Preface

These explanatory notes describe proposed amendments to the *Income Tax Act*. These explanatory notes describe these proposed amendments, clause by clause, for the assistance of Members of Parliament, taxpayers and their professional advisors.

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Deputy Prime Minister and Minister of Finance

These notes are intended for information purposes only and should not be construed as an official interpretation of the provisions they describe.

Legislative Proposals Relating to the Income Tax Act

Hybrid Mismatch Arrangements

Overview

New sections 12.7 and 18.4 and of the *Income Tax Act* (the "Act"), together with new subsection 113(5), are the core provisions of the new hybrid mismatch rules. These rules are intended to implement the recommendations in, and be generally consistent with, the report under Action 2 of the Group of 20 and Organisation for Economic Co-operation and Development's Base Erosion and Profit Shifting Project (the "BEPS Action 2 Report"), titled *Final Report on Neutralising the Effects of Hybrid Mismatch Arrangements*, with appropriate adaptations to the Canadian income tax context. The BEPS Action 2 Report recommends a number of specific rules for countries to implement in their domestic laws, which are intended to neutralize mismatches in tax results arising from "hybrid mismatch arrangements".

Hybrid mismatch arrangements are 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 to produce mismatches in tax results (referred to as "hybrid mismatches"). The two main forms of hybrid mismatch addressed by the recommendations in the BEPS Action 2 Report are:

- *Deduction/non-inclusion mismatches*: In general terms, these arise where a country allows a deduction in respect of a cross-border payment, the receipt of which is not fully included in ordinary income in the other country (where "ordinary income" generally means income that is subject to income tax at the recipient's full tax rate and is not effectively sheltered from tax).
- *Double deduction mismatches*: These arise where a tax deduction is available in two or more countries in respect of a single economic expense.

Consistent with the recommendations in the BEPS Action 2 Report, the hybrid mismatch rules eliminate hybrid mismatches and align the tax results in Canada and the other relevant country in respect of a mismatch, by restricting the amount deductible by a taxpayer in respect of a payment under a hybrid mismatch arrangement, or including an amount in income of a taxpayer who receives such a payment, as the case may be.

The legislative amendments introduced at this time implement the recommendations in Chapter 1 of the BEPS Action 2 Report, addressing deduction/non-inclusion mismatches that arise from payments under three types of arrangements: "hybrid financial instrument arrangements", "hybrid transfer arrangements" and "substitute payment arrangements". In addition, these amendments implement Recommendation 2.1 in Chapter 2 of the report, by restricting the dividends received deduction in section 113 to the extent that the dividend is deductible for foreign income tax purposes.

The 2021 budget announced that amendments implementing other recommendations of the BEPS Action 2 Report will be introduced at a later date.

Summary of main provisions

The legislative amendments introduced at this time include the following key provisions:

- *Interpretive rule*: Subsection 18.2(2) provides that the hybrid mismatch rules are to be interpreted consistently with the BEPS Action 2 Report, unless the context otherwise requires (such as where the hybrid mismatch rules depart from recommendations in the report). Accordingly, these explanatory notes are intended to be read together with the report.
- *Primary operative rule*: Consistent with Recommendation 1.1(a) of the BEPS Action 2 Report, subsection 18.4(4) neutralizes a deduction/non-inclusion mismatch arising from a payment under hybrid mismatch arrangement by restricting a deduction in respect of the payment.
- *Secondary operative rule*: Consistent with Recommendation 1.1(b), subsection 12.7(3) neutralizes a deduction/non-inclusion mismatch arising from a payment under a hybrid mismatch arrangement by including an amount in the income of a recipient of the payment. It is a "defensive" rule that applies only to the extent the hybrid mismatch is not otherwise neutralized by way of a restriction of a deduction under the hybrid mismatch rules of a foreign country.
- *Deduction/non-inclusion mismatch*: Subsection 18.4(6) determines if a payment gives rise to a deduction/non-inclusion mismatch. This generally occurs if the total amount deductible in respect of the payment for Canadian income tax purposes exceeds the total amount included in respect of the payment in taxable income for foreign income tax purposes, or if the total amount deductible for foreign income tax purposes exceeds the total amount included for Canadian income tax purposes. This accords with Recommendation 1.1 and the recommendations in Chapter 12 of the report.
- *Notional interest expense*: Subsection 18.4(9) ensures the hybrid mismatch rules address deduction/non-inclusion mismatches arising because of an income tax deduction under foreign law for a notional interest expense in respect of a debt.
- *Hybrid financial instrument arrangement*: Subsection 18.4(10) determines if a payment arises under a hybrid financial instrument arrangement. Consistent with the recommendations in Chapter 1 of the report, this generally occurs if a payment under a financial instrument results in a deduction/non-inclusion mismatch, and the mismatch arises because of differences in income tax treatment under the laws of different countries that are attributable to the terms or conditions of the financial instrument or related transactions. Subsection 18.4(11) determines the amount of the hybrid financial instrument mismatch, and ensures that subsection 12.7(3) or18.4(4) applies only to the extent that the deduction/non-inclusion mismatch results from the hybridity of the arrangement.
- *Hybrid transfer arrangement*: Subsection 18.4(12) determines if a payment arises under a hybrid transfer arrangement. Consistent with the recommendations in Chapter 1 of the report, this generally occurs if a payment under an arrangement for the transfer of a financial instrument gives rise to a deduction/non-inclusion mismatch, and the mismatch arises because the tax laws of different countries treat different entities as owning returns under the transferred financial instrument. Subsection 18.4(13) determines the amount of the hybrid transfer mismatch and is analogous in function to subsection 18.4(11).

- *Substitute payment arrangement*: Subsection 18.4(14) determines if a payment arises under a substitute payment arrangement. Consistent with the recommendations in Chapter 1 of the report, this generally occurs if a payment under or in connection with the transfer of a financial instrument (1) functions as a substitute for returns under the instrument, and (2) gives rise to a deduction/non-inclusion mismatch that would otherwise undermine the integrity of the rules on hybrid financial instrument arrangements and hybrid transfer arrangements in subsections 18.4(10) to (13). Subsection 18.4(15) determines the amount of the substitute payment mismatch and ensures subsection 12.7(3) or 18.4(4) applies only to the extent the deduction/non-inclusion mismatch arises from the portion of the payment that is a substitute.
- *Anti-avoidance rule*: Subsection 18.4(20) is an anti-avoidance rule that is intended to capture situations that, in substance, meet the essential characteristics of a hybrid mismatch arrangement, notwithstanding that one or more of the precise technical requirements of the hybrid mismatch rules is not met.
- *Limitation of dividends received deduction*: Consistent with Recommendation 2.1 of the BEPS Action 2 Report, subsection 113(5) restricts a taxpayer's ability to deduct certain amounts under section 113 in respect of dividends received by the taxpayer from a foreign affiliate out of the affiliate's exempt, hybrid, taxable and pre-acquisition surpluses, generally to the extent that a foreign income tax deduction is available in respect of the dividend to the affiliate or certain other entities.

