

# **New Rules for Cross-Border Financing: Base-Erosion Profit-Shifting & Interest Deductibility**

*Howard Chang CPA, CGA - Tax Principal*

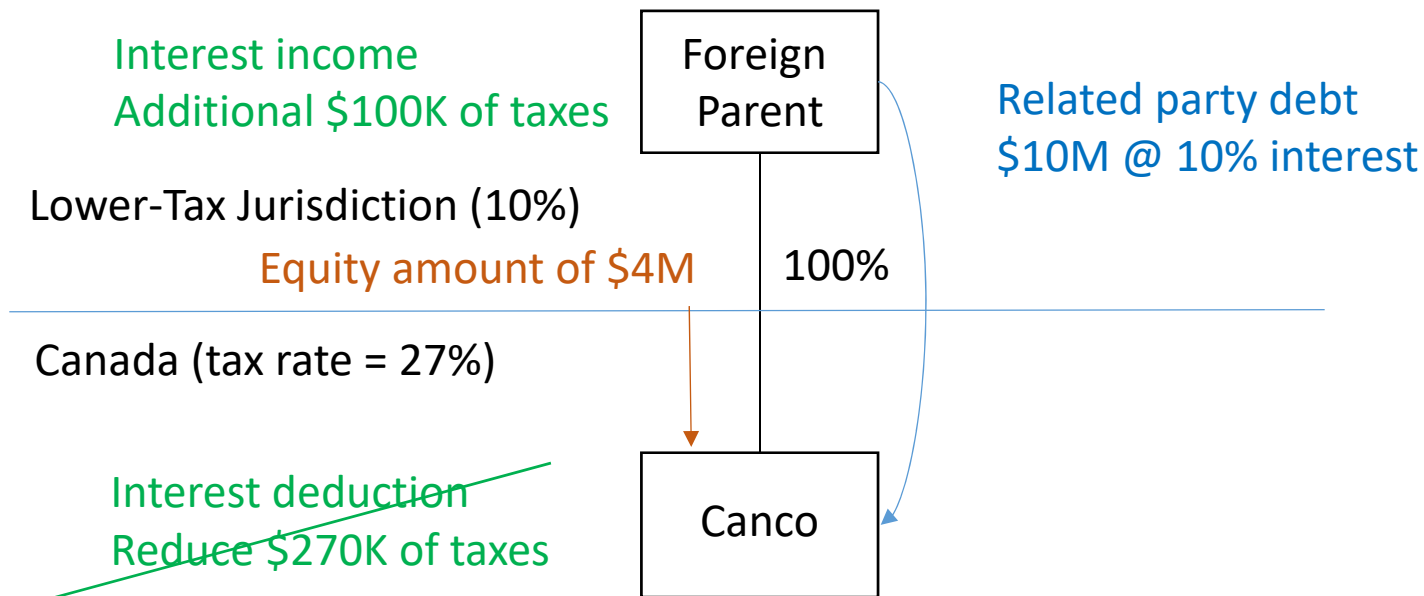
# Agenda

- BEPS Action 4 – Interest deductibility limitations
- BEPS Action 2 – Hybrid Mismatch Arrangements

# Interest Expense

- Simple way to shift profits out of Canada
- Deduction in higher tax jurisdiction and income in lower/no tax jurisdiction
- Funding foreign activities without taxable income

