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Tax Alert – Canada

Proposed hybrid mismatch arrangement rules

EY Tax Alerts cover significant tax news, developments and changes in legislation that affect Canadian businesses. They act as technical summaries to keep you on top of the latest tax issues. For more information, please contact your EY advisor or EY Law advisor.

On 29 April 2022, the federal government released draft legislative proposals and accompanying explanatory notes (referred to herein as the hybrid mismatch rules) to address certain hybrid mismatch arrangements.

As per the explanatory notes, these rules are intended to implement the recommendations in, and be generally consistent with, the Final Report under Action 2 of the Organisation for Economic Co-operation and Development/G20's Base Erosion and Profit Shifting Project (the **BEPS Action 2 Report**).

The hybrid mismatch rules will apply in respect of payments arising on or after 1 July 2022, with no grandfathering for existing arrangements.

Interested parties are invited to send comments on these draft proposals to Consultation-Legislation@fin.gc.ca by 30 June 2022.

The following is a summary of the draft proposals.

Building a better working world

The hybrid mismatch rules are related to the BEPS Action 2 Report, which recommends numerous rules for countries to implement into their domestic law that are intended to neutralize certain mismatches in tax results arising from so-called "hybrid mismatch arrangements." The Explanatory Notes define "hybrid mismatch arrangements" as "cross-border arrangements that exploit differences in the income tax treatment of business entities or financial instruments under the laws of two or more countries that produce mismatches in tax results." According to the Explanatory Notes, the BEPS Action 2 Report identified two main types of hybrid mismatch arrangements:

- *Deduction/Non-inclusion mismatches* (D/NI Mismatches), which generally arise where a country allows a deduction in respect of a cross-border payment, where the recipient does not fully include the payment in its ordinary income.

- *Double deduction mismatches*, which generally arise where a tax deduction is available in two or more countries in respect of a single economic expense.

The hybrid mismatch rules address *only* D/NI Mismatches. Specifically, the rules address recommendations made in Chapter 1 of the BEPS Action 2 Report, addressing D/NI Mismatches arising from payments under three types of arrangements: hybrid financial instrument arrangements, hybrid transfer arrangements and substitute payment arrangements. In addition, the hybrid mismatch rules implement Recommendation 2.1 in Chapter 2 of the BEPS Action 2 Report, by restricting dividend received deductions under section 113 of the *Income Tax Act* (the *Act*), in respect of dividends received from a foreign affiliate of a Canadian corporate taxpayer, to the extent that the dividend is deductible for foreign income tax purposes. The hybrid mismatch rules do, however, go beyond the recommendations of the BEPS Action 2 report in targeting certain notional interest deductions.

In an interesting and novel approach to Canadian tax legislation, new subsection 18.4(2) specifies that the hybrid mismatch rules relate to the implementation of recommendations in the BEPS Action 2 Report and, unless the context otherwise requires, are to be interpreted consistently with that report, as amended from time to time. This approach seems to suggest that the commentary in the BEPS Action 2 Report will be a relevant interpretive aid for the purposes of these rules.

The 2021 Federal Budget announced that the hybrid mismatch rules are to be implemented in stages, with rules addressing recommendations in Chapter 1 to be introduced prior to other recommendations.[1] The Explanatory Notes indicate that it remains the government's intention to address other BEPS Action 2 Report recommendations at an as-yet-unspecified later date.

[1] Refer to EY Tax Alert 2021 Issue No. 19.

New subsections 18.4 and 12.7 – primary and secondary operative rules

Recommendations in Chapter 1 of the BEPS Action 2 Report generally suggest neutralizing hybrid D/NI Mismatch outcomes from cross-border payments by introducing a primary rule that denies a deduction in the hands of the payer. If the paying jurisdiction does not have a rule denying a deduction in respect of a payment, then a secondary rule should be implemented that should require an inclusion in the hands of the recipient of a cross-border payment. The hybrid mismatch rules generally follow the recommended approach, with new subsection 18.4(4) representing a primary operative rule intended to deny deductions in respect of "the deduction component" of a hybrid mismatch arrangement, and a secondary rule in proposed subsection 12.7(3) requiring an inclusion into taxable income in respect of "a foreign deduction component" of a hybrid mismatch arrangement.

