enjoyed by residents of that State.

This exception, although reciprocal, is clearly intended to allow Canada to continue to apply its thin capitalization rules despite the treaty.⁶⁰ It applies only to restrictions on interest deductibility in effect at the time that the treaty was signed, and any subsequent modification of those restrictions that does not alter the general nature of those restrictions. Although the thin capitalization rules have been amended several times since they were first enacted in 1972,

⁵⁹ Armenia, Denmark, Lebanon, Mexico, Mongolia, Norway, Portugal, Romania, Slovak Republic, Slovenia, Sweden, and the United States.

⁶⁰ See the US Treasury Department, Technical Explanation to the Canada-United States Treaty (April 1984). The Canadian Department of Finance issued a news release indicating that the US Technical Explanation accurately reflects the understanding of the Government of Canada of the interpretation of the treaty.

none of those amendments have altered the general nature of the rules.⁶¹ Any new restrictions on the deduction of interest adopted by one state after such a treaty is signed can discriminate against residents of the other contracting state, but only if those restrictions are designed to ensure that those residents are not treated more favourably than the first state's own residents.

It is not obvious which of these four methods Canada prefers for preserving its thin capitalization rules in its tax treaties. As a result, it seems reasonable to assume that the method adopted in any particular treaty is the one preferred by the other country.

In addition to the four methods described above that are used by Canada to ensure that its tax treaties do not prevent the application of the thin capitalization rules, the treaties with Belgium, Brazil, Bulgaria, and Uzbekistan achieve the same result in a manner that is peculiar to each of these treaties. Article 24(4) of the treaty with Belgium applies only to royalties; Article 24(4) of the treaty with Brazil provides only most-favoured-nation treatment; and Article 24(4) of the treaty with Bulgaria provides national treatment for amounts other than interest, in accordance with Article 24(4) of the OECD and UN Model Conventions, but provides only most-favoured-nation treatment with respect to interest. Article 24(4) of the treaty with Uzbekistan is identical to Article 24(4) of the OECD and UN Model Conventions, but Article 24(7) contains an exception for domestic provisions designed to counter tax avoidance.⁶²

⁶¹ In *Ramada Ontario Ltd. v. The Queen* [1994] 1 CTC 2130 (TCC) the Tax Court held that in Article XXV(7) of the Canada-United States the "general nature" of the thin capitalization rules meant their purpose and that purpose was not affected by subsequent amendments that altered the definition of "equity." Similar provisions are typically found in the elimination-of-double-taxation articles in Canadian tax treaties. For a discussion of the meaning of these provisions see Brian J. Arnold, "Unlinking Tax Treaties and the Foreign Affiliate Rules: A Modest Proposal" (2002) 50:2 *Canadian Tax Journal* 607-29 at 619-23.

⁶² Article 24(7) provides: "The provisions of paragraph 4 shall not affect the provisions of the taxation laws of a Contracting State that are designed to counter transactions or arrangements having as their objective the avoidance of taxation." Presumably, the Canadian tax authorities would take the position that the thin capitalization rules are included in this exception for tax-

Canadian Tax Treaty Policy with respect to the Characterization of Interest and Dividends and Debt and Equity

The distinction between interest and dividends is implicitly assumed by the OECD and UN Model Conventions;⁶³ for example, Article 24(4) refers to the deduction of interest and other disbursements but does not mention dividends, presumably because dividends are not deductible. Therefore, it is unclear whether Article 24(4) or (5) of the OECD and UN Model Conventions prevents the application of domestic rules that deem interest to be dividends or dividends to be interest.

The term “dividends” is defined in Article 10(3) to mean income from shares “not being debt claims” and includes “income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident.” “Interest” is defined in Article 11(3) to mean “income from debt claims of every kind.” Canadian tax treaty practice is different in this regard. Under most Canadian tax treaties, the term “dividends” is defined to include “income that is subjected to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident.” Moreover, the definition of “interest” is defined to include “income assimilated to income from money lent by the taxation laws of the Contracting State in which the income arises” and excludes any amount included in the definition of a dividend. Thus, interest that is recharacterized as a dividend under the Act is treated as a dividend for purposes of Canadian tax treaties because it is taxed as income from shares under Canadian law, and because the definition of “dividend” in Canadian treaties is not limited to income from corporate rights.

avoidance provisions. According to paragraph 2 of the Protocol, both Article 24(4) and the exception will become effective only on an exchange of letters by the competent authorities. It is unclear whether such an exchange of letters has taken place. If an exchange of letters has not occurred, neither Article 24(4) nor the exception would apply and the treaty with Uzbekistan would not preclude the application of the Canadian thin capitalization rules.