Consistent with Recommendation 1.4 of the BEPS Action 2 Report and the recommendations in Chapters 10 and 11 of the report, sections 12.7 and 18.4 apply in respect of payments under hybrid financial instrument arrangements, hybrid transfer arrangements and substitute payment arrangements, only if the relevant parties satisfy a relationship test, or the payment arises under a structured arrangement.

The relationship test is met if the parties do not deal at arm's length, or if they are "specified entities", as defined in subsection 18.4(1), with reference to subsection 18.4(17). In general terms, parties are specified entities if one has a 25% equity interest in the other, or another entity has a 25% equity interest in both.

An arrangement is a structured arrangement if its pricing reflects the hybrid mismatch or if the arrangement is otherwise designed to produce a hybrid mismatch. However, even if a payment arises under a structured arrangement, subsection 18.4(5) ensures that the hybrid mismatch rules do not apply if it is reasonable to conclude that a taxpayer was unaware of the mismatch and derives no benefit from it (i.e., the payment was at fair market value).

Key differences from recommendations in the BEPS Action 2 Report

The hybrid mismatch rules differ from or supplement the recommendations in the BEPS Action 2 Report in the following key ways:

- The rules use Canadian income tax concepts in defining the requisite relationships between the parties to arrangements that are within the scope of the rules on hybrid financial instrument arrangements, hybrid transfer arrangements and substitute payment arrangements.

- The rules adopt a modified causal (or “hybridity”) test in the context of the hybrid transfer arrangement rules.
- The rules provide for a deduction, under paragraph 20(1)(yy), where subsection 18.4(4) has restricted a deduction in respect of a payment and the taxpayer demonstrates that an amount has actually been included in income for foreign tax purposes in respect of the payment.
- The rules apply where a foreign country allows an income tax deduction for a notional interest expense in respect of a debt and this results in a deduction/non-inclusion mismatch, by virtue of subsection 18.4(9).
- The rules treat interest expense of a corporation resident in Canada that is not deductible because of the hybrid mismatch rules as a deemed dividend for the purposes of Part XIII of the Act.

Effective date

These amendments generally apply in respect of payments arising on or after July 1, 2022, including payments under arrangements entered into before that date.

Clause 1

ITA
12.7

Hybrid mismatch arrangements – definitions

ITA
12.7(1)

The definitions in subsection 18.4(1) apply in section 12.7.

Secondary rule – conditions for application

ITA
12.7(2)

New subsection 12.7(2) sets out the conditions for the application of subsection 12.7(3), the secondary operative rule of the hybrid mismatch rules.

For subsection 12.7(3) to include an amount in income in respect of a payment (as defined in subsection 18.4(1)) of which a taxpayer is the recipient, three conditions must be met. In general terms, these conditions target payments arising under hybrid mismatch arrangements that give rise to a deduction/non-inclusion mismatch (as determined under subsection 18.4(6)), where there is a foreign income tax deduction without a corresponding income inclusion for Canadian tax purposes.

The first condition is that the taxpayer must be a recipient of the payment. Under the broad definitions of "payment" and "recipient" in subsection 18.4(1), if an amount accrues to a taxpayer because of an entitlement to be paid, credited or conferred the amount (either immediately or in the future, and either absolutely or contingently), the taxpayer is considered a recipient of a payment, even if it has not actually received the amount or there is only a future or contingent obligation to pay the amount. In addition, where the taxpayer is the creditor under, for example, a low-interest or non-interest bearing loan, subsection 18.4(9) may deem the taxpayer to be the recipient of a notional interest payment if the relevant foreign law gives the debtor a notional interest deduction. See the commentary on subsection 18.4(9).

The second condition, in paragraph 12.7(2)(a), requires that the payment arise under a hybrid mismatch arrangement, which is defined in subsection 18.4(1) to comprise the various categories of arrangement to which the hybrid mismatch rules apply. For more information, see the commentary on that definition.

It is not intended that subsection 12.7(3) and subsection 113(5), which restricts deductions under section 113 in respect of certain dividends received by a taxpayer from a foreign affiliate, would apply in respect of the same payment. If subsection 113(5) applies to restrict a deduction in respect of a particular dividend, this would be expected to result in Canadian ordinary income (as defined in subsection 18.4(1)) in respect of the dividend, such that the dividend would not arise

under a hybrid mismatch arrangement (because there would be no deduction/non-inclusion mismatch in respect of the dividend). For more information, see the commentary on the definition “Canadian ordinary income” and subsection 113(5).

Consistent with the BEPS Action 2 Report, subsection 12.7(3), as a secondary hybrid mismatch rule, does not apply if a foreign income tax deduction in respect of a payment is restricted by a “foreign hybrid mismatch rule” (as defined in subsection 18.4(1)). In effect, this gives priority to a foreign country’s primary hybrid mismatch rule, which is a rule that is comparable to subsection 18.4(4). This ordering results from the fact that, if a foreign hybrid mismatch rule restricts a foreign tax deduction of an amount, the amount is not included when calculating foreign deductions for purposes of variable C of paragraph 18.4(6)(b). Provided the application of the foreign hybrid mismatch rule reduces the amount of the deduction/non-inclusion mismatch to nil, there would be no hybrid mismatch arrangement and thus the requirement in paragraph 12.7(2)(a) would not be met.

The third condition, in paragraph 12.7(2)(b), is generally intended to limit the rule to payments that are deductible for foreign income tax purposes. That paragraph requires that there be a “foreign deduction component” of the hybrid mismatch arrangement under which the payment arises. This refers to an amount that is “deductible” in computing an entity’s “relevant foreign income or profits” (both as defined in subsection 18.4(1)) in respect of the payment. In other words, if the deduction side of a deduction/non-inclusion mismatch arising from the payment is a foreign tax deduction, there is a foreign deduction component of the hybrid mismatch arrangement and the third condition is met.

The existence of a foreign deduction component is determined under paragraphs 18.4(11)(c) (in respect of hybrid financial instrument arrangements), 18.4(13)(c) (in respect of hybrid transfer arrangements) and 18.4(15)(c) (in respect of substitute payment arrangements).

Finally, as noted elsewhere in this commentary, an effect of the broad definition of “payment” in subsection 18.4(1) is that multiple payments may arise in respect of the same amount at different points in time (e.g., one payment may arise when an entitlement to the amount arises because of an obligation to pay the amount in the future, and another may arise later when the amount is actually paid). Similarly, because the “recipient” definition tracks the breadth of the “payment” definition, a taxpayer may be a recipient of multiple payments in respect of the same amount.

However, as further discussed in the commentary on subsection 18.4(6), because only one of the payments would be expected to result in a foreign tax deduction (i.e., the foreign income tax laws would not allow multiple deductions in respect of the same amount), it is expected that only one of the payments would give rise to a deduction/non-inclusion mismatch. Thus, the broad meaning of “payment” and “recipient” would not cause subsection 12.7(3) to apply multiple times in respect of the same amount.

Secondary rule – consequences

ITA
12.7(3)

New subsection 12.7(3) is the secondary operative rule, which neutralizes a deduction/non-inclusion mismatch arising from a payment under a hybrid mismatch arrangement by including an amount in the income of a recipient of the payment. Subject to subsection 18.4(5), it applies if the conditions in subsection 12.7(2) are met in respect of the payment.

