

# **INTEREST DEDUCTIBILITY AND HYBRID MISMATCH RULES**

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# EXCESSIVE INTEREST AND FINANCING EXPENSES LIMITATION (“EIFEL”)

## INTRODUCTION AND OVERVIEW

- Legislation released on February 4, 2022 to implement 2021 budget proposal to limit deduction for interest and financing expenses
- Regime intended to be consistent with recommendation of Action 4 report of OECD BEPS Action Plan
- Generally applicable for taxation years that begin on or after January 1, 2023 (subject to certain anti-avoidance rules)

## INTRODUCTION AND OVERVIEW

Who do the rules apply to?

- Any corporation or trust other than an “excluded entity”
- Excluded entities:
  - Small CCPCs
  - Members of related groups whose total “Interest and financing expenses” (IFE) less its “interest and financing revenues” (IFR) is less than \$250k
  - Corporations and trusts that individually and together with all eligible group entities carry on all business in Canada, that do not have foreign affiliates or non-resident specified shareholders or beneficiaries and that do not pay IFE to tax indifferent investors

# INTRODUCTION AND OVERVIEW

What do the rules do?

- Deny the deduction of IFE for a proportion of the IFE incurred (directly and not through a partnership)
- Proportion equal to excessive IFE divided by total IFE
- Excessive IFE being the IFE less permissible IFE less IFR (ignoring “absorbed capacity” and “received capacity”)
- Permissible IFE can be calculated in two ways (1) using the fixed “ratio of permissible expenses” (RPE) (30%) or (2) the group ratio, in each case multiplied by “adjusted taxable income” (ATI)

# INTRODUCTION AND OVERVIEW

## Reducing Excessive IFE With Excess Capacity

- Excessive IFE can be reduced with absorbed capacity and received capacity
- Absorbed capacity is negative amounts of excessive IFE from prior years
- Received capacity is negative amounts of excessive IFE transferred to an eligible group corporation from another eligible group corporation

# INTRODUCTION AND OVERVIEW

Is there anything else?

- Special rules for partnerships could result in income inclusion under s.12(1)(1.2) for partner's share of excessive IFE incurred by partnership
- Election to exclude from IFE and IFR interest paid between eligible group corporations
- Requirement to exclude from IFR amounts received from non-arm's length persons or partnerships
- "Restricted interest and financing expenses" can be carried forward 20 years
- Numerous anti-avoidance rules

# OVERVIEW OF KEY DEFINITIONS AND RELATED ISSUES

## Interest and Financing Expenses

- Deductibility of IFE subject to potential denial under the EIFEL rules
- Added back in computing ATI
- Components of IFE
  - a. Interest, other than non-deductible interest and excluded interest
  - b. Other deductible financing costs – s.20(1)(e)(ii), s.20(1)(e)(ii.1), s.20(1)(e)(ii.2), s.20(1)(e.1), 20(1)(e.2) and s.20(1)(f)
  - c. Portion of CCA and resource pool deductions that is attributable to capitalised interest and financing costs - inclusion is for the year in which deduction is claimed, not for the year in which the expense was capitalised



# OVERVIEW OF KEY DEFINITIONS AND RELATED ISSUES

## Interest and Financing Expenses (cont'd)

### ◦ Components of IFE (cont'd)

d. Amounts paid or payable, or a loss or capital loss, under or as a result of an agreement or arrangement, where:

- The amount is otherwise deductible (but not under s.20(1)(e)(i)) in computing income for the year, or in the case of a capital loss, if claimed as an offset to taxable capital gains in the year
- The agreement or arrangement is entered into as or in relation to a borrowing, or other financing entered into, by the taxpayer, and
- The amount can reasonably be considered to be part of the cost of funding of the taxpayer or NAL person

## OVERVIEW OF KEY DEFINITIONS AND RELATED ISSUES

### Interest and Financing Expenses (cont'd)

- Components of IFE (cont'd)

- e. Expenses incurred in relation to derivatives in paragraph (d) (such as fees payable under the arrangement or costs incurred to enter into the arrangement)
- f. Lease financing amount, other than for excluded lease - imputes a financing cost to lessees in respect of their lease payments
- g. Pro-rata share of financing expenses of a partnership, less amounts specifically added back or denied under at-risk rules
- h. Portion of limited partnership loss deducted that is attributable to partnership's financing costs that was excluded in a prior year

Less: B - amounts received by the taxpayer under certain derivative arrangements described in paragraph (d) provided they are (i) included in income and (ii) reduce funding costs of the taxpayer or NAL person

## OVERVIEW OF KEY DEFINITIONS AND RELATED ISSUES

### Interest and Financing Expenses (cont'd)

- Related anti-avoidance rules
- Proposed s.18.2(13) – very broad anti-avoidance rule for interest expenses
  - An amount that would otherwise not be included in interest and financing expenses must be so included if:
    - The amount arises in the course of a transaction or series, and
    - It can reasonably be considered that “one of the purposes” of the transaction is to cause the amount not to be included in interest and financing expenses

## OVERVIEW OF KEY DEFINITIONS AND RELATED ISSUES

### Interest and Financing Revenues

- IFR increases the amount of IFE deductible under the EIFEL rules
- IFR included in computing a taxpayers' excess capacity
  - a. Interest received, other than excluded interest, that is included in computing income
  - b. Guarantee fees received

# OVERVIEW OF KEY DEFINITIONS AND RELATED ISSUES

## Interest and Financing Revenues (cont'd)

- c. Amounts received or receivable, or a gain as a result of an agreement or arrangement, where:
  - The amount is included in computing income for the year
  - The agreement or arrangement is entered into as or in relation to a loan made, or other financing provided, by the taxpayer, and
  - The amount can reasonably be considered to increase the taxpayer's return with respect to a debt obligation owing to the taxpayer

## OVERVIEW OF KEY DEFINITIONS AND RELATED ISSUES

### Interest and Financing Revenues (cont'd)

- d. Lease financing amounts received, other than on excluded lease
- e. Pro-rata share of financing revenues of a partnership

Less: (B) expenses and losses, including a capital loss to the extent it reduces a taxable capital gain, on derivatives that reasonably can be considered to reduce the taxpayer's return on a debt obligation owing to the taxpayer

# OVERVIEW OF KEY DEFINITIONS AND RELATED ISSUES

## Interest and Financing Revenues (cont'd)

- Related anti-avoidance rules
  - Proposed s.18.2(12) - related party interest income exclusion
    - No amount receivable from a NAL person or partnership is included in interest and financing revenues, except to the extent that it is included in computing the interest and financing expenses of a taxable Canadian corporation or Canadian resident trust that is subject to tax under Part I

# OVERVIEW OF KEY DEFINITIONS AND RELATED ISSUES

## Interest and Financing Revenues (cont'd)

- Related anti-avoidance rules (cont'd)
  - Proposed s.18.2(14) – very broad anti-avoidance for interest and financing revenues
    - Amount that would otherwise be interest and financing revenues must be excluded if:
      - The amount arises in the course of a transaction or series, and
      - One of the purposes of the transaction is to increase the taxpayer's interest and financing revenues in order to obtain a tax benefit



# OVERVIEW OF KEY DEFINITIONS AND RELATED ISSUES

## Interest and Financing Revenues (cont'd)

- Related anti-avoidance rules (cont'd)
  - Effect on borrowings by taxpayer to on-lend to another group entity, including foreign affiliates?
  - Effect on borrowings by taxpayer to on-lend to another Canadian entity that capitalize the interest expense?
  - Effect on loss consolidation transactions involving partnerships or trusts?