⁶³ Paragraph 3 of the UN Commentary on Article 11 states that “[A]t the domestic level, interest is usually deductible in calculating profits.”

However, interest deemed to be a dividend would be outside the definition of “dividends” in Article 10(3) of the OECD and UN Model Conventions because it is not income from corporate rights. Instead, such interest would appear to be within the definition of “interest” in Article 11(3) as income from a debt claim despite the fact that it is deemed to be a dividend under domestic law. Similarly, a dividend that is deemed to be interest under Canadian law would be treated as interest for purposes of the interest article because the definition of interest is not limited to income from debt claims; however, the deemed interest would be treated as a dividend under the OECD and UN Model Conventions because it is income from corporate rights and not from debt claims.

The term “interest” in Article 24(4) of the OECD and UN Model Conventions and in the interest article in Canadian tax treaties is not defined; the definition of “interest” in Article 11(3) literally applies “as used in this Article.” Thus, the issue is whether the definition of “interest” in Article 11(3) applies for purposes of Article 24(4). In the context of the treaty as a whole, including the reference to Article 11(6) in Article 24(4), the preferable interpretation is probably that interest for purposes of Article 24 should have the same meaning as it has for Article 11. However, this interpretation is not supported by any authority that I am aware of; and there is an argument that, as an undefined term, “interest” in Article 24(4) should have its domestic-law meaning in accordance with Article 3(2).

Under Canadian tax treaties, any interest that is deemed to be a dividend would not be subject to Article 24(4) irrespective of whether “interest” has the meaning it has for purposes of Article 11 or its meaning under the Act since both meanings are the same. However, under the OECD and UN Model Conventions, interest that is deemed to be a dividend under domestic law is still interest for purposes of Article 11. On the one hand, if this meaning applies for purposes of Article 24(4), Article 24(4) will apply to prevent the domestic-law restrictions on the deduction of the interest; on the other hand, if the domestic-law meaning of interest applies for purposes of Article 24(4), Article 24(4) will not apply because the interest is deemed to be a dividend.

Where, instead of deeming interest to be a non-deductible dividend, domestic law deems the underlying property in respect of which interest payments are made to be equity rather than debt, the result would likely be different. Article 11(3) of the OECD and UN Model Convention defines “interest” as income from “debt claims.” As an undefined term, “debt claims” should have its domestic-law meaning under Article 3(2) of the treaty unless the context of the treaty requires a different meaning. Therefore, if domestic law deems certain debt to be equity, and accordingly, any payments on the deemed equity are deemed to be dividends, Article 24(4) or (5) would not apply to such deemed dividends. This result seems to be at least curious, and probably unsatisfactory – not because the application of the treaty depends on domestic law, which is often the case, but because the application of the treaty depends on the way in which domestic law achieves a particular result and not on the result itself.

Canadian Tax Treaty Policy with respect to Article 9(1) [add reference to Specialty manufacturing]

Although Canada has effectively ensured that the nondiscrimination article does not prevent the application of Canada’s thin capitalization rules, the issue remains whether Article 9(1) of Canadian tax treaties does so.⁶⁴ A detailed analysis of the relationship between Article 9(1) and restrictions on the deduction of interest, including thin capitalization rules, is beyond the scope of this article;⁶⁵ however, a brief summary of the arguments is presented here.

⁶⁴ The issue was raised in one Canadian case, *Specialty Manufacturing Ltd. v. The Queen* [1999] FCJ 744 (FCA). The taxpayer argued that Article 9(1) of the treaty with the United States restricted Canada’s ability to apply its thin capitalization rules. The complete answer to this argument was the saving clause in the treaty; however, the court held that the amount of the debt was clearly in excess of an arm’s length amount so that Article 9(1) allowed Canada to disallow the excessive interest.