Subsection 18.4(5) provides an exception that, in general terms, applies where a payment is otherwise within the scope of the hybrid mismatch rules because it arises under a "structured arrangement" (as defined in subsection 18.4(1)), but a taxpayer was neither aware of the deduction/non-inclusion mismatch nor shared in any economic benefit resulting from the mismatch. For more information, see the commentary on subsection 18.4(5).

The amount included in income under subsection 12.7(3) is equal to the "hybrid mismatch amount" (as defined in subsection 18.4(1)) in respect of the payment. Very generally, the hybrid mismatch amount in respect of a payment arising under a hybrid mismatch arrangement is the portion of the deduction/non-inclusion mismatch in respect of the payment that is attributable to the "hybridity" of the arrangement (other than in the case of a substitute payment arrangement, which does not require hybridity). The hybrid mismatch amount is determined under:

- if the payment arises under a hybrid financial instrument arrangement, paragraph 18.4(11)(a);
- if the payment arises under a hybrid transfer arrangement, paragraph 18.4(13)(a); or
- if the payment arises under a substitute payment arrangement, paragraph 18.4(15)(a).

For more information, see the commentary on the definition "hybrid mismatch amount" in subsection 18.4(1) and on paragraph 18.4(7)(c).

Paragraph 12.7(3)(a) provides that the amount that is included in the taxpayer's income under subsection 12.7(3) in respect of a payment is considered to be from the same source as the payment.

Paragraph 12.7(3)(b) determines the timing of the income inclusion to a recipient of a payment by reference to the foreign taxation year in which the foreign tax deduction in respect of the payment is available. The amount is included in income for the last taxation year of the taxpayer that begins before the end of the "foreign taxation year" (as defined in subsection 18.4(1)) in which an amount in respect of the payment would be, or would reasonably expected to be, "deductible" by any entity in computing its "relevant foreign income or profits" (both as defined in subsection 18.4(1)), absent any "foreign expense restriction rule" (as defined in subsection 18.4(1)). If multiple entities are entitled to foreign tax deductions in respect of a given payment, an amount equal to the hybrid mismatch amount is included in taxpayer's income for its last taxation year that begins before the first foreign taxation year of any entity in which an amount in respect of the payment would reasonably be expected to be deductible.

Clause 2

ITA
18.4

Hybrid mismatch arrangements - definitions

ITA
18.4(1)

New subsection 18.4(1) defines a number of terms that apply for the purposes of section 18.4 and paragraph 20(1)(yy) in determining the application of the hybrid mismatch rules.

Canadian ordinary income

"Canadian ordinary income" of a taxpayer for a taxation year in respect of a payment essentially refers to amounts that are included in respect of the payment in the taxpayer's income (or its taxable income earned in Canada, if the taxpayer is non-resident) for the year, without any offsetting relief (other than relief that applies generally and not in respect of the payment, as discussed below).

Canadian ordinary income is principally relevant in determining if there is a corresponding inclusion in income that is taxable in Canada in respect of a payment that is deductible for foreign tax purposes. More particularly, this definition is relevant in determining if a payment gives rise to a deduction/non-inclusion mismatch and the amount of any such mismatch, under subsections 18.4(6) and (7), respectively. For more information, see the commentary on those subsections.

The definition is also relevant for the purposes of paragraph (g) of subsection 18.4(14), in determining if a payment arises under a substitute payment arrangement.

Canadian ordinary income of a taxpayer that is not a partnership is determined under paragraph (a) of the definition. Paragraphs (b) and (c) determine, respectively, Canadian ordinary income of a partnership and Canadian ordinary income resulting from an inclusion in the foreign accrual property income ("FAPI") of a controlled foreign affiliate of a taxpayer.

Under paragraph (a), an amount in respect of a payment is Canadian ordinary income of a Canadian-resident taxpayer if the amount is included in the taxpayer's income for the purposes of Part I of the Act. In the case of a non-resident taxpayer, only amounts included in the taxpayer's taxable income earned in Canada in respect of the particular payment are considered Canadian ordinary income.

Canadian ordinary income includes not only amounts that are included in computing income from a business or property, but also the taxable portion of any capital gain that is included in computing a taxpayer's income.

By virtue of subparagraph (a)(i), an amount is not included in Canadian ordinary income under paragraph (a) if it is included in Canadian ordinary income of a partnership or in a taxpayer's Canadian ordinary income as a result of being included in FAPI of a controlled foreign affiliate. This ensures that amounts included in Canadian ordinary income under paragraphs (b) and (c) are counted only once. For example, if an amount in respect of a payment is included in

computing income of a partnership that is allocable to a member of the partnership under paragraph 96(1)(f), that amount only gives rise to Canadian ordinary income of the partnership under paragraph (b) and is not included in Canadian ordinary income of the member.

Subparagraph (a)(iii) provides that Canadian ordinary income in respect of a payment does not include an amount to the extent that the amount can reasonably be considered to be effectively sheltered from Part I tax because the amount, or the payment giving rise to the amount, is entitled to some form of relief under the Act. This exclusion applies regardless of the specific form that the relief takes, including an exemption, exclusion, deduction, credit (other than a foreign tax credit for foreign withholding tax, since such a credit is for tax actually paid) or other form of relief. Only the portion of any amount included in income that cannot reasonably be considered to be sheltered from tax because of the relief is considered Canadian ordinary income.

Subparagraph (a)(ii) addresses a specific form of relief that is common under hybrid mismatch arrangements, by reducing Canadian ordinary income to the extent a deduction under section 112 (for intercorporate dividends) or section 113 (for dividends received from foreign affiliates) is available in respect of a payment. Any deduction restriction under subsection 113(5) is taken into account in determining whether a taxpayer is entitled to a deduction in respect of the dividend under section 113. It is therefore expected that the hybrid mismatch rule in section 12.7 and the rule in subsection 113(5) would not have duplicative effects in respect of the same dividend payment.

Relief will result in a reduction in determining Canadian ordinary income only if it either (i) applies specifically in respect of the amount included in income in respect of the payment and not in computing income generally, or (ii) arises in respect of the payment.

As determined under paragraph (b), Canadian ordinary income of a partnership in respect of a payment is essentially the amount included in respect of the payment in computing the partnership's income or loss (subject to any reductions where the amount or payment is entitled to some form of relief), pro-rated based on the share of that income or loss that is allocated to Canadian-resident members or included in computing the taxable income earned in Canada of non-resident members.

More specifically, variable A of paragraph (b) is the amount included in respect of the payment in the partnership's income in accordance with the principles in subsection 96(1), subject to reduction pursuant to subparagraphs (i) and (ii) of variable A. Subparagraph (i) prevents double counting where an amount in respect of a payment is included in computing FAPI attributable to the partnership under subsection 91(1). In that case, Canadian ordinary income in respect of the payment will arise only under paragraph (c). In the case of a chain of tiered partnerships, a "no double counting" rule in subsection 18.4(8) ensures that an amount in respect of a payment is not Canadian ordinary income of more than one partnership in the chain.