# Inbound Investment



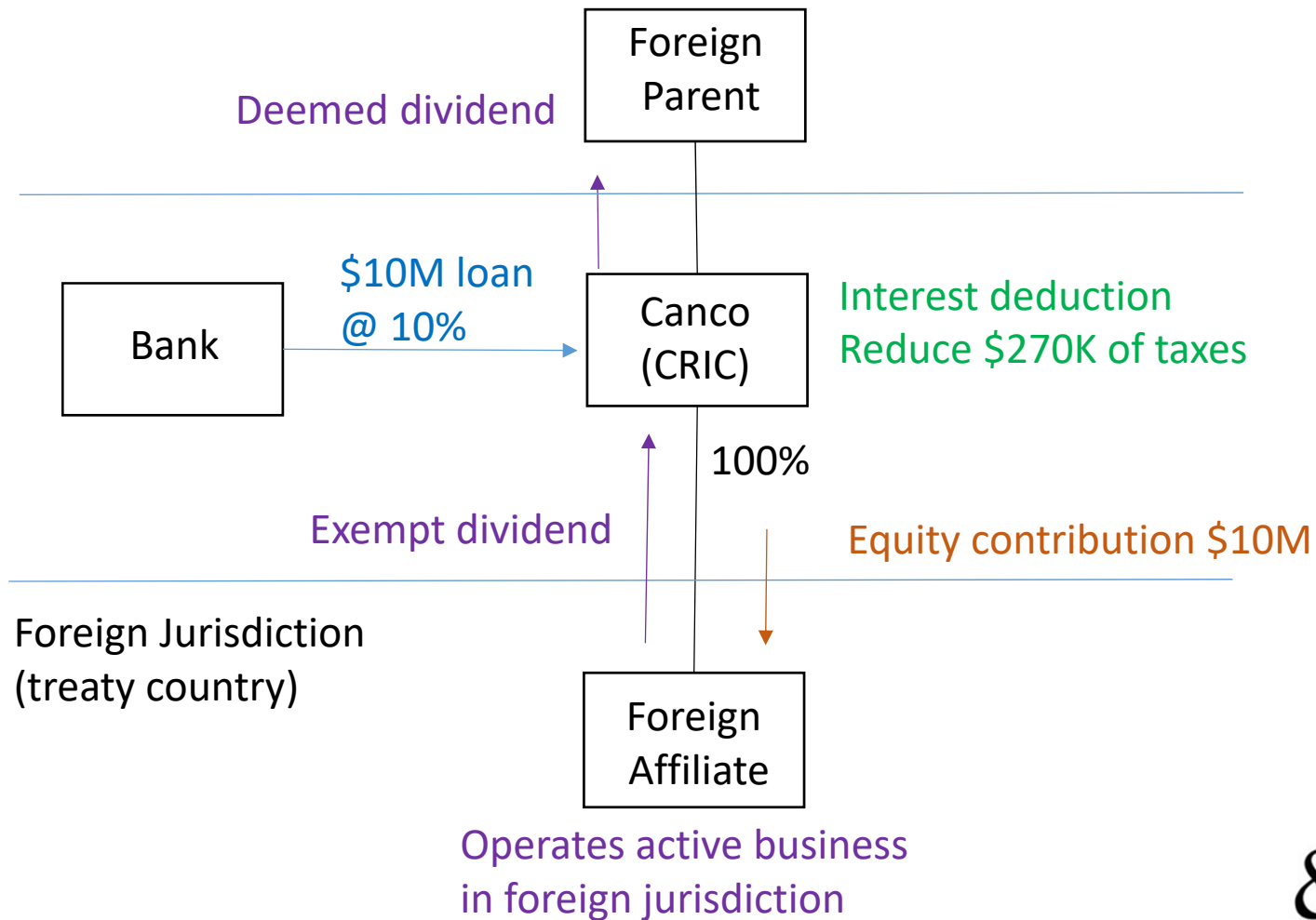
Total interest expense before thin cap =  $\$10M \times 10\% = \$1M$

Disallowed interest under thin cap =  $\$1M \times [\$10M - 1.5 \times \$4M] / \$10M = \$400K$

Allowed interest deduction =  $\$600K$

Deemed dividend =  $\$400K$

# Outbound Investment



# Proposed Rules

- Restrict “net interest expense” to a fixed ratio of “tax EBITDA”
- “Net interest expense” – interest/financing expense less interest/financing income
  - Excludes interest expense/income between Canadian members of a corporate group
- “Tax EBITDA” – taxable income, before interest expense/income, income tax, and deductions for tax depreciation/amortization

# Proposed Rules

- “Fixed ratio” – net interest expense to tax EBITDA
  - 40% for tax years beginning on or after Jan 1, 2023, but before Jan 1, 2024; and
  - 30% for tax years beginning on or after Jan 1, 2024
- Group ratio – net interest owing on third-party debt against “book EBITDA” of the consolidated group
- Denied interest - carry forward (20 years)/back (3 years)

# Proposed Rules

- Exemptions
  - CCPC with taxable capital employed in Canada less than \$15M (with associated corporation basis)
  - Corporate groups with net interest expense among Canadian members of \$250,000 or less
- Currently, no exemptions are mentioned for partnerships or for capital-intensive businesses
- Rules around financial institutions and insurance companies still pending



# Proposed Rules – Example

Facts and assumptions	Dec 31, 2022	Dec 31, 2023	Dec 31, 2024
Tax EBITDA	\$1,000,000	\$1,500,000	\$1,800,000
Net interest expense*	\$100,000	\$750,000	\$900,000
Group ratio	30%	30%	30%
Net interest to Tax EBITDA	10%	50%	50%
Applicable fixed ratio limit	N/A	40%	30%
Allowed interest expense	\$100,000	\$600,000	\$540,000
Denied interest	\$0	\$150,000	\$360,000

\*Arm's length party interest expense only

\*\*Associated group has more than \$15 million in taxable capital employed in Canada