While there is general consistency with the BEPS Action 2 Report recommendations, the hybrid mismatch rules deviate from the BEPS Action 2 Report recommendations in respect of notional interest expenses claimed in respect of cross-border loans. The BEPS Action 2 Report specifically considered mismatches in tax outcomes that relate to differences in the respective transfer pricing approaches to cross-border loans, and determined that if a debtor to a cross-border loan takes a notional interest deduction in respect of low-or-non-interest-bearing loans, whereas the creditor makes no similar upward adjustment to include an amount into its taxable income, because the resulting mismatch is not due to the hybridity of the financial instrument giving rise to the amount, then the outcome is not intended to be neutralized under the BEPS Action 2 Report recommendations. However, proposed subsection 18.4(9) of the hybrid rules does bring D/NI Mismatches resulting from notional interest expense claims on cross-border loans within the scope of the hybrid mismatch rules.

Generally speaking, in order for either the primary rule or the secondary rule to apply, (1) there must be a **payment**; (2) the payment must give rise to a **D/NI Mismatch**; and (3) the payment must arise under a **hybrid mismatch arrangement**, which is defined to mean any of (i) a **hybrid financial instrument arrangement**; (ii) a **hybrid transfer arrangement**; or (iii) a **substitute payment arrangement**. Each of these concepts, and the consequences in respect thereof, are summarized below.

Payment

The hybrid mismatch rules apply in respect of particular payments. However, the term "payment" is defined in proposed subsection 18.4(1) to be inclusive, in that it includes its ordinary meaning and is broadened to also include any amount of benefit that an entity has an obligation, including any future or contingent obligation, to pay, credit or confer. This is intended to be interpreted broadly, and it is noted in the Explanatory Notes that under this definition, more than one payment can arise in respect of the same payment obligation. For example, a payment can arise when the obligation first comes into existence, e.g., as interest accrues, and then again when an amount is actually paid. However, per the Explanatory Notes, "this would not be expected to result in multiple applications of the hybrid mismatch rules, since it is expected that only one deduction would be available in respect of the payment obligation."

D/NI Mismatch

For the purposes of proposed sections 12.7 and 18.4, proposed subsection 18.4(6) sets out that a payment gives rise to a D/NI Mismatch, generally, in either of the following two situations:

(a) The total amount deductible, determined without regard to subsection 18.4 as well as interest restriction rules in subsections 18(4) and 18.2(2), in respect of the payment for Canadian tax purposes exceeds the total of all amounts, in respect of the payment, that is included (i) in **foreign ordinary income** (as defined in proposed subsection 18.4(1)) and (ii) in **Canadian ordinary income** (also defined in proposed subsection 18.4(1)); or

(b) If the total amount deductible for foreign tax purposes in respect of the payment, determined without regard to a foreign country's own interest restriction rules, exceeds the total amount included in Canadian ordinary income and foreign ordinary income in respect of the payment.

If situation (a) is the case:

- Proposed paragraph 18.4(7)(a) establishes that the deduction component of the D/NI Mismatch is the total amount deductible in respect of the payment for Canadian tax purposes; and

- Proposed paragraph 18.4(7)(c) generally sets out that the amount of the D/NI Mismatch arising from the payment is generally the amount by which the deduction component of the D/NI Mismatch exceeds the total taxable income inclusions, if any, in respect of the payment for purposes of Canadian or foreign income tax (although inclusions that represent 10% or less than the deductible amount are ignored for this purpose).

In general, where the deduction component of the D/NI Mismatch relates to one of the three specified types of hybrid mismatch arrangements, it is the amount of the D/NI Mismatch that will generally be denied as a deduction under proposed subsection 18.4(4).