## OVERVIEW OF KEY DEFINITIONS AND RELATED ISSUES

### Interest and Financing Expenses and Revenues – Observations

- Not clear if IFR includes deemed interest income (e.g., s.17, PLOI loans, etc.), and amounts included in income or foreign affiliate dividends for which s.113 deduction denied under proposed hybrid mismatch rules
- As currently drafted, IFE and IFR of taxpayer do not include FAPI interest expense or revenue, and are not excluded from the calculation of ATI
- Treatment of hedging gains in variable B of IFE definition

## OVERVIEW OF KEY DEFINITIONS AND RELATED ISSUES

### Excluded Interest

- Two taxable Canadian corporations may jointly elect that one or more interest payments between them in a taxation year be “excluded interest”, where:
  - The Interest is paid or payable in respect of a debt owed by the payer corporation to the payee corporation throughout the period during which the interest accrued, and
  - The payee corporation is an eligible group corporation in respect of the payor corporation
- Intended to ensure the EIFEL rules do not negatively impact loss consolidation transactions but not limited to such transactions

## OVERVIEW OF KEY DEFINITIONS AND RELATED ISSUES

### Excluded Interest (cont'd)

- Excluded interest is:
  - Not included in payer corporation's IFE
  - Not included in payee's IFR – limits ability to use such revenues to shelter payee's interest expense or increase payee's excess capacity
- As currently drafted, the excluded interest election is not available:
  - to partnerships, trusts or non-residents, or
  - for payments that are not interest

# OVERVIEW OF KEY DEFINITIONS AND RELATED ISSUES

## Adjustable Taxable Income

- ATI is the basis for calculating a taxpayer's interest deductibility capacity ("tax-EBITDA")

A	+	B	-	C
Taxable income for the year		IFE (and RIFE from a prior year deducted in the current year)		IFR
<b>LESS</b> non-capital loss and net capital loss for the year		CCA claimed for the year		Foreign source income (if sheltered by foreign tax credits)
		Portion of the taxpayer's non-capital loss for another year (if this reasonably related to net interest and financing expenses deducted in that other year)		Share of income and taxable gains allocated to the taxpayer from a trust
		Part VI.1 tax deducted		Excess portion of interest and financing expense of a partnership  Other amounts of taxable income of the taxpayer not subject to tax under Part I

# OVERVIEW OF KEY DEFINITIONS AND RELATED ISSUES

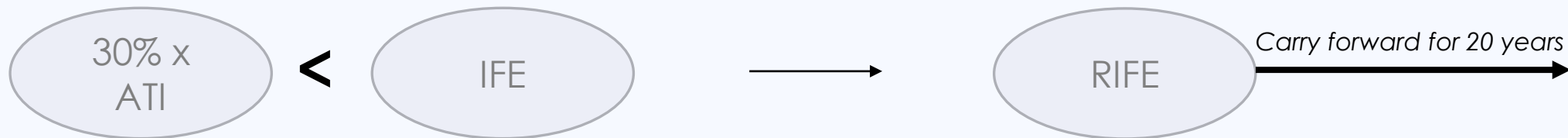
## Adjustable Tax Income – Observations

- Complex formulaic calculation which will require the calculation of taxable income as the starting point
- A portion of non-capital losses that do not relate to IFE in the year they arose (and all net capital losses) never increase ATI, even in the year they are utilized, leading to a reduction in ATI twice for these losses
- Dividends from other Canadian corporations and foreign affiliates are automatically excluded due to the starting point being taxable income

# OVERVIEW OF KEY DEFINITIONS AND RELATED ISSUES

## Carry Forward Rules

- Restricted Interest and Financing Expenses (“RIFE”)
  - Broadly arises where you do not have sufficient capacity in the year to deduct interest when compared with your actual interest and financing expenses for the period
  - Can be carried forward for 20 years
  - May be possible to deduct in a later period (within 20 years) if that period has an excess of capacity to deduct interest
- Broadly...



# OVERVIEW OF KEY DEFINITIONS AND RELATED ISSUES

## Carry Forward Rules (cont'd)

- Excess Capacity (“EC”)
  - Broadly arises where you have an excess of capacity in the year to deduct interest when compared with your actual interest and financing expenses for the period – i.e. “headroom” on deductibility
  - Can be carried forward from the preceding 3 years as Cumulative Unused Excess Capacity (“CUEC”)
  - Can be transferred to other eligible group corporations through a joint election
  - There are ordering rules which require a company to automatically use its own cumulative unused excess capacity in a later year if it has an interest restriction in that later year (i.e. using it as absorbed capacity before receiving capacity from other entities)
  - If the group ratio election is made for a year, the excess capacity for that year is deemed to be nil
- Broadly...





# OVERVIEW OF KEY DEFINITIONS AND RELATED ISSUES

## Carry Forward Rules – Observations

- The current draft rules require the same Canadian tax reporting currency in each group entity in order for two (or more) entities to transfer capacity amongst group members (or to share in the group ratio allocation)
- Financial institutions cannot transfer excess capacity (nor make the group ratio election)
- Loss restriction events result in the expiry of cumulative unused excess capacity - this may be a concern where there is a change of control above Canada, although the debt profile of Canada itself may not change as a result of the change of control
- The rules include transitional provisions for the “pre-regime” years to enable taxpayers to carry forward up to 3 years of excess capacity into the regime

# GROUP RATIO RULE

## Overview

- Intended to allow for deductible IFE in excess of fixed ratio based on third party interest expense of the consolidated group
- Elective regime that replaces excess capacity mechanism
  - Capacity calculated at group level and allocated among group members
- Legislative framework
  - s.18.21(1) – Definitions
  - s.18.21(2) – Conditions for application
  - s.18.21(3) – Allocation of group ratio amount
  - s.18.21(4) – Use of accounting terms
  - s.18.21(5) – Single member group

## GROUP RATIO RULE

### Conditions for Application (s.18.21 (2))

1. Must have a consolidated group (subject to single entity rule in s.18.21 (5))
  - Consolidated group defined as ultimate parent and all entities that are fully consolidated in that parent's consolidated F/S
  - Cannot apply regime to consolidated subgroup (i.e. a group that does not include the ultimate parent)
  - Consolidated group can have foreign parent(s), foreign sister(s)/brother(s) and/or foreign affiliates
2. Each related or affiliated Canadian corporation and trust in the consolidated group (i.e., each "Canadian group member"):
  - Must be a taxable Canadian corporation or trust resident in Canada
  - Must have the same taxation year as the ultimate parent of the consolidated group
  - Must have the same tax reporting currency

