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Canadian anti-hybrid rules and EU debt equity bias reduction allowance

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Recent EU tax measures extend to taxpayers the benefit of notional interest deductions on equity while Canada targets certain notional interest deductions as part of its proposed hybrid mismatch rules.

Canadian anti-hybrid rules: presumptively effective as of July 1, 2022

The Canadian anti-hybrid rules released in draft on April 29, 2022 are now presumptively applicable to any payments made on or after July 1, 2022. Although the public consultation period only ended on June 30, 2022 and Parliament has yet to pass the relevant legislation, the draft legislation provides for the new rules to apply to payments made or deemed to be made on or after July 1, 2022. As currently drafted, there are no grandfathering exceptions for arrangements already in place as of July 1, 2022.

The draft anti-hybrid rules published by the Department of Finance are the first of two packages of draft legislation aimed at addressing tax benefits of certain hybrid mismatch arrangements that are viewed by the Department of Finance as inappropriate. The proposed rules primarily target hybrid arrangements that give rise to deduction/non-inclusion mismatch situations, and were, to a large extent, based on and aligned with the recommendations summarized in the OECD's Report on Neutralising the Effects of Hybrid Mismatch Arrangements. For more details about the Canadian anti-hybrid rules contained in the first package of draft legislation and presumptively currently effective, please see Osler Update dated May 4, 2022.

Taxpayers should take note that one of the hybrid mismatch arrangements targeted by Canada's anti-hybrid rules involves circumstances where a debtor is allowed to deduct notional interest expense on a debt in a foreign country and there is no corresponding income inclusion (or an offsetting deduction) in Canada.

EU debt equity bias reduction allowance

On May 11, 2022, the European Commission released a Directive proposal to tackle the tax bias in the European Union (EU) that currently favours debt funding. In an attempt to align and harmonize, to some extent, the tax treatment of debt and equity financing, the proposal introduces a debt equity bias reduction allowance (DEBRA). At a high level, this allowance is a notional tax deduction with respect to equity growth. The proposal also includes additional limits on the tax deductibility of interest payments.

The proposed EU rules are expected to become effective on January 1, 2024. For the six EU member states that already have in place notional tax deductions with respect to equity, they should be able to defer the application of the new rules for up to 10 years.

Canadian corporations should consider the tax implications of foreign notional tax deductions, including the proposed DEBRA, in the context of surplus calculations, FAPI, foreign tax credits and anti-hybrid rules.

If you have any questions or require additional analysis of the Canadian anti-hybrid rules or international tax developments, please contact any member of our National Tax Department.