If situation (b) is the case:

- Proposed paragraph 18.4(7)(b) establishes that the foreign deduction component of the D/NI Mismatch is the total of all amounts that, absent any foreign expense restriction rule (defined in proposed subsection 18.4(1) to generally mean a rule similar to our thin cap rules or the newly proposed interest limitation rules in section 18.2), would be or would reasonably be expected to be deductible, in respect of the payment, in computing the foreign taxable income of the debtor; and

- Proposed paragraph 18.4(7)(c) generally sets out that the amount of the D/NI Mismatch arising from the payment is generally the amount by which the foreign deduction component of the D/NI Mismatch exceeds the total taxable income inclusions, if any, in respect of the payment for the purposes of Canadian or foreign tax (and once again, inclusions that represent 10% or less than the deductible amount are ignored for this purpose).

In general, where the foreign deduction component of the D/NI Mismatch relates to one of the three specified types of hybrid mismatch arrangements, it is the amount of the D/NI Mismatch that will generally be included in income under subsection 12.7(3).

It is noted that "**foreign ordinary income**" is not a straightforward concept and is subject to a number of adjustments, including where the income is subject to tax at a zero rate (or a rate that is lower than the highest rate imposed by the relevant foreign country on such income), or is included in income because of a foreign hybrid mismatch rule.

Hybrid mismatch arrangements

The final condition for a payment to give rise to consequences under the hybrid rule is that that payment must arise under a hybrid mismatch arrangement. A hybrid mismatch arrangement under which a payment arises is defined in proposed subsection 18.4(1) to mean any of (a) a hybrid financial arrangement under which the payment arises, (b) a hybrid transfer arrangement under which the payment arises, or (c) a substitute payment arrangement under which the payment arises.

Hybrid financial instrument arrangement

Proposed subsection 18.4(10) sets out the conditions for a payment to arise under a hybrid financial instrument arrangement, with proposed subsection 18.4(11) then setting out the consequences. Very generally, per the BEPS Action 2 Report, this rule is meant to target arrangements (financial instruments) that are treated as debt, equity or derivative contracts under local law, and where a D/NI Mismatch results due to a difference in treatment of the instrument by two or more countries.

Under proposed subsection 18.4(10), a payment arises under a hybrid financial instrument arrangement if all of the conditions outlined in (a) to (d) below are satisfied.

(a) The payment (other than a payment that arises under a substitute payment arrangement) arises under, or in connection with, a financial instrument (defined generally to mean a debt, an equity interest or any other arrangement that gives rise to an equity or financing return);

(b) Either (i) a payer of the payment does not deal at arm's length with, or is a **specified entity** in respect of, a recipient of the payment, or (ii) the payment arises under, or in connection with, a **structured arrangement** (discussed below);

    For the purposes of the hybrid mismatch rules, a payer and recipient should generally be **specified entities** with respect to one another if the payer or recipient has a 25% equity interest in the other, or a third person has a 25% equity interest in both. A **structured arrangement** is defined to generally mean any transaction, or series of transactions, if the transaction or series includes a payment that gives rise to a D/NI Mismatch, and it can reasonably be considered that any economic benefit arising from the D/NI Mismatch is reflected in the pricing of the transaction or series, or the transaction or series was otherwise designed to give rise to the D/NI Mismatch;

(c) The payment gives rise to a D/NI Mismatch; and

(d) A final condition set out in subparagraph 18.4(10)(d)(i), which is a causal test to assess whether the mismatch arises because of "hybridity." This causal test includes a two-step analysis. The first step asks if it can reasonably be considered that the D/NI Mismatch arose in whole or in part because of a difference in the treatment for tax purposes of the financial instrument under which the payment arose, or one or more transactions that includes the payment or that relates to the financial instrument, under the laws of two or more countries. The second step in the causal test asks if it is reasonable to consider that the difference in tax treatment is attributable to the terms or conditions of the financial instrument or the transaction or transactions.

The hybridity condition in subparagraph 18.4(10)(d)(i) can also be satisfied if it would be so satisfied if any other reason for the D/NI Mismatch were disregarded, i.e., if the same D/NI Mismatch outcome would result not only because of hybridity, but also due to other facts and circumstances, then these other circumstances are ignored and the hybridity test in paragraph 18.4(10)(d) would then presumably be satisfied.