## GROUP RATIO RULE

### Conditions for Application (s.18.21 (2)) (cont'd)

3. Cannot have a “relevant financial institution” as a Canadian group member
  - Bank, insurance corporation, mutual fund corporation or trust, etc.
  - Broadly defined
4. Must have audited consolidated F/S prepared based on acceptable accounting standards – IFRS or Canadian/US/certain other jurisdiction GAAP
5. Each Canadian group member must jointly elect

## GROUP RATIO RULE

### Computation/Allocation of Group Ratio Amount (s.18.21 (3))

- Group ratio amount can be allocated among each Canadian group member on a discretionary basis
- Allocation is made as part of joint election
- Total of allocated amounts cannot exceed lesser of:
  - “Group ratio” of consolidated group X aggregate ATI of all Canadian group members;
  - “Group net interest expense” of the consolidated group; and
  - Total ATI of Canadian group members

## GROUP RATIO RULE

Computation/Allocation of Group Ratio Amount (s.18.21 (3)) (cont'd)

- Computation of group ratio
  - Group net interest expense (“GNIE”) divided by group adjusted net book income (“GANBI”)
- Decreasing proportionate capacity for ratios exceeding 40%

## GROUP RATIO RULE

### Computation/Allocation of Group Ratio Amount (s.18.21 (3)) (cont'd)

- GNIE:
  - “Specified interest expense” of consolidated group minus “specified interest income” of consolidated group
  - Adjusted for amounts to/from “specified non-members” (non-consolidated entities that nonetheless have a significant connection with the group (non-arm’s length or 25% votes or value))

## GROUP RATIO RULE

### Computation/Allocation of Group Ratio Amount (s.18.21 (3)) (cont'd)

- GNIE (cont'd):
  - “Specified interest expense”
    - Total of consolidated interest expense, capitalized interest, and guarantee or similar fees, plus same amounts for equity-accounted entities; less any dividends included in the foregoing
      - Dividends excluded on the basis that shares of corporations may be treated as debt for financial reporting purposes
  - “Specified interest income” involves similar calculation



## GROUP RATIO RULE

### Computation/Allocation of Group Ratio Amount (s.18.21 (3)) (cont'd)

- GANBI:

- Consolidated net income

- +/- specified interest expense/revenue

- +/- income tax expense/recovery

- + book depreciation

- +/- gains and losses from disposition of fixed assets

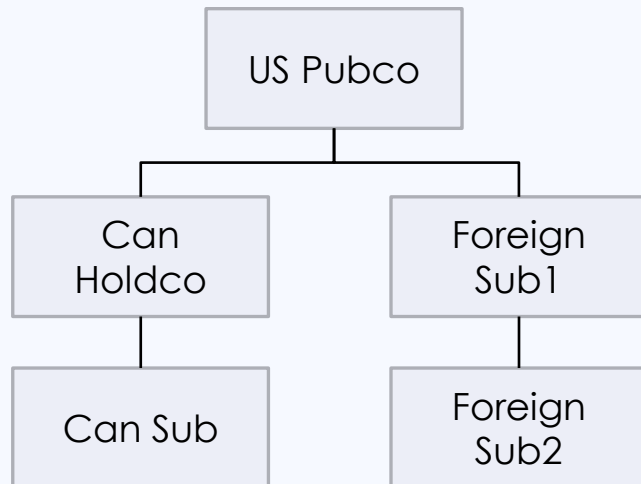
- +/- charges for fixed asset impairment

## GROUP RATIO RULE

### Issues and Observations

- Potential distortions for accounting-based income/expenses
  - e.g., stock-based comp, unrealized FX gains/losses
- Identification of possible consolidated group(s)
- Group ratio not available for non-residents, even if subject to Part I tax in Canada

# Group Ratio Rule – Example



## Facts

- US Pubco has audited F/S that consolidate its Canadian and foreign subsidiaries
- Financial information:

	Consolidated F/S Amounts	Legal entity	
		Can Holdco	Can Sub
Consolidated net income	1,000	N/A	N/A
Taxable income	N/A	-	200
Interest expense	500	-	95
Capitalized interest	10	-	-
Interest income	10	-	2
Income tax expense	150	N/A	N/A
Depreciation	20	-	5

# Group Ratio Rule – Example

Facts	Consolidated F/S Amounts	Legal entity	
		Can Holdco	Can Sub
Consolidated net income	1,000	N/A	N/A
Taxable income	N/A	-	200
Interest expense	500	-	95
Capitalized interest	10	-	-
Interest income	10	-	2
Income tax expense	150	N/A	N/A
Depreciation	20	-	5

Computation of group ratio			
<b>GNIE</b>			
Specified interest expense			
Consolidated interest expense	510		
Specified interest income			
Consolidated interest income	(10)		
	500	A	
<b>GANBI</b>			
Consolidated net income	1,000		
Specified interest expense	500		
Specified interest income	(10)		
Depreciation	20		
	1,510	B	
<b>Group ratio [A / B]</b>	<b>33.1%</b>		
<b>Allocation of group ratio</b>			
Can Holdco	Nil	(Cannot exceed ATI of Can Holdco)	
Can Sub			
ATI	298	(200 + 95 - 2 + 5)	
Group ratio	33.1%		
Maximum deductible amount	99		
IFE deduction limited to:	95	(Actual amount incurred)	

## Example – Carry Forward Rules

### Facts

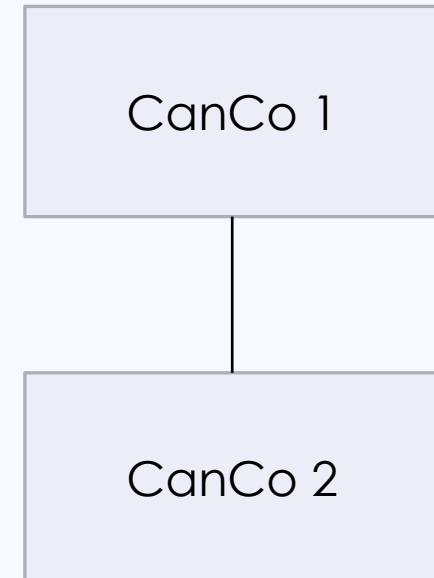
- There are two eligible group corporations – CanCo 1 and CanCo 2 – which are not financial institutions

### CanCo 1

- CanCo 1 has RIFE brought forward from 2023 of \$10m and no brought forward excess capacity for years preceding 2023
- CanCo 1 is assumed to have IFE of \$15m per year
- CanCo 1's based deduction capacity changes year-on-year as shown

### CanCo 2

- CanCo 2 has no IFE or ATI for 2024 through to 2026
- In 2027 and 2028, it incurs IFE of \$20m
- CanCo 2 has no ATI of its own in 2027 and has base deduction capacity in 2028 of \$10m