Subparagraph (ii) provides a reduction to reflect any portion of the amount included in the partnership's income that is effectively sheltered due to a form of relief described in subparagraph (a)(iii) (i.e., a form other than a deduction under section 112 or 113). This relief

could apply at either the partnership or partner level, and in either case can reduce the variable A amount to the extent it effectively provides shelter from Part I taxation.

Variable A is multiplied by the proportion B/C to effectively limit the portion of the variable A amount that is included in Canadian ordinary income, based on the share of the partnership income (in which the payment is included) of members that are persons resident in Canada, or non-resident persons to the extent the income is included in their taxable income earned in Canada. Subsection 18.4(18) provides a "look-through" rule for tiered partnerships to address cases where a person is a member of an upper-tier partnership that is a member of a lower-tier partnership in whose income the payment is included. For more information, see the commentary on that subsection.

Variable D of paragraph (b) reduces a partnership's Canadian ordinary income in respect of a payment that is a dividend included in partnership income, to the extent that members are entitled to a deduction under section 112 or 113 in respect of the payment.

Paragraph (c) of this definition includes as Canadian ordinary income amounts that are included in computing the FAPI of a controlled foreign affiliate of a taxpayer, but only to the extent the FAPI is not effectively sheltered from tax and is included in computing the taxpayer's income for the year under subsection 91(1). The overall effect of variable F of paragraph (c) is that, if the taxpayer is a partnership, the partnership will only have Canadian ordinary income under paragraph (c) to the extent of the proportion of the FAPI that is included in the income of ultimate members that are persons resident in Canada.

controlled foreign company tax regime

The definition "controlled foreign company tax regime" is relevant in determining an entity's foreign ordinary income for a foreign taxation year in respect of a payment. Under variable A in the definition "foreign ordinary income", amounts that are included in relevant foreign income or profits in respect of which the entity is subject to tax under a controlled foreign company tax regime are excluded from foreign ordinary income.

This definition is modelled on the definition of the same term in the Global Anti-Base Erosion Model Rules (Pillar Two) published by the Organisation for Economic Co-operation and Development. It describes a set of tax rules that impose tax on a direct or indirect shareholder (referred to in this commentary as the "shareholder") in respect of income of an entity outside that jurisdiction (referred to in this commentary as the "foreign entity"). The foreign accrual property income rules in section 91 (and related provisions) are an example of such a regime. Although controlled foreign company tax regimes vary in their exact application and operation from jurisdiction to jurisdiction, the general effect of these rules is to subject the shareholder to current taxation on a share of certain income earned by the foreign entity, despite the fact that the income may not be actually distributed to and received by the shareholder.

Controlled foreign company tax regimes generally apply where the shareholder has a sufficiently high level of ownership or investment in the foreign entity (directly or indirectly), often measured by reference to the shareholder's ability to exercise control over the foreign entity.

Typically only certain types of income earned or derived by the foreign entity are subject to the controlled foreign company tax – for example, investment income or other income from property. Tax is computed by the shareholder in respect of this income, notwithstanding that the foreign entity is generally recognized as a separate entity for tax purposes under the laws of the shareholder's jurisdiction. This tax is often effected by means of an income inclusion to the shareholder in proportion to the shareholder's ownership interest.

Because controlled foreign company tax regimes are often among the most complicated and variable tax provisions of a jurisdiction's tax laws, the above description of common features is not intended to be read in an overly technical manner. For example, while this definition describes a regime under which a direct or indirect shareholder of a foreign entity is subject to taxation, this is not intended to exclude regimes that also apply in other situations, such as controlled foreign company tax regimes that, in certain circumstances, subject members of partnerships, beneficiaries under trusts or head offices in respect of foreign branches, to current taxation in respect of income of the partnership, trust or branch, respectively. Such regimes are within the scope of this definition.

However, this definition does not encompass fiscal transparency regimes, in which a shareholder is considered to earn income derived by another entity because that entity is fiscally transparent. Similarly, the definition is not intended to encompass specified minimum tax regimes, in which a shareholder may be liable to tax because of insufficient tax paid by its subsidiaries, rather than because of the attribution of income to the shareholder. Such a regime would generally be covered by the definition "specified minimum tax regime".

For more information, see the commentary on the definitions "foreign ordinary income", "relevant foreign income or profits" and "specified minimum tax regime" in this subsection.

deductible

The definition of "deductible", in respect of a payment in computing relevant foreign income or profits, is an inclusive one. It is intended by implication to include the ordinary meaning of that term, but is broadened so as to also capture any relief that is broadly equivalent in effect to granting a deduction in computing relevant foreign income or profits. This includes, but is not limited to, circumstances where a payment gives rise to a refund of, or an exemption, exclusion or credit that can be set-off against, a foreign income tax liability. A refund, exemption, exclusion or credit can have the same net effect on tax paid or payable as a deduction that reduces the overall amount of relevant foreign income or profits.

Imputation or franking credits available under certain foreign income tax laws to ensure integration between the corporate and shareholder levels of taxation would not be considered "relief equivalent in effect to a deduction" to the extent that such credits represent tax paid by the recipient.

entity

The definition of “entity” has the same meaning as in subsection 95(1). It includes an association, a corporation, a fund, a natural person, a joint venture, an organization, a partnership, a syndicate and a trust. This is a broad, non-exhaustive definition and is intended to describe entities or arrangements that exist under Canadian law as well as foreign entities or arrangements as they exist under the foreign law.

equity interest

An “equity interest” is defined to include a share of the capital stock of a corporation, an income or capital interest as a beneficiary under a trust, an interest as a member of a partnership or any similar interest in any entity. This includes any right that can generally be considered to equate to an ownership interest or similar right or entitlement in an entity – including any right, whether absolute or contingent, to receive, either immediately or in the future, an amount that can reasonably be regarded as all or any part of the capital, of the revenue or of the income of the entity. However, this does not include a right to receive an amount as creditor.

Subsection 18.4(17) contains deeming rules that are relevant to determining equity interests for the purposes of the definition “specified entity”. For more information, see the commentary on subsection 18.4(17) and the definition of “specified entity”.

The definition “equity interest” is also relevant for the definitions “financial instrument” and “foreign ordinary income”. For more information, see the commentary on those definitions in this section.

equity or financing return

The definition “equity or financing return” is relevant in determining whether an arrangement falls within the definition “financial instrument” in this subsection. Any arrangement that provides for such a return is a financial instrument.

As noted in the commentary on the definition “financial instrument” under this subsection, the BEPS Action 2 Report recommends that jurisdictions apply their hybrid mismatch rules with respect to payments under any arrangement that gives rise to an equity or financing return (and that meets the other conditions for being a “hybrid mismatch arrangement” set out in that report).

Under this definition, if a payment under an arrangement can reasonably be considered to be in respect of, or determined by reference to, any of the amounts or criteria described in paragraphs (a) to (c), the payment is an equity or financing return because it is, in substance, dependent on the success of a business or investment, or compensation for the use (or “time-value”) of money. Notably, the term “payment” is broadly defined under this subsection to include, among other things, an amount payable or a contingent payment obligation; for more information, see the commentary on that definition.