\*\*\*2022 is the first year of operation

# Proposed Rules – Example

Facts and assumptions	Dec 31, 2022	Dec 31, 2023	Dec 31, 2024
Tax EBITDA	\$1,000,000	\$1,500,000	\$1,800,000
Net interest expense	\$100,000	\$750,000	\$900,000
Denied interest	\$0	\$150,000	\$360,000
Interest with 2023 carryback	\$250,000		
Revised ratio to Tax EBITDA	25%		
Fixed ratio for 2023 carryback	40%		
Interest with '23/'24 carryback	\$610,000		
Revised ratio to Tax EBITDA	61%		
Fixed ratio for 2024 carryback	30%		
Allowed 2024 interest carry back	\$50,000		
Denied interest carry forward		\$0	\$310,000

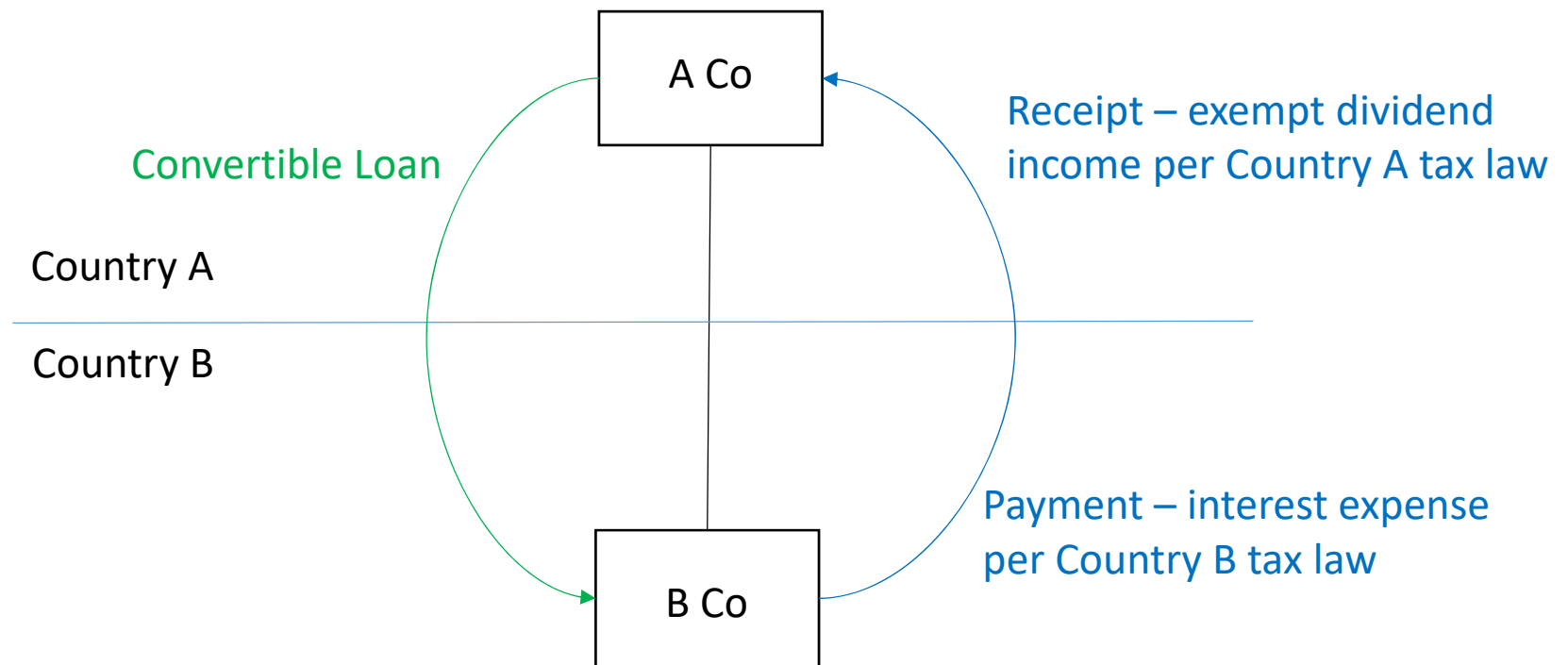
# Hybrid Mismatch Arrangements

- “Cross-border tax avoidance structures that exploit differences in the income tax treatment of business entities or financial instruments under the laws of two or more countries to produce mismatches in tax results”