## Example – Carry Forward Rules (cont'd)

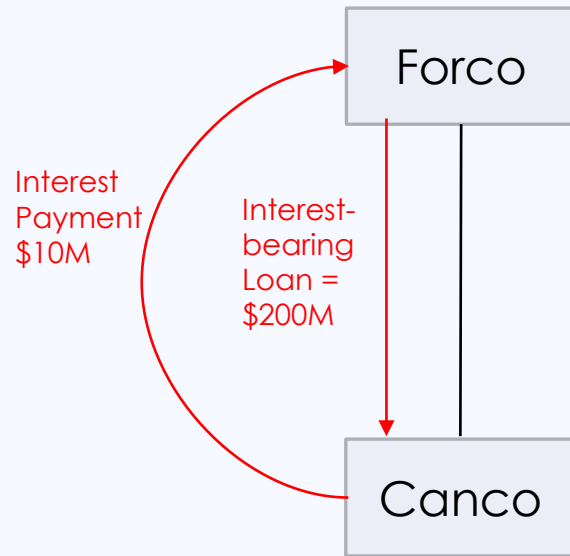
	CanCo 1 (2024)	CanCo 1 (2025)	CanCo 1 (2026)	CanCo 1 (2027)	CanCo 1 (2028)
RIFE brought forward (C)	\$10m	-	-	-	-
RIFE permitted to be deducted in current year	(\$10m)	-	-	-	-
RIFE carried forward	-	-	-	-	-
<b>Current year facts:</b>					
Base deduction capacity (Fixed ratio x ATI) (A)	\$50m	\$35m	\$5m	\$30m	\$nil
IFE (B) – assumed \$15m per taxation year	\$15m	\$15m	\$15m	\$15m	\$15m
<b>Permissible interest deduction in the current year:</b>					
Current year IFE permitted to be deducted (i.e. sufficient capacity)	\$15m	\$15m	\$5m	\$15m	-
Absorbed capacity utilized	-	-	\$10m	-	\$15m
RIFE permitted in current year	\$10m	-	-	-	-
<b>Current year deduction allowed for IFE</b>	<b>\$25m</b>	<b>\$15m</b>	<b>\$15m</b>	<b>\$15m</b>	<b>\$15m</b>
<b>Cumulative unused excess capacity:</b>					
Cumulative unused excess capacity brought forward (from prior 3 years)	-	\$25m	\$45m	\$35m	\$30m
Excess capacity for current year (A-B-C)	\$25m	\$20m	-	\$15m	-
Transferred capacity (by 18.2(4) election) to CanCo 2	-	-	-	(\$20m)	(\$10m)
Absorbed capacity (utilized)	-	-	(\$10m)	-	(\$15m)
<b>Cumulative unused excess capacity carried forward</b>	<b>\$25m</b>	<b>\$45m</b>	<b>\$35m</b>	<b>\$30m</b>	<b>\$15m</b>

## Example – Carry Forward Rules (cont'd)

	CanCo 2 (2027)	CanCo 2 (2028)
RIFE brought forward (C)	-	-
RIFE permitted to be deducted in current year	-	-
RIFE carried forward	-	-
<b>Current year facts:</b>		
Base deduction capacity (Fixed ratio x ATI) (A)	-	\$10m
IFE (B) – assumed \$15m per taxation year	\$20m	\$20m
<b>Permissible interest deduction in the current year:</b>		
Current year IFE permitted to be deducted (i.e. sufficient capacity)	-	\$10m
Absorbed capacity utilized	-	-
Transferred in capacity (by 18.2(4) election) from CanCo 1	\$20m	\$10m
RIFE permitted in current year	-	-
<b>Current year deduction allowed for IFE</b>	<b>\$20m</b>	<b>\$20m</b>
<b>Cumulative unused excess capacity memo:</b>		
Cumulative unused excess capacity brought forward (from prior 3 years)	-	-
Excess capacity for current year (A-B-C)	-	-
Transferred out capacity (by 18.2(4) election)	-	-
Absorbed capacity (utilized)	-	-
<b>Cumulative unused excess capacity carried forward</b>	<b>-</b>	<b>-</b>

Through transferring capacity from CanCo 1, CanCo 2 achieves a full deduction for its IFE in 2027 and 2028, even though its base deduction capacity is below its IFE in both years

## Example – Interaction with Thin Capitalization rules



### Facts

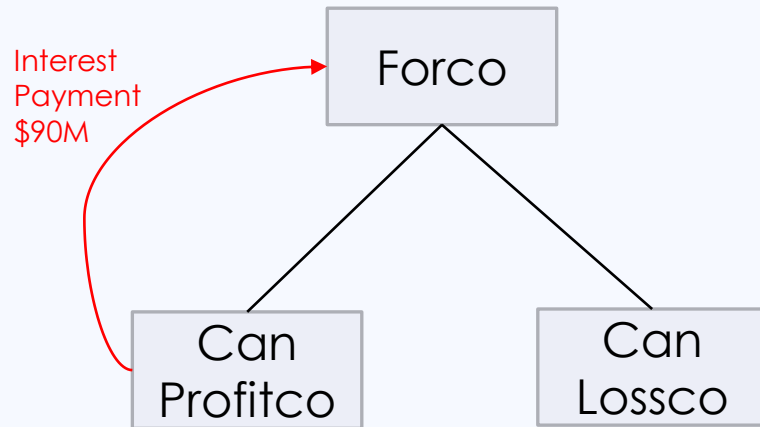
- Canco's equity amount for the year = \$100M
- Canco's taxable income (before interest payment) = \$20M
- Canco's interest expense paid to Forco = \$10M

### Implications

- Interest denied (and deemed dividend) under s.18(4) = \$2.5M
- IFE = \$10M - \$2.5M = \$7.5M
  - Ratio of permissible expenses = 30% (40% initially)
  - 18.2(2) = no deduction to the extent of the proportion of  $(A - (B + C + D + E)) / A$ , where:
    - A = 7.5M
    - B = 30% x 20M = 6M
    - C = 0
    - D = 0
    - E = 0
    - 1.5M/7.5M of interest denied under 18.2(2), i.e., \$1.5M of interest denied



## Example – Loss Consolidation and Excluded Interest



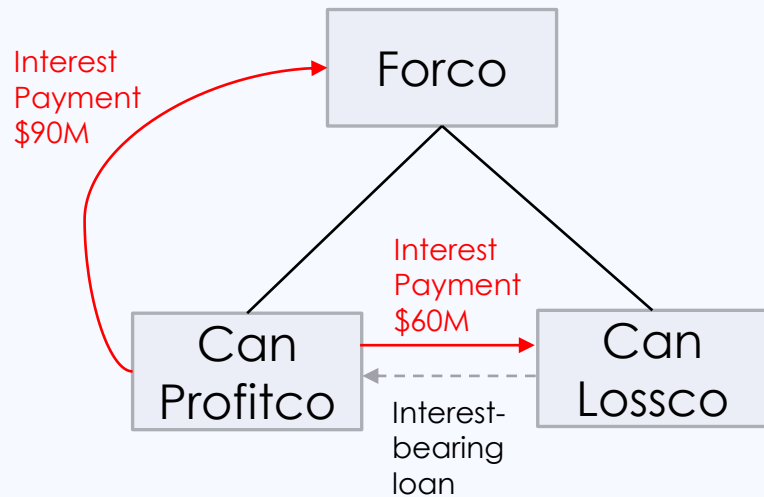
### Facts

- Can Lossco's loss (generated from business activities) = \$60M
- Can Profitco's taxable income (before interest payment) = \$300M
- Can Profitco's interest expense paid to Forco = \$90M
- Assume s.18(4) do not limit deduction of interest expense paid to Forco due to Can Profitco having sufficient equity amount