Paragraph (a) ensures that an arrangement that provides for a return based on an amount or benchmark that may generally be considered to be a reasonable proxy for an entity’s profits is treated as a financial instrument.

Paragraphs (b) describes any distributions out of an entity's income, profits or capital. These are returns typically derived from equity instruments.

Paragraph (c) describes returns under financing arrangements, including amounts that are not legally interest but that are compensation for the use of money.

Among other things, this definition is intended to ensure that derivative instruments are treated as financial instruments, to the extent that any payment under or in respect of the derivative instrument can reasonably be considered to be determined by reference to any of the amounts or criteria in paragraphs (a) to (c).

While it is expected that many arrangements that give rise to an equity or financing return are already described in the definition "financial instrument", the definition "equity or financing return" backstops that definition, as required particularly in light of the continually evolving market for derivative instruments. For more information, see the commentary on the definition "financial instrument" in this subsection.

financial instrument

The definition "financial instrument" is relevant for the rules on hybrid financial instrument arrangements, hybrid transfer arrangements and substitute payment arrangements, as set out in subsections 18.4(10), (12) and (14), respectively. In general, each of those arrangements involves a payment under, or in connection with, a financial instrument or transfer of a financial instrument, that gives rise to a deduction/non-inclusion mismatch.

A financial instrument is defined to be any of:

- a debt or "equity interest" (as the latter term is defined in this subsection);
- a right that replicates a right to participate in profits or gain of any entity; or
- any other right or arrangement that gives rise to an "equity or financing return" (as defined in this subsection).

This definition therefore comprises both a "legal form" analysis, in the determination of whether an instrument is a debt or equity interest, and an "economic substance" test that considers whether, in effect, the arrangement gives the holder a right that replicates an equity-holder's right to participate in profits, or the type of economic rights or returns generally provided under a debt or equity interest.

This definition is consistent with the recommendations in the BEPS Action 2 Report, which defines a financial instrument as any arrangement that is taxed as debt, equity or derivatives. However, because jurisdictions differ in the tax treatment of financial instruments, and given the complexity and continuing evolution of financial products, the report recommends that jurisdictions ensure their hybrid mismatch rules apply in respect of any arrangement that gives rise to an equity or financing return, so as to give full effect to the underlying policy of aligning the tax treatment of payments made under all equity or financing instruments between jurisdictions and to ensure that all such instruments are within the scope of the rules.

Consistent with the Action 2 Report, the "financial instrument" definition is not intended to include arrangements for the supply of services, ordinary operating leases, licensing agreements, arrangements for the assumption of non-financial risk (such as insurance) or asset transfers that do not involve any equity or financing return.

In determining whether a particular instrument or arrangement is a financial instrument, this definition first considers whether it presents the essential characteristics of a debt or equity interest. Because the hybrid mismatch rules generally apply to instruments that are characterized differently for tax purposes between jurisdictions, certain instruments tested under this definition will necessarily demonstrate essential characteristics of more than one formal legal category, this being generally the very cause of the differential treatment. For example, instruments such as subordinated debt, profit participating loans and convertible debt may present characteristics of both debt and equity interests (although they may generally be characterized as debt for purposes of the Act), and a finance lease may present characteristics of both debt and lease. Therefore, a flexible and purposive interpretation of this definition is required to ensure that the very hybridity of a given arrangement does not by itself frustrate its characterization as a financial instrument.

Paragraph (b) of the definition considers whether there exists any right that may reasonably be considered to replicate a right to participate in profits or gain of any entity. This is intended to ensure that any arrangement providing a right equivalent to, for example, a shareholder's right to receive dividends from a corporation – even where no payment has yet arisen under the arrangement – is considered to be a financial instrument. Such an arrangements exists, for example, where a person holds a right under a derivative contract entitling the holder to amounts determined by reference to dividends paid on shares of a corporation, whether or not any such dividends are ever paid. Although that person does not hold an equity interest in the corporation, the right under the derivative contract constitutes a financial instrument because it replicates a shareholder's right to participate in corporate distributions.

Paragraph (c) requires an analysis of the nature of the return under an arrangement (i.e., the payments arising under the arrangement) and seeks to ensure that any arrangement that provides a return based on the success of a business or investment, or on compensation for the use (or "time-value") of money, is a financial instrument. For more information, see the commentary on the definition "equity or financing return".

foreign expense restriction rule

The definition "foreign expense restriction rule" is used throughout the hybrid mismatch rules when calculating foreign deductions. Where used, generally the deductible amount in respect of a payment must be calculated as if any foreign expense restriction rule did not apply. This effectively allows the hybrid mismatch rules to apply in circumstances where a payment would have given rise to an actual mismatch (e.g., a deduction/non-inclusion mismatch) if another country had not denied a deduction under a foreign expense restriction rule.

“Foreign expense restriction rule” means a rule, regulation, or other tax provision under the laws of a foreign country that either:

- has an effect, or is intended to have an effect, that is substantially similar to subsection 18(4) or 18.2(2); or
- implements the Global Anti-Base Erosion Model Rules (Pillar Two).

Any rules, regulations or other tax provisions will be considered to have an effect that is substantially similar to subsection 18(4) or 18.2(2) if they limit the deductibility of interest or financing expenses based on a measure of excessive interest or financing expenses or excessive debt relative to a given benchmark, including, for example, shareholder equity (as in the thin-capitalization rules in the Act) or corporate earnings (as in the excessive interest and financing expenses limitation in section 18.2).

A foreign law will generally be considered to have an effect that is substantially similar to subsection 18(4) or 18.2(2) even if, for example, it is mechanically different from those rules or has a different scope from those rules, provided the ultimate effect of the foreign law is or is intended to be similar.

Paragraph (b) of this definition is expected to be relevant in the case where a foreign deduction is denied because of the application of a provision of a foreign law that implements, or is intended to implement, the UTPR component of the Global Anti-Base Erosion Model Rules (Pillar Two).

foreign hybrid mismatch rule

The “foreign hybrid mismatch rule” definition is principally relevant for the computation of foreign ordinary income, which is also defined in subsection 18.4(1). To ensure the appropriate coordination of Canadian and foreign hybrid mismatch rules, it is necessary, in computing foreign ordinary income of an entity, to disregard amounts included in computing the entity’s income for foreign tax purposes as a result of the application of a foreign hybrid mismatch rule (other than any rule that is substantially similar in effect to subsection 113(5)). For more information, see the commentary on the definition “foreign ordinary income”.

The term “foreign hybrid mismatch rule” is defined broadly to include any rules, regulations, or other foreign tax provisions that are intended to implement the BEPS Action 2 Report (in whole or in part, and as amended from time to time) or that have substantially the same effect as section 12.7 or 18.4, or subsection 113(5). The reference to “in whole or in part” in paragraph (a) allows for flexibility, including with respect to any departures from the recommendations or guidance in the BEPS Action 2 Report as a result of different policy or system design choices by a foreign country. The reference to “as amended from time to time” recognizes that foreign hybrid mismatch rules may evolve to take into consideration future revisions or updates to the BEPS Action 2 Report.