If all of the conditions in subsection 18.4(10) are satisfied such that a payment arises under a hybrid financial instrument arrangement, subsection 18.4(11) sets out that:

(a) The amount of the hybrid financial instrument mismatch, in respect of the payment, is generally the portion of the amount of the D/NI Mismatch arising from the payment;

(b) The deduction component, if any, of the D/NI Mismatch is the deduction component of the hybrid financial instrument arrangement (see the discussion above regarding D/NI outcomes for the definition of deduction component); and

(c) The foreign deduction component, if any, of the D/NI Mismatch is the foreign deduction component of the hybrid financial instrument arrangement (see the discussion above regarding D/NI outcomes for the definition of foreign deduction component).

In the case of a deduction component of the D/NI Mismatch, the consequence is that conditions in paragraph 18.4(3)(b) should be satisfied, resulting in subsection 18.4(4) denying a deduction in respect of the payment to the extent of the hybrid mismatch amount in respect of the payment. In the case of a foreign deduction component of the D/NI Mismatch, the conditions in subsection 12.7(2) should be satisfied, resulting in subsection 12.7(3) requiring an inclusion in taxable income of an amount equal to the hybrid mismatch amount in respect of the payment.

Special rule for notional interest expense – deemed payment, deemed receipt and deemed hybridity

Under proposed subsection 18.4(9), which applies for the purposes of subsections 12.7 and 18.4, if, in the absence of any foreign expense restriction rule, an amount (referred to as the "**deductible amount**") would be deductible by a debtor in respect of a notional interest expense on a debt in computing its relevant foreign income or profits for the year:

(a) The debtor is deemed to make a payment in the year under the debt to the creditor in an amount equal to the deductible amount, and the creditor is deemed to be the recipient of such payment;

(b) The deductible amount is deemed to be in respect of the payment;

(c) Any amount included in the creditor's foreign ordinary income or Canadian ordinary income is deemed to be in respect of the deemed payment; and

(d) Any D/NI Mismatch arising from the payment is deemed to satisfy the "hybridity" requirement in paragraph 18.4(10)(d).

A general outcome of subsection 18.4(9) is that, in respect of a cross-border loan, if a debtor has a downward transfer pricing adjustment resulting in a notional interest expense, that notional interest expense may be deemed to be a payment under the hybrid financial instrument. This would then result in the deemed payment being considered to result in an income inclusion under section 12.7.

Hybrid transfer arrangement

Subsections 18.4(12) and (13) set out the conditions for when a payment arises under a hybrid transfer arrangement and the related consequences. In general, this rule is meant to target arrangements involving the transfer of financial instruments where differences in the tax treatment of that arrangement result in different entities being treated as the owner of the return on the transferred instrument. Where the hybrid transfer arrangement involves a financial instrument, the D/NI Mismatch is not caused by differences in the characterization or treatment of financial instruments, but rather generally results from a difference in the tax treatment of two or more countries of the transfer of the financial instrument or related series of transactions, or of certain payments connected with the transfer or series. For example, this may involve a scenario where the tax laws of two countries each treat a taxpayer that is resident in their country as the owner of a share, and where payments made under the arrangement are deductible by one party but not included in income by the other party.

Under proposed subsection 18.4(12), a payment arises under a hybrid transfer arrangement if the following conditions are met:

(a) The payment arises under, or in connection with, (i) a "transfer arrangement" that includes a disposition, loan or other transfer by an entity to another entity (referred to as the transferor and transferee) of all or a portion of a financial instrument (referred to as the "transferred instrument"), or (ii) the transferred instrument;

(b) At any time during the transfer arrangement, either (i) a payer of the payment or transferor, as the case may be, does not deal at arm's length with, or is a "specified entity" in respect of, a recipient of the payment or the transferee, or (ii) the payment arises under, or in connection with, a structured arrangement;

(c) The payment gives rise to a D/NI Mismatch; and

(d) Similar to paragraph 18.4(10)(d) in respect of hybrid financial instrument arrangements, paragraph 18.4(12)(d) sets out three separate "causal tests", each effectively assessing whether the D/NI Mismatch arises because of the "hybridity" of the arrangement, which are slightly broader than the equivalent rule that applies to hybrid financial instrument arrangements. One of these three hybridity tests must be met. Similar to the rule in 18.4(10)(d)(ii), the causal tests are to be considered without regard to any other factors that may cause a D/NI Mismatch.