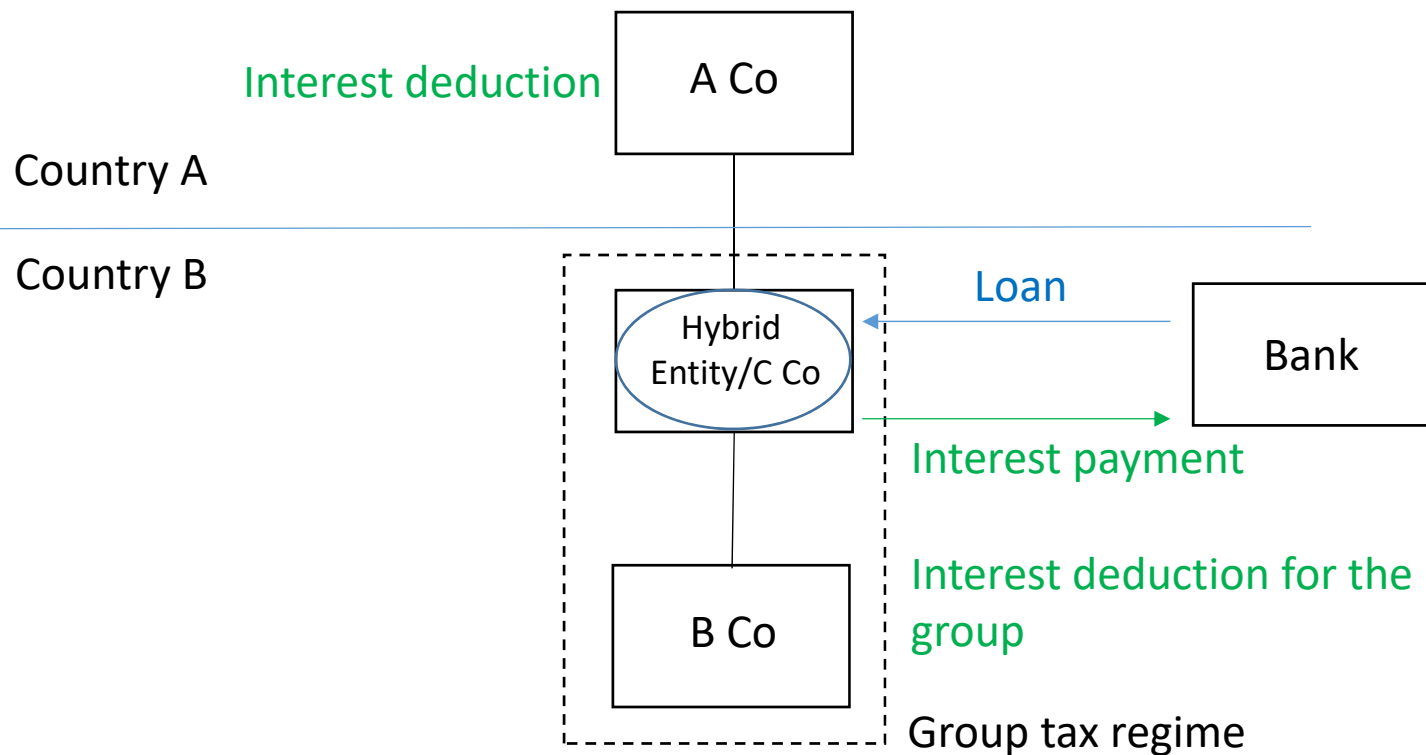
# Hybrid Mismatch Arrangements

- Deduction/non-inclusion mismatch
- Double deduction mismatch
- Imported mismatch
- Branch mismatch