Any rule, regulation or other foreign tax provision will be considered to have an effect that is substantially similar to a hybrid mismatch rule in section 12.7 or 18.4, or subsection 113(5), if it forces an income inclusion, or denies a deduction or other relief, to eliminate the tax benefits of hybrid mismatch arrangements. This is a macro-level inquiry: even if the foreign tax provision

departs significantly from, or predates, the BEPS Action 2 Report, it looks at whether the rule applies similar general concepts to eliminate the mismatch in tax outcomes or has an effect that is substantially similar to the hybrid mismatch rules in the Act. For example, this includes a foreign tax provision that denies a participation exemption or other relief (e.g., an exemption, deduction or credit) in respect of a dividend, consistent with recommendation 2.1 of the BEPS Action 2 Report, notwithstanding that the denied relief may take a different form from the relief denied under subsection 113(5).

The definition is also relevant for the conditions of application of the substitute payment rule in subsection 18.4(14). Finally, it is relevant for the deduction restriction rule in subsection 113(5).

foreign ordinary income

"Foreign ordinary income" of an entity for a foreign taxation year in respect of a payment essentially refers to an amount that is included in respect of the payment in the income of the entity that is taxable in a foreign country, without any offsetting relief (other than relief that applies generally and not in respect of the payment, as discussed below).

The "foreign ordinary income" concept is the foreign analogue to "Canadian ordinary income" (as defined in this subsection) and is principally relevant in determining if there is a corresponding inclusion in foreign taxable income in respect of a deductible payment. This definition is thus relevant in determining whether a payment gives rise to a deduction/non-inclusion mismatch and the amount of the mismatch under subsections 18.4(6) and (7), respectively.

As with Canadian ordinary income, foreign ordinary income is also relevant in determining if a payment arises under a substitute payment arrangement under paragraph (g) of subsection 18.4(14).

Foreign ordinary income is determined by the formula: A – B – C – D – E – F.

Variable A essentially describes an amount (referred to as a "relevant amount") that, in respect of the payment, is included in income in respect of which the entity is subject to foreign income or profits tax.

An amount is included under variable A in two scenarios.

The first is where the entity is a "recipient" (as defined in this subsection) of the payment. In this case, an amount is a relevant amount to the extent it is included in respect of the payment in computing the entity's "relevant foreign income or profits" (as defined in this subsection), which are income or profits in respect of which the entity is subject to an income or profits tax imposed by a country other than Canada.

The second scenario is where the entity is not a recipient of the payment, but an amount in respect of the payment is nonetheless included in its relevant foreign income or profits because it has a direct or indirect "equity interest" (as defined in this subsection) in the recipient. This

addresses cases where a recipient of a payment is fiscally transparent under foreign income tax law, or is otherwise not subject to foreign income or profits tax (e.g., by virtue of a foreign corporate consolidation system) in respect of the payment, but the payment is included in relevant foreign income or profits of an entity by virtue of its equity interest in the recipient. For example, this would include an income inclusion to an investor in a fiscally-transparent recipient or a member of a recipient partnership.

In either scenario, an amount is included under variable A in computing an entity's foreign ordinary income in respect of the payment only if the entity is actually subject to income or profits tax of a foreign country in respect of the income or profits in which the payment is included. This is inherent to the concept of "relevant foreign income or profits". As a result, if, for example, the recipient of the payment is classified as a partnership under Canadian law, an amount is only foreign ordinary income of the recipient if the recipient is actually subject to foreign income or profits tax in respect of the payment (i.e., the partnership is fiscally opaque for purposes of the foreign income or profits tax).

It is intended that a given amount is only counted once in determining an entity's foreign ordinary income in respect of a payment. A "no double counting" rule in subsection 18.4(8) ensures that an amount in respect of a payment that has already been included as foreign ordinary income of an entity is not to be included again in computing foreign ordinary income of that entity or any other entity.

The effect of the reference in variable A to "a tax substantially similar to tax under Part XIII" is that the application of foreign withholding tax to a payment does not result in foreign ordinary income (just as Canadian withholding tax applicable to a payment to a non-resident does not result in Canadian ordinary income).

Amounts included in income or profits subject to a "controlled foreign company tax regime" or a "specified minimum tax regime" (both as defined in this subsection) are not relevant amounts for the purposes of variable A. This approach differs from the approach in respect of Canadian ordinary income, which can include amounts included in "foreign accrual property income" (as defined in subsection 95(1)). For more information, see the commentary on the definitions "controlled foreign company tax regime" and "specified minimum tax regime" in this subsection.

Variable B reduces the amount computed as foreign ordinary income in respect of the relevant amount to nil if the relevant amount is included in computing relevant foreign income or profits in respect of which income or profits tax is charged at a nil rate, in recognition that such income or profits are only nominally subject to tax.

Variable C is, in effect, an ordering rule that is intended to give the operative rule in subsection 18.4(4) priority over a "foreign hybrid mismatch rule" (as defined in this subsection), other than any rule that is substantially similar in effect to subsection 113(5) (as discussed below). This reflects the recommendation in the BEPS Action 2 Report that a country's "primary rule" (denying a deduction in respect of a payment under a hybrid mismatch arrangement) should apply in priority to another country's secondary (or "defensive") rule (requiring an income

inclusion in respect of such payment) in order to coordinate countries' hybrid mismatch rules. If any portion of a relevant amount is included in relevant foreign income or profits as a result of a foreign country applying its hybrid mismatch rules, that portion is effectively disregarded in computing foreign ordinary income. This can result in subsection 18.4(4) denying a deduction in respect of a payment, notwithstanding that another country's secondary rule simultaneously neutralizes the deduction/non-inclusion mismatch. For more information, see the commentary on the definition "foreign hybrid mismatch rule".

As noted, variable C does not apply if a relevant amount is included in relevant foreign income or profits because of a foreign tax provision "substantially similar in effect to subsection 113(5)". Subsection 113(5) is introduced in connection with the hybrid mismatch rules in this section and section 12.7 and implements recommendation 2.1 of the BEPS Action 2 Report. It restricts a deduction under section 113 for dividends received from foreign affiliates that are deductible for foreign income tax purposes. This carve-out from variable C is consistent with the recommendation in the BEPS Action 2 Report that if, in accordance with recommendation 2.1, a country adopts a rule that restricts its "participation exemption" (or equivalent relief, regardless of the particular mechanism used to provide such relief) in respect of "deductible" dividends received from foreign corporations, such a rule ought to take precedence over another country's primary rule. This carve-out from variable C ensures this order of priority by, in effect, "turning off" subsection 18.4(4) where an amount has been included in relevant foreign income or profits because of a foreign tax provision implementing recommendation 2.1.

Variable D provides for another reduction in computing foreign ordinary income, which applies to the extent some form of foreign tax relief results in the payment being effectively sheltered from foreign tax despite having been included in relevant foreign income or profits. Accordingly, the reduction under variable D applies only if the relief is somehow linked to the payment or relevant amount, in that it:

- applies specifically in respect of all or a portion of the relevant amount and not in computing the relevant foreign income or profits of the entity in general; or
- arises in respect of the particular payment, for example where the relief is available as a result of the payment.