Where all of the conditions in subsection 18.4(12) are satisfied such that a payment arises under a hybrid transfer arrangement, subsection 18.4(13) sets out the consequences. These consequences are generally similar to those set out in subsection 18.4(11) in respect of hybrid financial instrument arrangements, namely:

(a) The amount of the hybrid transfer mismatch, in respect of the payment, is generally the portion of the amount of the D/NI Mismatch arising from the payment;

(b) The deduction component, if any, of the D/NI Mismatch is the deduction component of the hybrid transfer arrangement; and

(c) The foreign deduction component, if any, of the D/NI Mismatch is the foreign deduction component of the hybrid transfer arrangement.

The consequences are, in the case of a deduction component of the D/NI Mismatch, that the conditions in paragraph 18.4(3)(b) should be satisfied, resulting in subsection 18.4(4) denying a deduction in respect of the payment to the extent of the hybrid mismatch amount in respect of the payment. In the case of a foreign deduction component of the D/NI Mismatch, the conditions in subsection 12.7(2) should be satisfied, resulting in subsection 12.7(3) requiring an amount equal to the hybrid mismatch amount in respect of the payment to be included in income.

Substitute payment arrangement

Subsections 18.4(14) and (15) set out the conditions for when a payment arises under a substitute payment arrangement and the related consequences.

The BEPS Action 2 Report defines a substitute payment to mean:

"Any payment, made under an arrangement to transfer a financial instrument, to the extent it includes, or is payment of an amount representing, a financing or equity return on the underlying financial instrument where the payment or return would:

(i) not have been included in ordinary income of the payer;

(ii) have been included in ordinary income for the payee; or

(iii) have given rise to hybrid a mismatch

if it had been made directly under the financial instrument."

According to the BEPS Action 2 Report, this rule is meant to target arrangements involving the transfer of financial instruments where a payment is made in substitution for the financing or equity return on the transferred asset and differences between the tax treatment of that payment and the underlying return on the instrument have the net effect of undermining the integrity of the hybrid financial instrument rule. This appears to be somewhat of a catch-all category, which may apply generally where a payment is made in respect of a transferred financial instrument (e.g., a share or a loan), the transferee makes a payment to the transferor, and a portion of the payment relates to an underlying return in respect of the transferred financial instrument, and any portion of the payment that is deductible by the transferee exceeds the amount included in income of the transferor.

Proposed paragraphs 18.4(14)(a) to (g) set out the conditions for when a payment arises under a substitute payment arrangement. These conditions generally follow criteria set out in the BEPS Action 2 Report for the payment to be a substitute payment, including that the payment must be in respect of the transfer of a financial instrument (e.g., a share or debt) between a transferee and transferor, the amount of the payment is determined in whole or in part by reference to an "underlying return" (e.g., a dividend paid on the share, or interest on the debt), there is a D/NI Mismatch, and it is the case that (i) the transferee and transferor, or recipient and payer of the payment, either do not deal at arm's length or are specified entities in respect of one another, or (ii) the payment is connected with a structured transaction, among other conditions.

However, unlike the conditions for a hybrid financial instrument arrangement and a hybrid transfer arrangement, subsection 18.4(14) does not include a condition that the D/NI Mismatch arises due to the "hybridity" of the transaction or arrangement. It also appears that transactions between two Canadian resident taxpayers may be within the scope of the substitute payment mismatch rules. This could be seen as running counter to the definition for "hybrid mismatch arrangement" in the BEPS Action 2 Report, as described above, which is described first and foremost as involving a "cross-border transaction."