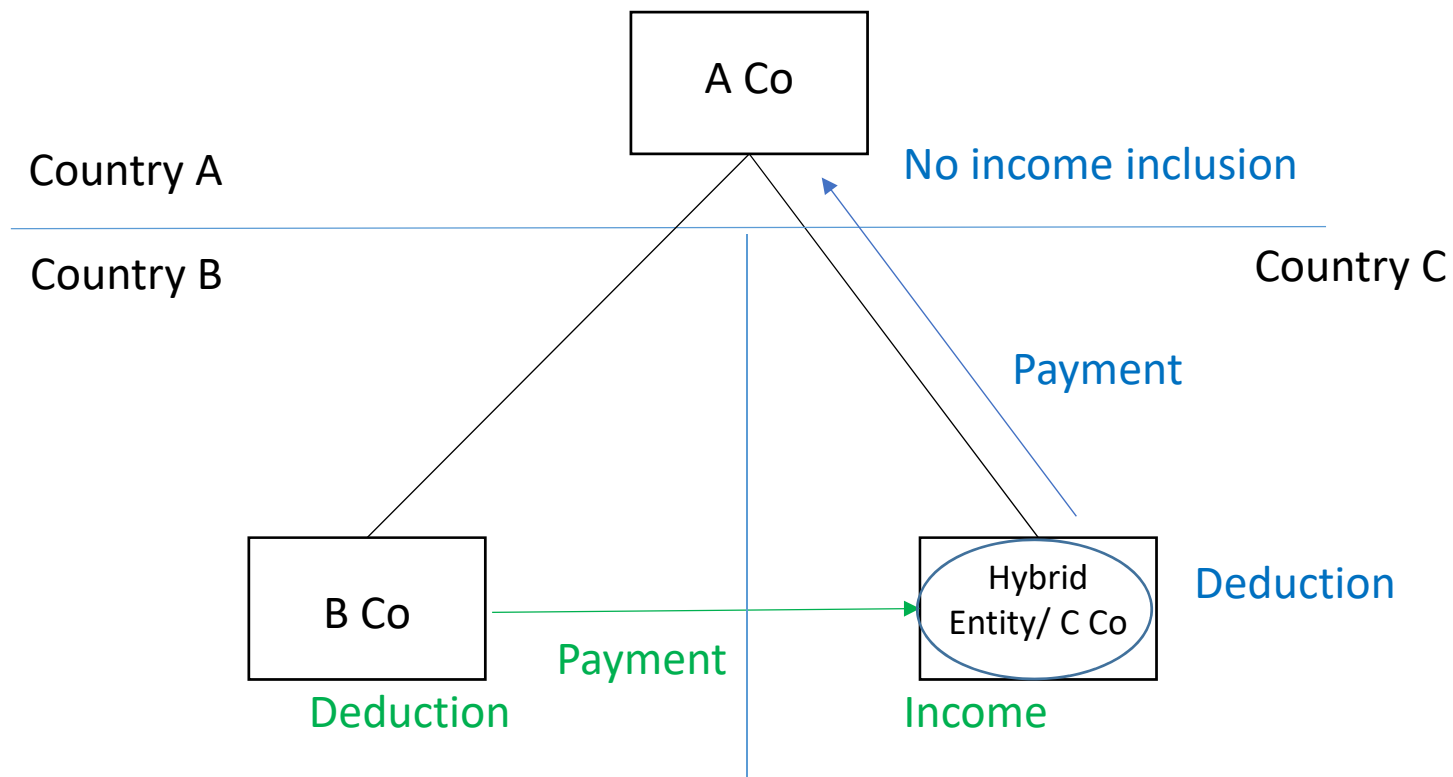
# Deduction/Non-Inclusion (D/NI) Mismatch