⁶⁵ For my views on this issue see Brian J. Arnold, “The Relationship between Thin Capitalization Rules and Tax Treaties,” in *Hoyt Skattet, Festschrift til Frederik Zimmer* (Oslo: Universitetsforlaget 2014) at 5-28. For the more conventional view that Article 9(1) prevents a country from taxing more than the arm’s length profits of taxpayers see Ekkehart Reimer and

In general, the issue is whether Article 9(1) is “restrictive” or “illustrative.” These two interpretations reflect the divergent views of OECD member countries as discussed in the 1986 Report on Thin Capitalisation.⁶⁶ Under the “restrictive” approach, Article 9(1) prohibits adjustments to the profits of an enterprise in excess of an arm’s-length amount (for example, by denying or limiting the deduction of interest paid by a resident to an associated non-resident). As discussed subsequently, most commentators conclude that unless Article 9(1) restricts countries in this way it is meaningless. In contrast, under the “illustrative” approach, Article 9(1) provides a non-binding statement of the arm’s-length principle and a framework for the adjustment of profits, but it does not prohibit a country from taxing profits of resident enterprises in excess of an arm’s-length amount. Assuming that Article 9(1) prevents a country from taxing profits in excess of an arm’s-length amount, does it also prevent the application of domestic anti-avoidance rules, such as thin capitalization rules, that may have this effect? A subsidiary issue is whether Article 11(6), which deals with excessive payments of interest, is consistent with the proper interpretation of Article 9(1).

As noted above, although the OECD Commentary is not completely clear, it seems to favour the restrictive view of Article 9(1); and it clearly states that thin capitalization rules based on a fixed debt:equity ratio that apply only to payments of interest to non-residents are contrary to Article 9(1) to the extent that they result in the taxation of more than the arm’s-length profits of an enterprise.⁶⁷ Surprisingly, no country, and in particular Canada, has entered a reservation on Article 9(1), perhaps because a reservation is unnecessary in light of the two views recognized in

Alexander Rust eds., Klaus Vogel on Double Taxation Conventions, 4th edition, (Alphen aan den Rijn, WoltersKluwer 2015) 600-604.

⁶⁶ OECD, *Thin Capitalisation*, adopted by the OECD Council on 26 November 1986, reproduced in OECD Model Tax Convention (Full Version) at R(4)-1-35.

⁶⁷ Paragraph 3 of the Commentary on Article 9 of the OECD Model Convention and paragraph 1 of the Commentary on Article 9 of the UN Model Convention, quoting paragraph 3 of the Commentary on Article 9 of the OECD Model Convention.

the OECD Thin Capitalisation Report. However, the Commentary on Article 9(2) recognizes that countries might tax more than the arm's-length profits of an enterprise and indicates that in such situations the other country is not required to make a corresponding adjustment.⁶⁸

A textual analysis of Article 9(1) indicates that it uses the permissive word “may” rather than the mandatory “shall.”⁶⁹ Therefore, the plain meaning of Article 9(1) permits, but does not require, a country to increase the profits of an enterprise as a result of non-arm's-length transactions. Further, by implication, it does not preclude a country from taxing the profits of an enterprise in excess of its arm's-length profits by limiting interest deductions. Literally, Article 9(1) allows a country to increase the profits of an enterprise where it engages in transactions with an associated enterprise in the other contracting state and the profits of the first enterprise are understated because of the non-arm's-length conditions of these transactions. Article 9(1) does not say anything about whether a country can tax a resident enterprise on profits in excess of its arm's-length profits.

Taking into account the context of the treaty as a whole, the restrictive interpretation of Article 9(1) is not persuasive. It should be noted that Article 9 is different from the other distributive rules of the treaty in that it deals with the allocation of taxing rights between two residence countries, whereas the other rules deal with the allocation of taxing rights between the source and residence countries. Nevertheless, the restrictive view of Article 9(1) is contrary to the fundamental principle

⁶⁸ Paragraph 6 of the Commentary on Article 9 of the OECD Model Convention and paragraph 6 of the Commentary on Article 9 of the UN Model Convention, quoting paragraph 6 of the Commentary on Article 9 of the OECD Model Convention.

