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Canadian Tax & Legal Alert

International tax measures in the federal budget, including new interest deductibility limits and anti-hybrid rules

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On April 19, 2021, the Deputy Prime Minister and Minister of Finance, Chrystia Freeland, introduced the government's first budget in two years. We refer you to our tax alert which provides tax highlights from the budget.

Included in the budget are certain long-anticipated international measures relating to the Organisation for Co-operation and Development's base erosion and profit shifting (BEPS) project, of which Canada has been an active participant. Specifically, the budget includes proposals for new interest deductibility limits and anti-hybrid rules based on the recommendations outlined in the reports on Action 4 (*Limitation of interest deductions*) and Action 2 (*Neutralising the effects of hybrid mismatch arrangements*). In both cases, the proposals will not apply immediately, but will rather have future effective dates, as outlined below.

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Interest deductibility limits

The budget proposes to introduce a new earnings-stripping rule that would limit the amount of net interest expense that a corporation, trust, partnership or Canadian branch may deduct in computing its taxable income to no more than a fixed ratio of EBITDA determined on a tax basis.

- The new limitation is to be phased in, with a fixed ratio of 40% of EBITDA for taxation years beginning on or after January 1, 2023, but before January 1, 2024; and 30% for taxation years beginning on or after January 1, 2024.
- Net interest expense includes interest expense and deductions economically equivalent to interest, as well as other financing-related expenses, less interest and financing-related income.
- EBIDTA for these purposes is based on taxable income before taking into account interest expense, interest income and income tax, and deductions for depreciation and amortization, in each case as determined for tax purposes.
- As EBITDA is based on taxable income, it excludes dividends that qualify for the inter-corporate dividend deduction or the deduction for certain dividends received from foreign affiliates.
- Existing interest deductibility restrictions continue to apply, including the thin capitalization rules which limit the deductibility of interest expense where the amount of debt owing to specified non-residents exceeds a 1.5-to-1 debt-to-equity ratio.
- Interest on debts between Canadian members of a corporate group are generally excluded from the new rule in order to facilitate domestic loss consolidation transactions.
- Exemptions are available for certain taxpayers, including Canadian-controlled private corporations which, together with associated corporations, have taxable capital employed in Canada of less than $15 million, as well as groups or corporations and trusts with total net interest expense of $250,000 or less.
- Any interest denied under the earnings-stripping rule can be carried forward for up to 20 years or back for up to 3 years, under certain conditions, including for taxation years prior to the date on which the legislation takes effect.
- Unused capacity to deduct interest can be transferred to another Canadian member of a corporate group whose net interest expense deductions would otherwise be limited by the rule.
- A "group ratio" rule is included that allows the deduction of interest in excess of the fixed ratio where a taxpayer can demonstrate that the ratio of net third party interest to book EBITDA of its consolidated group implies a

higher deduction limit is appropriate. Under the group ratio rule, the measures of net third party interest expense and book EBITDA would be based on the group's audited consolidated financial statements, with certain adjustments.

- While no sector-specific carve-outs are contemplated, the above-noted group ratio concept is expected to provide relief for taxpayers in industries that are more reliant on debt financing.

- Standalone Canadian corporations and Canadian corporations that are members of a group, none of whose members is a non-resident, are not expected to have their net interest deductions limited by the new rule.

- Specific considerations for financial institutions and life insurance companies are mentioned, including a proposal to limit their ability to transfer unused capacity to deduct interest to other members of their corporate groups that are not also regulated banking or insurance entities. Consideration is also being given to whether targeted measures could be introduced to address base erosion concerns associated with excessive interest deductions by banks and life insurance companies.

- The earnings-stripping rule applies to taxation years that begin on or after January 1, 2023 and will apply with respect to both existing and new borrowings. An anti-avoidance rule will be included in order to prevent taxpayers from deferring the application of the measure.

- Draft legislation was not included in the budget material but is expected to be released for comment in the summer.

Hybrid mismatch arrangements

Also included in the budget is a proposal for new rules aimed at hybrid mismatch arrangements, consistent with the recommendations in the BEPS Action 2 Report. Hybrid mismatch arrangements are described in the budget as "cross-border tax avoidance structures that exploit differences in the income tax treatment of certain business entities or financial instruments under the laws of two or more countries to produce mismatches in tax results."

- Two main types of hybrid mismatch arrangements are addressed by the Action 2 recommendations:

    - Deduction/non-inclusion mismatches, which arise when one country allows a deduction in respect of a cross-border payment that is not included in the taxable income of the recipient within a reasonable period of time; and
    - Double deduction mismatches, which arise when a single economic expense gives rise to a tax deduction in two or more countries.

- The Action 2 recommendations also address other hybrid mismatch arrangements, including branch mismatch arrangements, imported mismatches, and reverse hybrids.

- The budget proposes to implement rules consistent with the Action 2 recommendations, with appropriate adaptations to the Canadian income tax context.

- Under the main proposed rules, payments made by a Canadian resident under a hybrid mismatch arrangement would not be deductible for Canadian income tax purposes if the amounts are deductible in another country or are not included in the income of the non-resident recipient. Similarly, payments received by a Canadian resident under a hybrid mismatch arrangement would be included in income and, in the case of a dividend, would not be eligible for the deduction otherwise available for certain dividends received from foreign affiliates.

- Rules to address branch mismatch arrangements, imported mismatches, and reverse hybrids may be introduced to the extent relevant and appropriate in the Canadian context.

- The new rules are to be implemented in two separate legislative packages, neither of which were included in the budget material:

    - The first package will address deduction/non-inclusion mismatches arising from payments in respect of financial instruments, consistent with Chapters 1 and 2 of the Action 2 Report. This package is to be released for comment later in 2021 and would apply as of July 1, 2022.
    - The second package will focus on other Action 2 recommendations not addressed in the first package. This package is to be released for comment after 2021 and would apply no earlier than 2023.

Summary

The new interest deductibility limits and anti-hybrid rules will have a significant impact on many Canadian-based multinationals, as well as many foreign-based multinationals with Canadian subsidiaries. In particular, they will have a significant impact on decisions concerning the location and manner in which to raise external financing, and the nature and extent to which internal cross-border financing is made available to other group companies. It remains to be seen what, if any, impact the domestic earnings-stripping rule may have in the context of Canada’s foreign affiliate rules, since certain components of foreign affiliate earnings are required to be computed with reference to Canadian rules, except to the extent the context otherwise requires. With respect to rules neutralizing the effects of hybrid mismatch arrangements, while certain existing structures employed by Canadian multinationals for the purpose of financing foreign operations may remain unaffected, it is important to keep in mind the potential impact that multilateral discussions regarding the introduction of a global minimum tax could have on the viability of such structures. It will be important for organizations to evaluate all structures and future planning alternatives comprehensively, having regard to the ever-increasing complexity in the cross-border tax landscape.

How can Deloitte help you?

Deloitte's International Tax professionals can help you understand how these new tax measures may impact your business.

If you have any questions on any of the above, please reach out to your Deloitte advisor or any of the individuals noted on this alert.

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