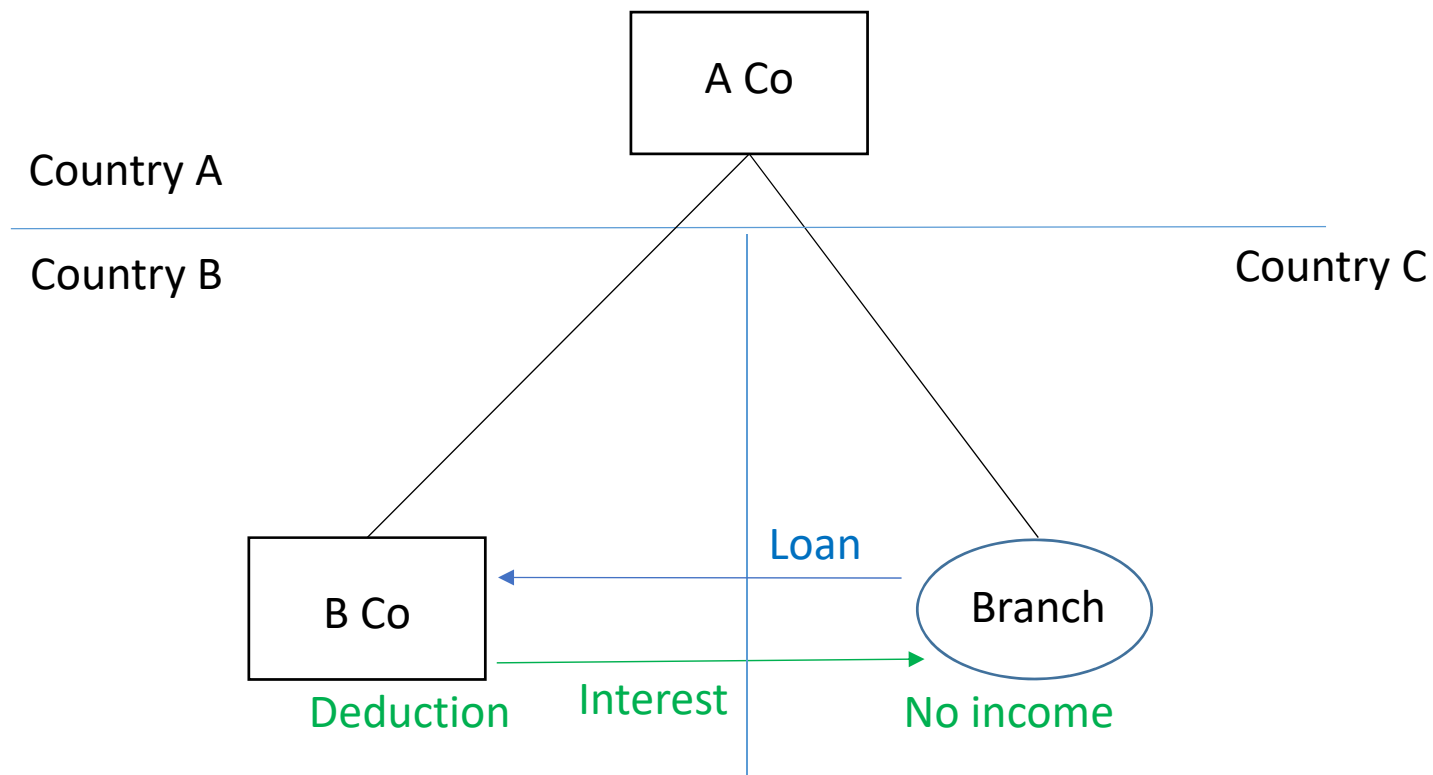
# Double Deduction (DD) Mismatch



# Imported Mismatch



# Branch Mismatch

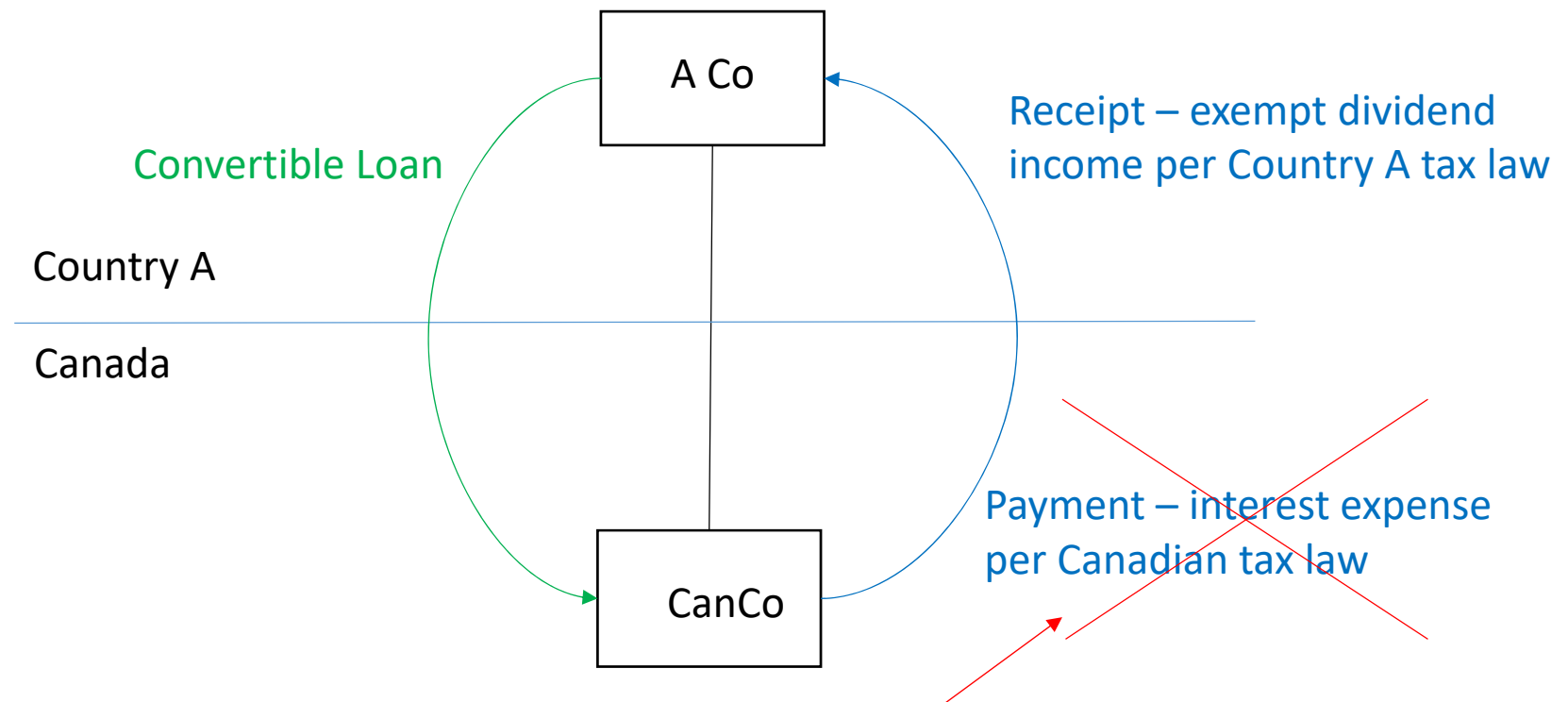




# Proposed Rules

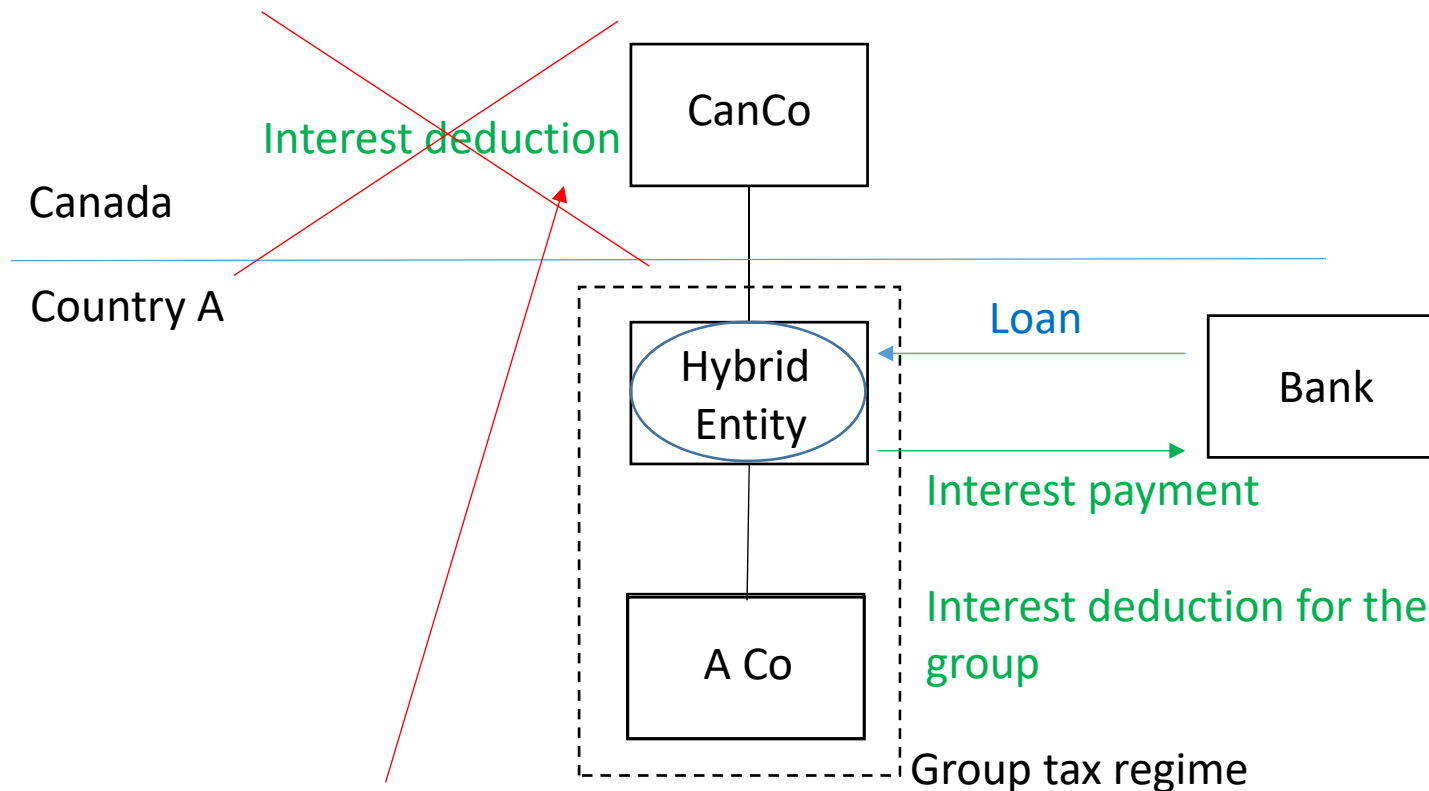
- A payment made by a Canadian resident under a hybrid mismatch arrangement would not be deductible to the extent the payment is not included in the recipient's ordinary income or creates a deduction in another country
- A payment made by a non-Canadian resident under a hybrid mismatch arrangement that is deductible for foreign tax purposes would not be deductible against the income of a Canadian resident; and
- A payment made by a non-Canadian resident under a hybrid mismatch arrangement that is deductible for foreign tax purposes and received by a Canadian resident as a dividend would not qualify for the deduction otherwise available for dividends from foreign affiliates