⁶⁹ Wherever the word “may” is used in other distributive articles of the OECD and UN Model Conventions, the provisions are not intended to be restrictive of the taxing rights of the relevant country. Moreover, wherever the word “may” is used in a provision that imposes a limitation on a country's taxing rights, the limitation is explicit; see, for example, Article 7. Where the provisions of the Model Conventions are intended to operate in a restrictive fashion, they use the term “shall be taxable only,” or the expression “may be taxed,” with the restriction spelled out explicitly, as in Articles 7, 10 and 11 (and 12 and 12A of the UN Model Convention).

that tax treaties do not restrict a country's rights to tax its own residents unless it does so explicitly.⁷⁰ This principle, which is reflected in the saving clause (Article 1(3), added to the OECD and UN Model Conventions in 2017), is subject to several exceptions, but Article 9(1) is not among them.⁷¹ Therefore, the restrictive view of Article 9(1) is contrary to Article 1(3) and to the fundamental principle that treaties do not restrict the rights of countries to tax their own residents, which, according to the Commentary, is implicit in all tax treaties.

The relationship between Articles 7 and 9 is also a relevant consideration. Under Article 7, a country *may* tax the business profits of a resident of the other country carrying on business through a PE in the country but only the profits attributable to that permanent establishment.” It would be strange for Article 7 to restrict the authority of a country in which a PE is located to tax an amount in excess of the arm's-length profits attributable to the PE, but not for Article 9 to do so with respect to associated enterprises.⁷² Therefore, it is argued that Article 9(1) should be interpreted to restrict a country's right to tax a resident enterprise on more than its arm's length profits. Although this is a reasonable argument in terms of tax treaty policy, the wording of Article 9(1) does not justify a restrictive interpretation as clearly as the wording of Article 7 does.

Three other points support the illustrative view of Article 9(1). First, although the G20/OECD BEPS Action 4 Final Report⁷³ did not deal with the relationship between restrictions on the deduction of interest under domestic law and Articles 9(1) and 24, its recommendation to limit interest deductions to a percentage of an enterprise's earnings before interest, taxes, depreciation

⁷⁰ Paragraph 18 of the Commentary on Article 1.

⁷¹ Article 9(2) is an exception to Article 1(3) so the exclusion of Article 9(1) cannot be considered an oversight.

⁷² See Reimer and Rust, eds., *supra* note 65, at 603.

⁷³ OECD/G20, Base Erosion and Profit Shifting Project, Action 4: 2015 Final Report, *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments*, available at www.oecd.org.

and amortization applies to interest paid to both arm's-length and non-arm's-length persons. Second, it is widely accepted that tax treaties do not affect limitations on the deduction of meals and entertainment expenses even where those expenses are incurred with respect to arm's-length persons; it is difficult to differentiate between such expenses and other expenses, including interest. Third, in the particular case of Canada, it would be perverse to interpret Article 9(1) to prevent Canada from applying its thin capitalization rules when Canada has taken such clear action in all its tax treaties to ensure that the nondiscrimination article does not prevent their application.

Therefore, my view is that, despite the overwhelming weight of case law and scholarly authority to the contrary, Article 9(1) does not and should not preclude the application of thin capitalization rules even if they result in the taxation of a resident enterprise on more than its arm's-length profits. Tax treaties should prevent the application of thin capitalization rules and other restrictions on the deduction of expenses only if those restrictions are contrary to Article 24.

Canadian Tax Treaty Policy with respect to Non-residents Carrying on Business in Canada Through a PE

The issue here is whether the provisions of Canadian tax treaties equivalent to Articles 7 and 24(3) of the OECD and UN Model Conventions prevent restrictions on the deduction of interest by non-residents in computing profits attributable to a PE. As discussed above, Article 7 limits Canada to taxing the profits attributable to a PE in Canada; the arm's-length transfer pricing guidelines under Article 9 apply for this purpose. Thus, an argument can be made that Canada cannot deny interest deductions that result in the taxation of a non-resident on more than the arm's-length profits attributable to the PE. However, Article 7 deals with the computation of profits (revenue and expenses) attributable to a PE; it does not deal with the deductibility of expenses for this purpose. Since it is generally accepted that countries can limit the deduction of meals and entertainment expenses incurred by non-residents, it would seem that they can also limit the deduction of interest expenses in determining taxable profits. Therefore, in my view, Article 7 of

Canada's tax treaties does not prevent the application of Canada's thin capitalization rules to non-residents carrying on business in Canada.