### Implications

- Ratio of permissible expenses = 30% (40% initially)
- 18.2(2) = no deduction to the extent of the proportion of “(A – (B+ C+ D+ E))/ A”, where:
  - A = 90M
  - B = 30% x 300M = 90M
  - C = 0
  - D = 0
  - E = 0
  - 0/90 of interest denied under 18.2(2) (i.e., none denied)

# Example – Loss Consolidation and Excluded Interest



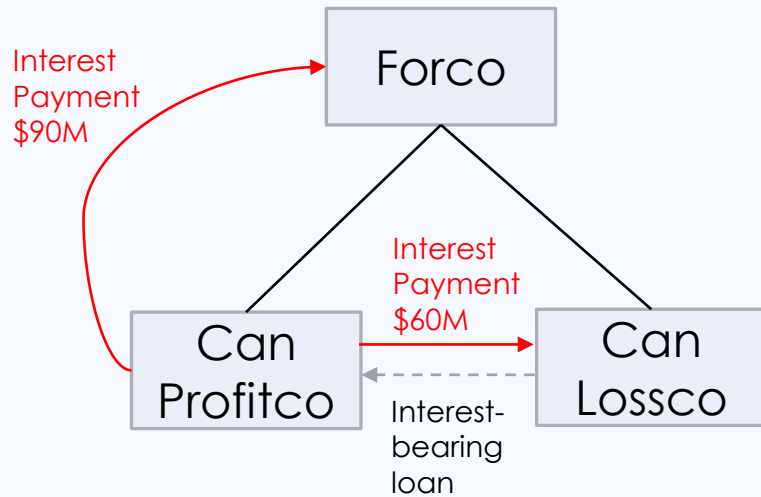
## Facts

Same facts as previous slide, but implement preferred share debt loop where Can Lossco makes interest-bearing loan to Can Profitco to subscribe for Can Lossco preferred shares with a dividend rate that slightly exceeds interest rate on interest-bearing loan. Can Profitco pays 60M interest to Can Lossco on interest-bearing loan.

## No Excluded Interest Election

- Can Lossco's excess capacity =  $G - H \times I$ 
  - $60M - 30\% \times 60M = 42M$
- 42M transferred to Can Profitco under 18.2(4)
  - Requires an election to transfer
- 18.2(2) = no deduction to the extent of the proportion of " $(A - (B + C + D + E)) / A$ ", where:
  - $A = 90M + 60M = 150M$
  - $B = 30\% \times 300M = 90M$
  - $C = 0$
  - $D = 42M$
  - $E = 0$
  - 18/150 of interest denied under 18.2(2)

# Example – Loss Consolidation and Excluded Interest



## Excluded Interest Election

- 60M is not considered IFE of Can Profitco and IFR of Can Lossco
- Can Lossco's excess capacity =  $G - H \times I$ 
  - $0 - 30\% \times 0 = 0$
- Can Profitco's adjusted taxable income = \$240M
- 18.2(2) = no deduction to the extent of the proportion of "A – (B+ C+ D+ E))/ A", where:
  - A = 90M
  - B =  $30\% \times 240M = 72M$
  - C = 0
  - D = 0
  - E = 0
  - 18/90 of interest denied under 18.2(2)
  - 60M interest paid to Can Lossco is not subject to the limitation in 18.2(2)

# APPLICATION TO PARTNERSHIPS



20%



Corp A  
 Taxable Income = \$70  
 IFE = \$30  
 IFR = \$0

Partnership ABC  
 IFE = \$100  
 IFR = \$25  
 Income = \$50

Corp A

$$\text{IFE} = \$30 + \$20 = \$50$$

$$\text{IFR} = 0 + \$5 = \$5$$

$$\text{ATI} = \$70 + \$10 + \$50 - \$5 = \$125$$

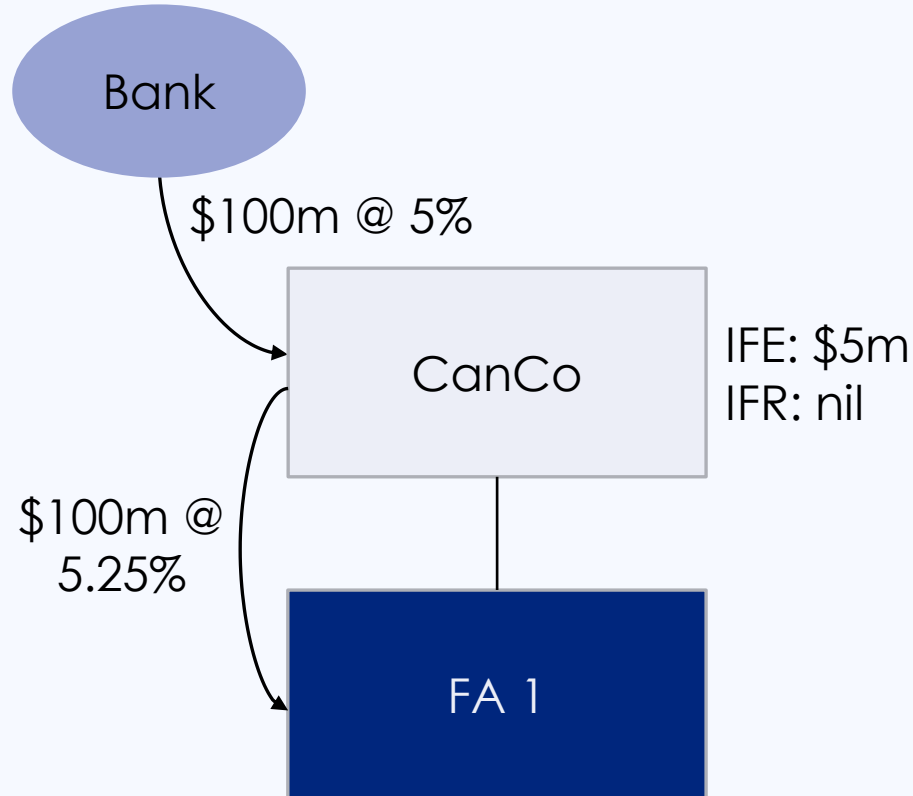
$$\text{Excessive IFE Proportion} = \frac{\$(50 - (.3)(125) - 5)}{50}$$

$$= 15\%$$

$$\text{Denied Interest 18.2(2)} = .15 \times 30 = \$4.50 \longrightarrow \text{Both amounts added to}$$

$$12(1)(1.2) \text{ inclusion} = .15 \times 20 = \$3.00 \longrightarrow \text{RIFE}$$