Although there is no specific condition in either the hybrid financial instrument rule or the hybrid transfer mismatch rule that there must be a cross-border element, adding the "hybridity" condition effectively ensures that the rules would likely not apply where both parties to the relevant arrangement are resident in the same country. It is unclear if it was intended that the substitute payment rule could apply in the case of a wholly domestic transaction, or if it would be appropriate to include an additional condition requiring a "cross-border element" to a payment or transfer for the substitute payment rule to apply.

Double tax relief – paragraph 20(1)(yy)

Proposed paragraph 20(1)(yy) provides that a taxpayer may claim a deduction in cases where an amount is or was previously denied under subsection 18.4(4) in respect of a payment. In order to apply, a taxpayer must demonstrate that an amount is foreign ordinary income of an entity in respect of the payment that ends within 12 months of the end of the taxpayer's year. To avoid double counting, the amount of foreign ordinary income must not have already been taken into account in determining the D/NI Mismatch/subsection 18.4(4) denial in the first instance, nor in determining the amount of a previous deduction under paragraph 20(1)(yy).

Subsection 113(5)

Subsection 113(5) may limit a taxpayer's ability to claim deductions under section 113 in respect of dividends received from a foreign affiliate of the taxpayer. Subsection 113(5) implements recommendation 2.1 of the BEPS Action 2 Report, which recommends that countries limit dividend exemptions for payments that are treated as deductible by the payer.

Subsection 113(5) applies to deem any amount, that in the absence of the subsection would be a dividend received by a corporation resident in Canada on a share of the capital stock of a foreign affiliate of the corporation for the purposes of section 113, not to be a dividend received to the extent of the total amount in respect of the dividend, if that amount:

(a) Is an amount that generally is or can reasonably be expected to be deductible in computing the income or profits of the affiliate or of another entity for a foreign taxation year; or

(b) Would, in the absence of any foreign hybrid mismatch rule or other foreign restriction rule, be described in paragraph (a).

This condition in (b) above effectively ensures that, in a case of a D/NI Mismatch otherwise arising, Canada will reserve the right to neutralize the D/NI Mismatch by forcing the amount to be recognized as taxable income in priority to the foreign country denying the deduction under their equivalent hybrid mismatch arrangement rules. The application of this rule is not, however, conditional on any "hybridity" as such.

Part XIII withholding tax

Under proposed subsection 214(18), interest paid or credited by a corporation resident in Canada that is not deductible because of the hybrid mismatch rule in proposed subsection 18.4(4) is deemed to be a dividend and not interest for the purposes of Part XIII of the Act. This rule, in effect, is intended to align the treatment of these interest payments for the purposes of withholding tax under Part XIII with the tax treatment for the purposes of Part I and under the relevant foreign tax law and prevents taxpayers from using hybrid mismatch arrangements as equity substitutes to inappropriately avoid dividend withholding tax.

Anti-avoidance rule – subsection 18.4(20)

Finally, proposed subsection 18.4(20) is an anti-avoidance rule that sets out that the tax consequences to a person shall be redetermined in order to deny a tax benefit to the extent necessary to eliminate any D/NI Mismatch, or "other outcome that is substantially similar," arising from a payment if:

(a) It can reasonably be considered that one of the main purposes of a transaction or series of transactions that includes the payment is to avoid or limit the application of subsections 12.7(3) or 18.4(4) or 113(5) in respect of the payment; and

(b) Any of the following conditions is met:

(i) The payment is a dividend and an amount would be, or would be expected to be, deductible in respect of the payment in computing foreign income under foreign law;

(ii) The mismatch or other outcome arises because of a difference in the tax treatment of any transaction or series of transactions under the laws of more than one country that is attributable to the terms or conditions of the transaction or one or more transactions included in the series; or

(iii) The mismatch or other outcome would arise in whole or in part because of a difference described in subparagraph (ii), if any other reason for the mismatch or other outcome were disregarded.

This specific anti-avoidance rule is rather broad and not subject to any of the other conditions that would apply under the general anti-avoidance rule (as has become a more common trend in recent Canadian legislative proposals). The Explanatory Notes also specifically suggest that the "hybridity" test in the anti-avoidance rule be interpreted more broadly than the similar language used in proposed paragraph 18.4(10)(d).

Learn more

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