Variable D is intended to capture the wide range of ways in which a payment or a relevant amount could receive relief from taxation, including among other things: a participation exemption for dividends received by a parent corporation that owns a threshold equity interest in a subsidiary resident in another country; deductions for dividends received; dividend tax credits for underlying tax paid in another country; and deductions, exclusions or exemptions specific to a category of income or payment (e.g., payments re-characterized as exempt stock dividends).

The reduction under variable D applies if the relevant amount can reasonably be considered to be sheltered from tax, without requiring the sheltering to apply in respect of the income or profits of any particular entity. Thus, for example, the relief could apply in computing relevant foreign income or profits of the entity that received the payment or of another entity that has an equity interest in the recipient.

A relevant amount is not excluded, reduced, offset or otherwise effectively sheltered because of a deduction (e.g., for depreciation or operating losses) that applies generally in computing relevant foreign income or profits.

Variable E provides a reduction in computing foreign ordinary income to the extent a refund is available for foreign income or profits tax paid or payable in respect of the relevant foreign income or profits in which the relevant amount is included. A refund of income or profits tax in respect of a refundable credit will also result in a reduction under variable E, whether the refund is paid to the entity that is liable to pay the foreign income or profits tax or some other entity. However, no such reduction will occur in the case of a refund resulting from a loss carryover.

While a reduction under variable E may result in a deduction/non-inclusion mismatch, the operative rule in 18.4(4) will apply to deny a deduction only to the extent the other requirements in this section are met (most notably, the causal tests in paragraphs 18.4(10)(d) and (12)(d), which assess the "hybridity" of a financial instrument or transfer arrangement). An example of an arrangement involving a refund of foreign tax that could satisfy these other requirements is one where the refund is available because an entity receives income of a specified character.

Finally, variable E includes an ordering rule, the effect of which is that any reduction under variable E is determined after the reductions in variables C and D have been taken into account.

Variable F provides for a reduction in computing foreign ordinary income if a payment is taxed at a preferential rate in certain circumstances. This is consistent with the BEPS Action 2 Report, which recommends that payments give rise to a deduction/non-inclusion mismatch if they are not taxed at the full marginal rate. The report specifies, however, that not all preferential tax rates give rise to a deduction/non-inclusion mismatch. For example, a mismatch should not be considered to arise simply because a foreign country taxes business or employment income at a higher rate than payments under financial instruments. Rather, the test is whether the reduced rate is less than the highest rate of income or profits tax the foreign country applies to payments under financial instruments. Accordingly, the reduction under variable F applies only if the rate at which a foreign income or profits tax is charged in respect of the relevant amount is lower than the highest rate of income or profits tax charged by the country in respect of income from a financial instrument. An example of a preferential rate within the scope of variable F is where a country taxes a payment that it treats as a dividend at a lower rate than it would charge if it treated the payment as interest.

A preferential tax rate that applies to payments received on the disposition of a capital asset may also fall within the scope of variable F. However, if only a portion of the payment is included in relevant foreign income or profits (e.g., the taxable portion of a capital gain), this would be reflected under variable A. Any resulting deduction/non-inclusion mismatch could result in a payment being considered to arise under a hybrid transfer arrangement or a substitute payment arrangement under subsection 18.4(12) or (14), respectively. For more information, see the commentary on those subsections.

Variable F includes an ordering rule, the effect of which is that any reduction in computing foreign ordinary income under this variable is determined after the reductions under variables C,

D and E have been taken into account. Therefore, if, for example, a payment under a financial instrument is taxed at a preferential rate and is also entitled to another form of relief described in variable D, the reduction under variable F is determined after first taking into account the reduction under variable D.

foreign taxation year

The "foreign taxation year" definition is principally relevant to the calculation of foreign ordinary income, which must be done for a foreign taxation year in determining whether a payment gives rise to a deduction/non-inclusion mismatch.

The term is also relevant in paragraph 20(1)(yy). For more information, see the commentary on that paragraph.

This definition is modelled on the definition of "taxation year" in relation to a foreign affiliate in subsection 95(1), with appropriate modifications to apply the definition in the context of the hybrid mismatch rules (including applying the term for the purpose of computing an entity's relevant foreign income or profits, as defined in this subsection). In general terms, the foreign taxation year is the taxation year of the entity under the taxation laws of a country in which the entity is subject to tax on its income or profits, which in most cases would be its country of residence.

hybrid mismatch amount

The definition "hybrid mismatch amount" is used in the operative rules in subsections 12.7(3) and 18.4(4). Where the operative rules apply, the hybrid mismatch amount determines the amount of the deduction that will be denied (in the case of the primary rule in subsection 12.7(3)) or the amount that will be included in income (in the case of the secondary rule in 18.4(4)) in respect of a payment.

There are separate categories of hybrid mismatch amount, each corresponding to a particular category of hybrid mismatch arrangement (hybrid financial instrument arrangements, hybrid transfer arrangements, and so on) and calculated in accordance with the rules in section 18.4 that apply to that particular type of hybrid mismatch arrangement. However, very generally, in the case of any hybrid mismatch arrangement that involves a deduction/non-inclusion mismatch, the hybrid mismatch amount in respect of a payment arising under the arrangement represents the amount by which amounts deductible in respect of the payment exceed income inclusions in respect of the payment, to the extent this excess is attributable to "hybridity" of the arrangement (other than in the case of a substitute payment arrangement, which does not require hybridity).

hybrid mismatch arrangement

The definition of "hybrid mismatch arrangement" comprises the various categories of arrangements to which the hybrid mismatch rules apply. The definition is used in the conditions of application of the operative rules in subsections 12.7(3) and 18.4(4). In order for the operative rules to apply to a payment, the payment will need to arise under at least one category of hybrid

mismatch arrangement. There are separate provisions in this section setting out the conditions for each type of hybrid mismatch arrangement.

The term includes a hybrid financial instrument arrangement, a hybrid transfer arrangement and a substitute payment arrangement as described in subsections 18.4(10), (12) and (14), respectively. It is intended that additional categories of hybrid mismatch arrangement will be added in future legislative amendments.

payer

The definition "payer" follows the broad definition of "payment" that applies for the purposes of the hybrid mismatch rules. Accordingly, in addition to the ordinary meaning of the term, a payer is also any entity that has any obligation, including any future or contingent obligation, to make a payment. As a consequence, there can in some cases be multiple payers in respect of a single payment for the purposes of these rules.

For more information, see the commentary on the definition "payment" under this subsection.

payment

The existence of a payment is a threshold condition for the hybrid mismatch rules, in that the operative rules in subsections 12.7(3) and 18.4(4) apply in respect of payments arising under hybrid mismatch arrangements.

The definition "payment" is an inclusive one, which is intended by implication to include the ordinary meaning of that term, but is broadened to also include any amount or benefit that an entity has an obligation, including any future or contingent obligation, to pay, credit or confer.