## Example – Back-to-Back Loan With a Foreign Affiliate



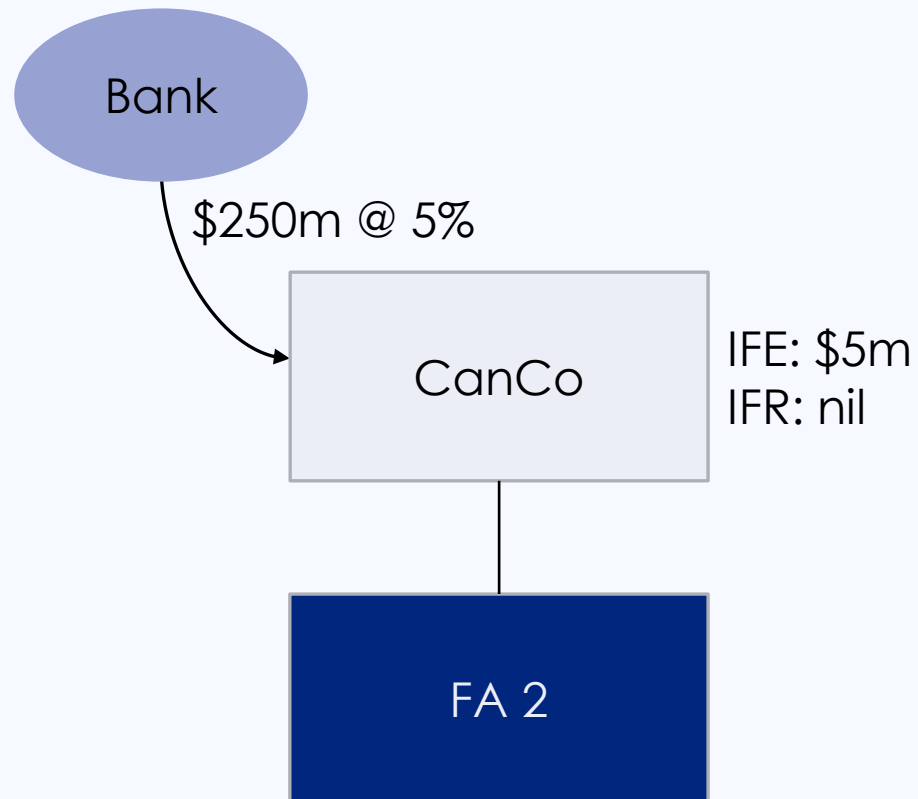
### Facts

- CanCo has a wholly-owned foreign affiliate, FA1
- CanCo borrows \$100m from an external lender, with an interest rate of 5%, to finance FA1 with debt, with an interest rate of 5.25% - leading to net interest income in CanCo of \$250k

### Observations

- There is no indication currently as to how the EIFEL rules are expected to apply to FA1 itself as a foreign affiliate
- For CanCo, as the rules are currently drafted, 18.2(12) provides a broad exclusion from including interest income in interest and financing revenues from a related entity (which is not a Canadian entity). Depending on the EBITDA-capacity, this could lead to a denial of interest, even though CanCo is in a net interest income position economically.

## Example – CanCo Borrows to Fund Acquisition of FA shares



### Facts

- CanCo borrows \$250m to acquire the shares of a new foreign affiliate, FA2
- The external loan bears interest at a rate of 5%, leading to an interest expense of \$12.5m for CanCo

### Observations

- Subject to EBITDA-capacity in CanCo, or other Canadian group entities, CanCo may be subject to an interest restriction on the borrowing to acquire FA2's shares and may need to consider the most tax-efficient holding entity to acquire future FAs

# ANTI-HYBRID RULES

# ANTI-HYBRID RULES

## Overview

- Proposed legislation released April 29, 2022, first of two legislative packages
- Intended to neutralize deduction/non-inclusion outcomes associated with:
  - Three types of hybrid mismatch arrangements
  - Foreign deductions for notional interest expense
- Rules proposed to apply effective July 1, 2022, with submissions requested by June 30, 2022 (1 day before effective date!)
- Proposed legislation for second package to follow, with rules to apply no earlier than 2023



## ANTI-HYBRID RULES

### Key Elements

- Definitions – s.18.4(1)
- Interpretational rule – s.18.4(2)
  - Rules explicitly intended to implement and be consistent with chapters 1 and 2 of BEPS Action 2 Report, as amended
- Primary rule – s.18.4(3)/(4)
  - Denial of Canadian deduction to the extent it exceeds foreign/Canadian income inclusion
  - Mismatch amount determined under s.18.4(6)(a)/18.4(7)(a)
  - s.18.4(8) – No double counting of income inclusion
  - s.18.4(9) – Deeming rule for notional interest expense on debt

## ANTI-HYBRID RULES

### Key Elements (cont'd)

- Secondary rule – s.12.7
  - Canadian income inclusion where foreign deduction exceeds Canadian/foreign income inclusion
  - s.12.7(1) – Definitions by reference to s.18.4(1)
  - s.12.7(2)/(3) – Operative rules
  - Mismatch amount determined under s.18.4(6)(b)/18.4(7)(b)
  - s.18.4(8) – No double counting of income inclusion

## ANTI-HYBRID RULES

### Key Elements (cont'd)

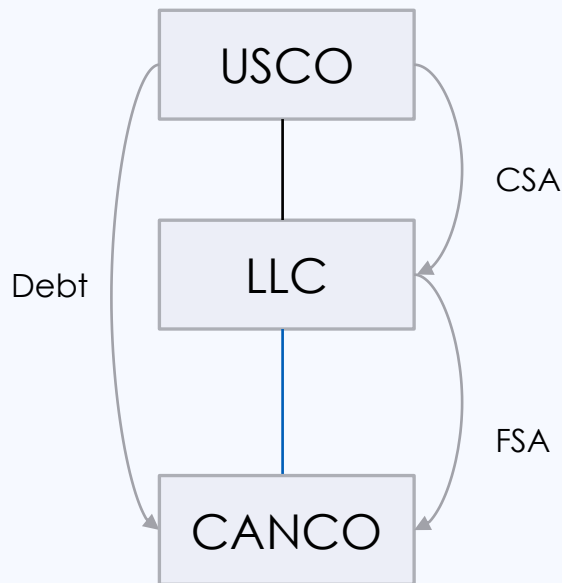
- Types of hybrid mismatch arrangements – s.18.4(10)-(15)
  - s.18.4(10)/(11) – Hybrid financial instrument arrangements
  - s.18.4(12)/(13) – Hybrid transfer arrangements
  - s.18.4(14)/(15) – Substitute payment arrangements
- Supporting rules – 18.4(16)-(19)
- Anti-avoidance rule – 18.4(20)
  - Potentially applies where one of the main purposes of a transaction/series is to avoid the application of the rules or to limit the consequences of the rules