# Proposed Rule – D/NI Mismatch



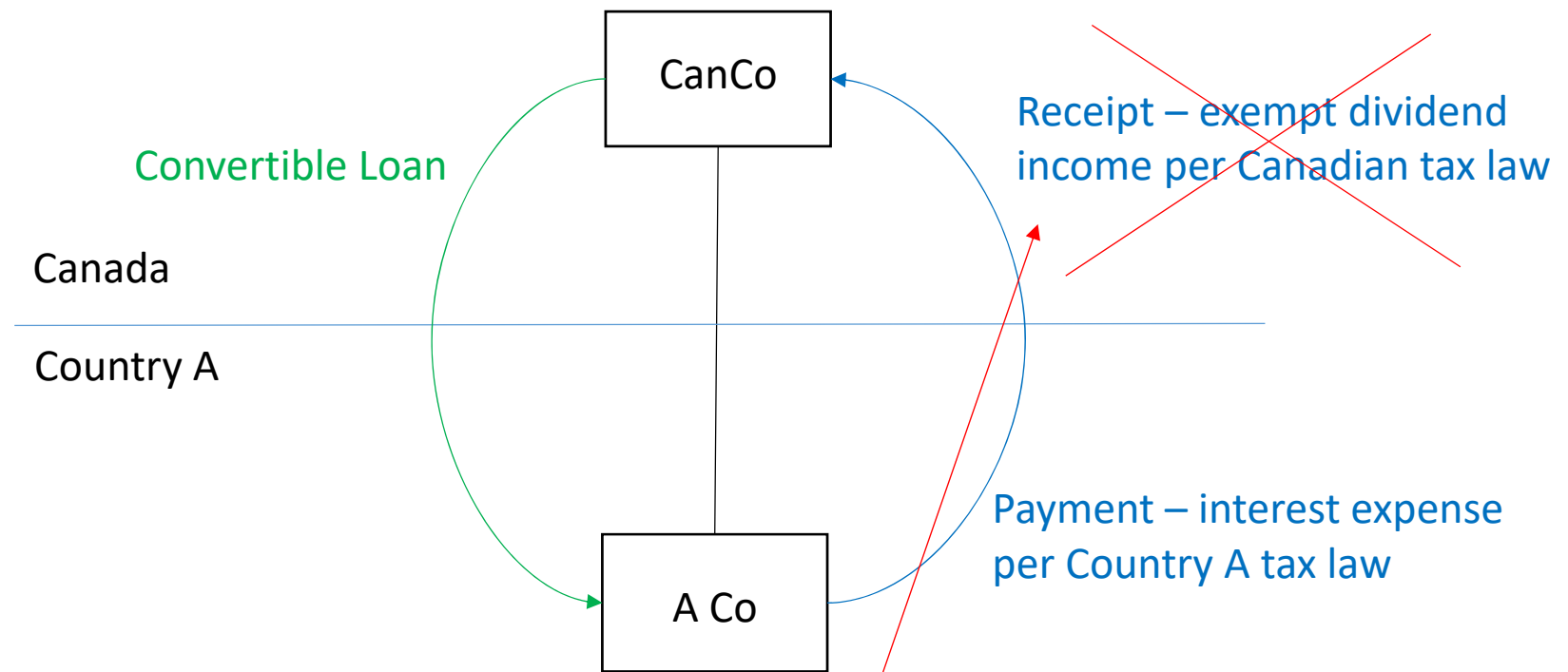
Proposed Rule – if A Co does not have income inclusion, deduction in Canada is denied

# Proposed Rule – DD Mismatch



Proposed Rule – if the consolidated group in Country A is able to deduct the interest expense, CanCo cannot deduct the same amount for Canadian tax purposes

# Proposed Rule – D/NI Mismatch



Proposed Rule – if A Co is allowed to deduct the interest expense, CanCo is not allowed to deduct the amount under par. 113(1)(a) of ITA

# Proposed Rules

- Rules implementing other Action 2 recommendations (e.g. branch mismatch and imported mismatch arrangements, etc.) would be introduced to the extent relevant and appropriate in the Canadian context
- Consistent with the Action 2 recommendations:
  - Mechanical in nature and not based on purpose test
  - Apply to related party payments and certain unrelated party arrangements designed to produce a mismatch
  - The ordering rules recommended by the report would also apply to ensure the proposed rules are coordinated with similar rules in other countries

# Proposed Rules

- To be implemented in two separate legislative packages
- First package would comprise rules implementing recommendations in Chapters 1 and 2 of the Action 2 report (neutralize a D/NI mismatch) – apply as of July 1, 2022
- Second package would comprise rules consistent with the remaining Action 2 recommendations not addressed in first package – apply no earlier than 2023

# Summary

- The new interest deductibility rules will apply starting 2023 based on a fixed ratio method on net interest expense otherwise deductible.
- The anti-mismatch rules will apply to neutralize deduct/non-inclusion mismatches starting July 1, 2022 and double deduction mismatches no earlier than 2023.