Article 24(3) of Canada's tax treaties prohibits Canada from discriminating against non-residents carrying on business in Canada through a PE. Under Canada's thin capitalization rules, the deduction of interest paid by a non-resident to other non-residents is restricted, but interest paid to Canadian residents is not similarly restricted. Therefore, the issue is whether a non-resident carrying on business in Canada that is not allowed to deduct interest under Canada's thin capitalization rules is treated less favourably than a resident of Canada carrying on similar activities. The key point in the analysis of this issue is the selection of the appropriate comparator. In my view, the appropriate comparator is a Canadian enterprise carrying on similar business activities to those carried on by the non-resident through the PE and paying interest to non-residents. Such a Canadian enterprise would be subject to Canada's thin capitalization rules and would not be entitled to the protection against discrimination provided by Article 24(4) and (5) of the OECD and UN Model Conventions. This result makes sense because under Articles 7 and 24(3), non-residents carrying on business through a PE in Canada are treated the same with respect to restrictions on the deduction of interest as Canadian corporations or trusts paying interest to non-residents are treated under Articles 9(1) and 24(4) and (5).

In contrast, applying the same comparator in the context of the OECD and UN Model Conventions would prevent the application of Canada's thin capitalization rules to a non-resident carrying on business in Canada through a PE in Canada to the extent that those rules result in the disallowance of arm's-length interest. Since a Canadian enterprise paying interest to non-residents would be entitled to the protection of Article 24(4) and (5), a non-resident carrying on business through a PE in Canada would be entitled to the same protection under Article 24(3). However, the exceptions for Article 9(1) and 11(6) in Article 24(4) would also apply for purposes of Article 24(3), with the result that domestic restrictions on the deduction of interest in excess of an arm's-

length amount would not be prevented by Article 24(3).⁷⁴ This result makes sense in the context of the Model Conventions because under Articles 7 and 24(3), non-residents carrying on business through a PE are treated the same with respect to restrictions on the deduction of interest as resident enterprises paying interest to non-residents are treated under Articles 9(1) and 24(4) and (5).⁷⁵

CONCLUSION

This article has analyzed whether the provisions of Canadian tax treaties affect the restrictions on the deduction of interest under Canadian law. It reviewed the relevant provisions of Canadian tax treaties and the OECD and Model Conventions to determine whether they would prevent the application of the Canadian restrictions on the deduction of interest. On the basis of this review, the article concludes that all Canada's tax treaties have been carefully negotiated and drafted to ensure that they do not prevent the application of Canada's thin capitalization rules and rules that deem interest to be dividends. In contrast, the OECD and UN Model Conventions would prevent the application of any thin capitalization rules, including Canada's, based on a fixed debt:equity ratio to the extent that those rules applied only to interest paid to non-residents and disallowed the deduction of interest that complies with the arm's-length standard.

The article questions whether the position of the OECD and UN Model Conventions with respect to thin capitalization rules represents good tax treaty policy. In particular, it suggests that, in light of the addition of the saving clause to the Model Conventions in 2017, Article 9(1) should not be interpreted to prevent the application of domestic restrictions on the deduction of interest that result in the taxation of more than the arm's-length profits of an enterprise. Instead, domestic

⁷⁴ Paragraph 42 of the Commentary on Article 24 of the OECD Model Convention and paragraph 2 of the Commentary on Article 24 of the UN Model Convention, quoting paragraph 42 of the OECD Commentary on Article 24.

⁷⁵ The parallel results for the tax treatment of non-residents carrying on business through a PE under Articles 7 and 24(3) and the tax treatment of residents under Articles 9(1) and 24(4) and (5) would be clearer if Article 7(2) were an explicit exception to Article 24(3) and if the issue had been explained in the Commentary.

restrictions on the deduction of interest should be prevented only if they are discriminatory under Article 24(3), (4) or (5).