## ANTI-HYBRID RULES

### Key Elements (cont'd)

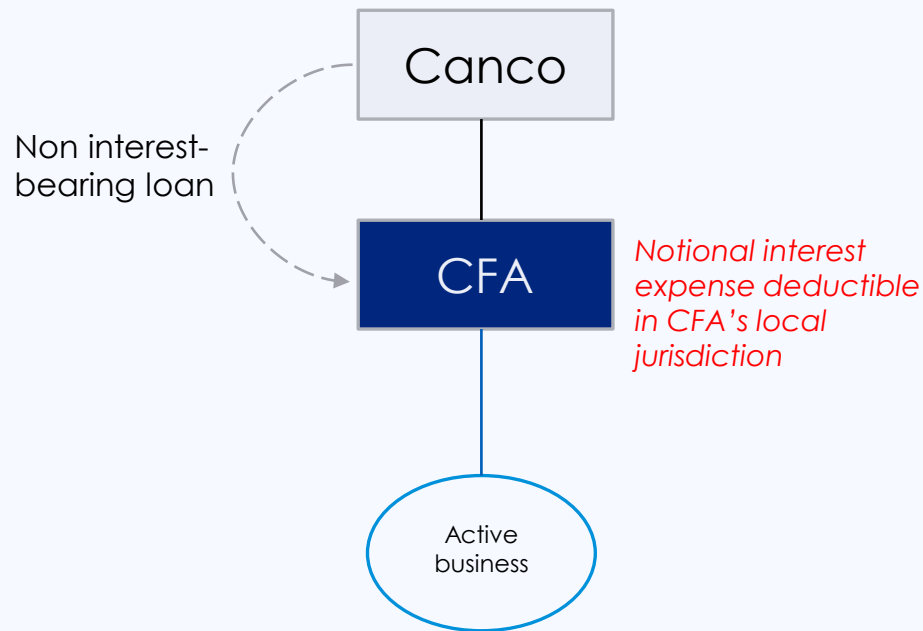
- Relief for no awareness/benefit under structured arrangement – s.18.4(5)
- Relief for foreign income inclusion – s.20(1)(yy)
  - Allows a deduction where deduction previously denied under primary rule and taxpayer subsequently demonstrates that an amount has been included in foreign income
- Dividend deduction denial rule – s.113(5)
  - s.113 deduction denied to the extent dividend is deductible in foreign jurisdiction
- Deemed dividend/WHT – s.214(18)
  - Denied interest under primary rule deemed to be a dividend subject to Canadian WHT

## Example – Inbound Hybrid Debt



- Typical inbound hybrid debt arrangement with loan, forward subscription agreement and capital support agreement (or guarantee)
- Deduction for interest in Canada, no inclusion in US so payment of interest gives rise to a deduction/ non-inclusion mismatch under s.18.4(6)(a)
- Other conditions in s.18.4(10) are satisfied so s.18.4(11) applies
- No deduction for payment to the extent of the hybrid mismatch amount under s.18.4(4) and that amount is deemed to be payment of a dividend under s.214(18)

# Example – Notional Interest Expense



## Assumptions

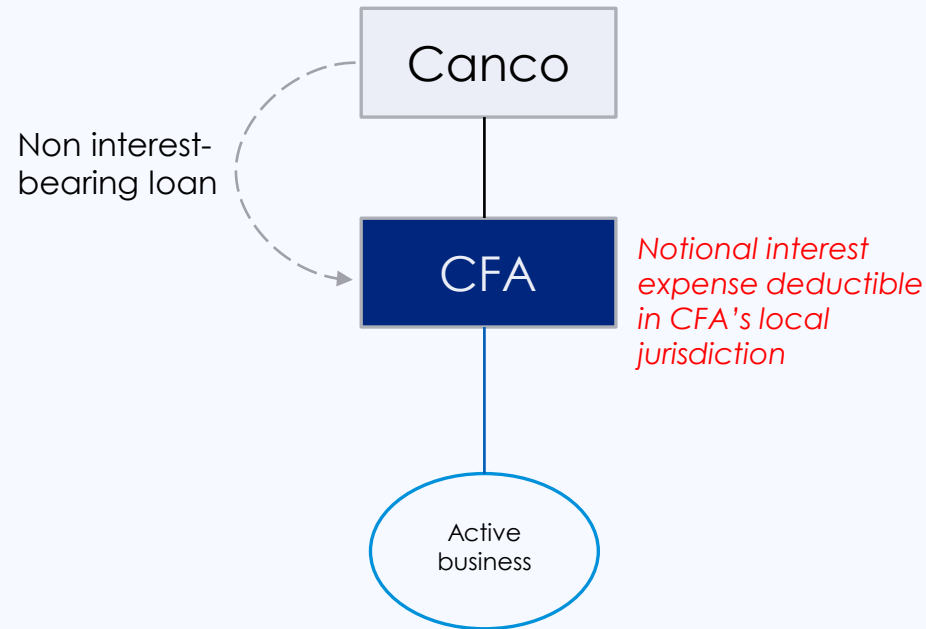
- Canco (a taxable Canadian corporation) makes a non-interest bearing loan to a CFA; CFA uses the borrowed money to earn income from an active business
- CFA is a resident in a jurisdiction that, through the operation of its transfer pricing rules (or otherwise), allows CFA to deduct an amount of notional interest expense for tax purposes corresponding to the rate of interest that would be charged by an arm's length party
- There is no corresponding income inclusion in Canada, as a result of the exceptions provided in s.17(8) and s.247(7)

## Analysis

The deduction in respect of a notional interest expense in the debtor jurisdiction gives rise to a deduction/non-inclusion mismatch under proposed s.18.4(6)(b) by operation of the deeming rules in proposed s.18.4(9)

- Proposed s.18.4(9)(a): debtor deemed to make a payment under the debt to the creditor equal to the deductible amount, and
- Proposed s.18.4(9)(b): deems the deductible amount to be in respect of the payment
- Proposed s.18.4(9)(c): does not apply in this case as Canco does not have an income inclusion in respect of the debt because of s.17(8) and s.247(7).
- Proposed s.18.4(9)(d): deems the mismatch to meet the causal condition in proposed s.18.4(10)(d)
- Other conditions in proposed s.18.4(10) are met

## Example – Notional Interest Expense (cont'd)



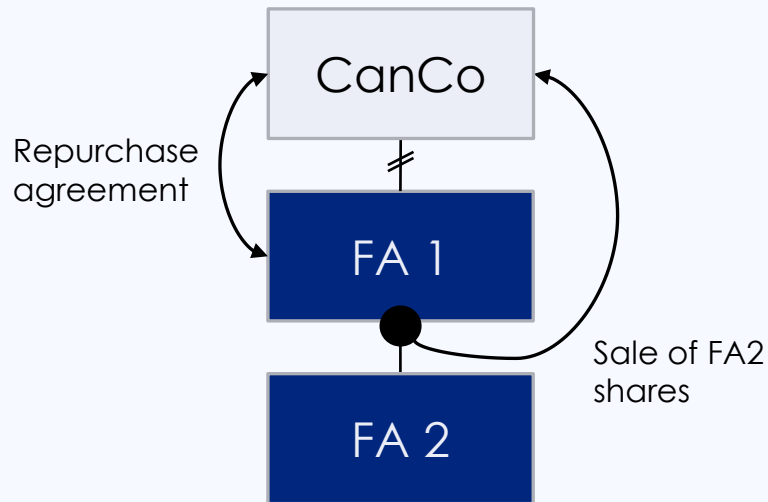
### Result

- The deemed payment is considered to arise under a hybrid financial instrument arrangement and proposed s.18.4(11) applies
- “Hybrid mismatch amount” = deductible amount in respect of the notional interest expense on the debt included in computing Canco's income per proposed s.12.7(3)

### Observations

- Proposed s.18.4(9) reflects a departure from the recommendations in the BEPS Action 2 Report
- Deductible amount is determined as if “foreign expense restriction rules” did not apply
- A “foreign expense restriction rule” is foreign tax rule that either has an effect, or is intended to have an effect, that is substantially similar to s.18(4) or proposed s.18.2(2); or implements Pillar Two
- “Notional interest expense” is not defined
- Explanatory Notes states: “A notional interest expense is one that does not have corresponding legal obligation to pay interest. Thus s.18.4(9) can apply, for example, where a country allows a debtor a deduction in respect of a low- or non-interest bearing debt as if the debtor had paid interest at a market rate”

## Example – REPO Transaction – Hybrid Transfer Arrangement



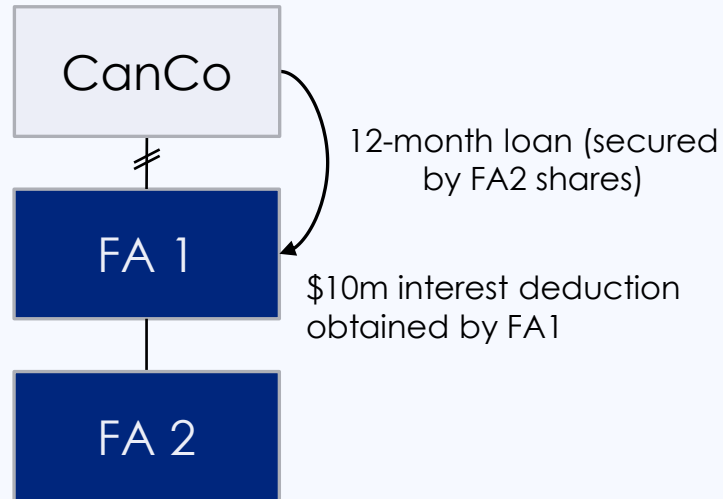
### Facts

- FA1 sells shares (may be preferred shares) of FA2 to CanCo for \$100m
- The FAs are both tax resident in Country X, a tax-treaty territory
- At the same time as the FA2 share sale, FA1 enters into an agreement to repurchase the FA2 shares from CanCo exactly one year later for \$110m (reduced by any dividends paid during the year)
- During the year FA2 pays a \$10m dividend which CanCo is entitled to receive as legal shareholder of FA2
- At maturity, FA1 repurchases the FA2 shares for the agreed price of  $\$110\text{m} - \$10\text{m} = \$100\text{m}$



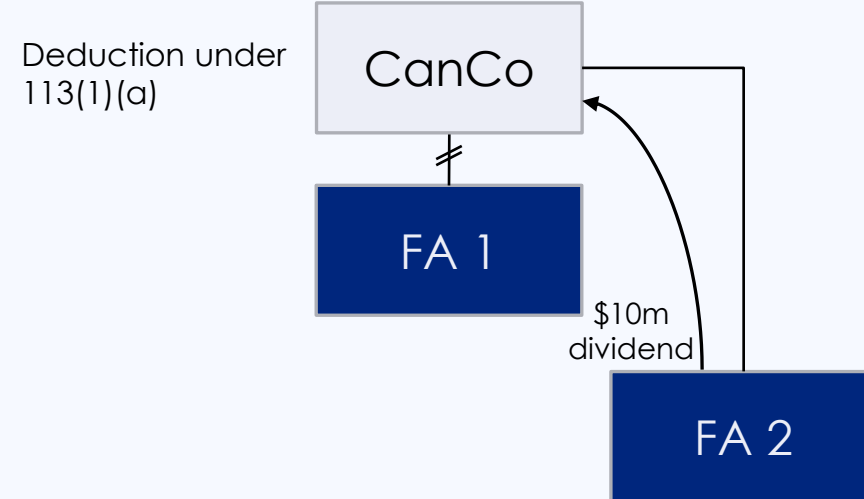
## Example – REPO Transaction – Hybrid Transfer Arrangement (cont'd)

### Country X Tax Treatment



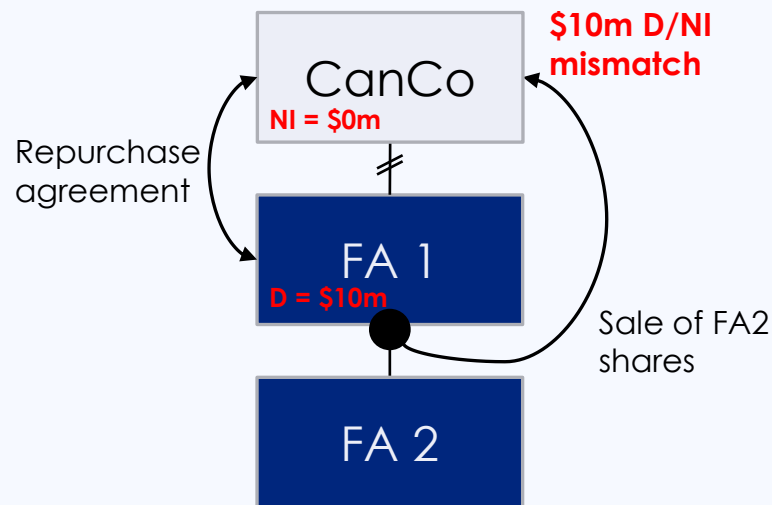
- Country X treats the series of transactions as a 12-month loan from CanCo to FA1, secured by the FA2 shares, on the basis that the substance of the overall arrangement is a financing arrangement between FA1 and CanCo
- Country X treats FA1 as the continued owner of FA2 shares and FA1 obtains a \$10m interest deduction in respect of the secured loan

### Canada Tax Treatment



- Canada treats the FA2 shares as being beneficially owned by CanCo during the year, as a result:
  - The \$10m dividend received is treated as taxable income in accordance with s. 90(1)
  - A deduction for the dividend received is obtained through s.113(1)(a) on the basis that FA2 is paying the \$10m dividend out of its exempt surplus

## Example – REPO Transaction – Hybrid Transfer Arrangement (cont'd)



### Application of the Hybrid Mismatch Rules

- The conditions of proposed 18.4(12) are met – i.e. the dividend paid arises under a **hybrid transfer arrangement** because:
  - There is a **transfer arrangement** involving the transfer of FA2 shares (which constitute a **financial instrument**)
  - The dividend is a **payment** arising under the transferred instrument
  - FA1 (transferor) does **not deal at arm's length** with CanCo (transferee)
  - A **deduction/non-inclusion mismatch** arises under 18.4(6) due to the \$10m interest deduction obtained by FA1 (**D**), but **no Canadian ordinary income** arises due to the 113(1)(a) deduction (**NI**) – the amount of the mismatch is \$10m

As the \$10m interest expense deduction is a **foreign deduction component**, the conditions of 12.7(2) for the application of 12.7(3) are met. As a result, 12.7(3) includes **\$10m in CanCo's income**

There is no denial of the s. 113(1)(a) dividend deduction

**Note:** if Country X denies a deduction in respect of "interest" under its hybrid mismatch rules, there would be no D/NI mismatch as defined in 18.4(6) and no resulting 12.7(3) income inclusion