As a threshold condition, "payment" is intended to be broadly interpreted. This is to ensure that the hybrid mismatch rules, which necessarily take into account the tax treatment of amounts under the laws of foreign countries, can apply in a wide range of circumstances where a foreign country allows a deduction in respect of an obligation to pay.

For example, where an entity resident in a particular country accrues an amount, under its accounting standard, as a deemed discount on a non-interest bearing loan, and the entity is allowed a corresponding deduction in the particular country, no actual payment arises at the time of the deduction because neither the deemed discount nor the loan principal is paid or payable at that time. Thus, absent the extended definition of "payment" in this subsection, the hybrid mismatch rules could not apply even if there were a mismatch resulting from the creditor's country not requiring an income inclusion in respect of this arrangement. The broad definition of "payment", however, allows for the deduction to be considered in respect of a payment because the taxpayer has a future obligation to pay the principal. Consequently, the arrangement can be tested to determine whether the other elements of a hybrid mismatch arrangement are satisfied.

Under this definition, more than one payment can arise in respect of the same payment obligation – for example, first when the obligation comes into existence, and then again when an amount in

respect of that obligation is actually paid. However, 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.

Subsections 18.4(9) and (19) provide deeming rules to address particular issues with respect to the concept of a "payment" under the hybrid mismatch rules. Subsection 18.4(9) ensures that deductions for notional interest expense on a loan (e.g., a non-interest bearing loan), which are available under the tax laws of some countries, are deemed to be payments for the purposes of the hybrid mismatch rules. Absent this deeming rule, such a deduction would not be in respect of a payment – and thus would not be within the scope of the hybrid mismatch rules – since there is no corresponding actual payment obligation.

Subsection 18.4(19) applies in a situation where there would otherwise be multiple recipients of a particular payment, and deems the particular payment to instead be multiple payments, each corresponding to a given recipient's share of the particular payment. For more information, see the commentary on that subsection.

recipient

The definition "recipient" follows the broad definition of "payment" that applies for the purposes of the hybrid mismatch rules. Accordingly, in addition to the ordinary meaning of the term, a recipient is also any entity that has any entitlement, including any future or contingent entitlement, to be paid, credited or conferred a payment.

In cases where there would otherwise be multiple recipients in respect of a single payment, subsection 18.4(19) provides that each recipient's portion of the payment is treated as a separate payment.

For more information, see the commentary on the definition "payment" under this subsection and on subsection 18.4(19).

relevant foreign income or profits

"Relevant foreign income or profits" of an entity refers to income or profits in respect of which the entity is subject to an income or profits tax that is imposed by the government of a country other than Canada. To qualify as such, the income or profits tax must be imposed by the national government of the country and not by that of a state, province or other political subdivision of the country.

This definition is relevant in several respects in applying the hybrid mismatch rules in sections 12.7 and 18.4 and the restriction on deductions for certain dividends received from foreign affiliates in subsection 113(5). Most notably, for an amount to be "foreign ordinary income" of an entity in respect of a payment, or a foreign deduction to be relevant in the context of the hybrid mismatch rules, it must be included or deductible, as the case may be, in computing the entity's relevant foreign income or profits.

specified entity

The "specified entity" definition provides a relationship rule that is relevant to determining whether transactions between particular entities are within the scope of the hybrid mismatch rules. More specifically, it is relevant to determining whether the relevant parties to a transaction have the requisite relationship to be within the scope of the rules on financial instrument arrangements, hybrid transfer arrangements or substitute payment arrangements. This is consistent with the recommendations of the BEPS Action 2 Report, under which each category of hybrid mismatch rule has its own relationship rule, with the hybrid mismatch rules relating to financial instruments (set out in Chapter 1 of the BEPS Action 2 Report) generally applying where one party has a 25% or greater equity interest in another (or certain other tests are met, which largely correspond to non-arm's length relationships and "structured arrangements").

In general terms, the definition provides that two entities will be treated as specified entities in respect of one another if one entity, directly or indirectly, holds a 25% equity interest in the other entity, or a third entity, directly or indirectly, holds a 25% equity interest in both entities (in all cases taking into consideration the rules in subsection 18.4(17)). Specifically:

- Paragraph (a) applies where a particular entity (entity A), alone or together with non-arm's length parties, owns, directly or indirectly, equity interests that give it 25% or more of the value of another entity (entity B). If entity B is a corporation, paragraph (a) will also apply if entity A owns 25% or more of the voting shares of entity B. Where a condition in paragraph (a) is satisfied, entity A is a specified entity in respect of entity B.
- Paragraph (b) applies where the other entity (entity B), alone or together with non-arm's length parties, owns, directly or indirectly, equity interests that give it 25% or more of the value of the particular entity (entity A). If entity A is a corporation, paragraph (b) will also apply if entity B owns 25% or more of the voting shares of entity A. Where a condition in paragraph (b) is satisfied, entity B is a specified entity in respect of entity A.
- Paragraph (c) applies where a third entity, alone or together with non-arm's length parties, owns, directly or indirectly, equity interests that give it 25% or more of the value of both the particular entity and the other entity (entities A and B). Where entity A or B is a corporation, the third entity can also meet the test in paragraph (c) in respect of entity A or B if the third entity owns 25% or more of the voting shares of entity A or B, respectively. Where the conditions in paragraph (c) are satisfied, entity A and entity B will be specified entities in respect of one another. They will also be specified entities in respect of the third entity, and vice versa, due to the application of paragraphs (a) and (b).

The term "equity interest" is defined separately in this subsection. Subsection 18.4(17) contains deeming rules that are also relevant to determining equity interests. For more information, see the commentary on the definition "equity interest" and on subsection 18.4(17).

specified minimum tax regime

The "specified minimum tax regime" definition applies for the purpose of determining an entity's foreign ordinary income for a foreign taxation year. Variable A in the definition "foreign ordinary income" excludes amounts that are included in the entity's relevant foreign income or profits because of a specified minimum tax regime.

A set of tax provisions is a specified minimum tax regime if it is the global intangible low-taxed income ("GILTI") regime applicable to American persons under the United States *Internal Revenue Code of 1986*, or it can reasonably be considered to have been enacted with the intention to implement either the Global Anti-Base Erosion Model Rules (Pillar Two) published by the OECD or a Qualified Domestic Minimum Top-up Tax (within the meaning of the model rules). This reflects both the similar purpose and scope of these regimes.

An amount included in computing relevant foreign income or profits of an entity as a result of the application of a specified minimum tax regime is excluded from the entity's foreign ordinary income because global minimum taxes and domestic minimum top-up taxes are in substance alternative minimum taxes and do not subject income to tax at a country's general corporate income tax rate (or the rate otherwise applicable to income from the source of the payment in question). Accordingly, allowing such an inclusion to constitute foreign ordinary income would undermine the policy of the hybrid mismatch rules.

structured arrangement

The "structured arrangement" definition is relevant to the scope of the hybrid mismatch rules. In general terms, the hybrid mismatch rules apply to transactions between entities that satisfy a particular relationship test (e.g., the hybrid mismatch rules relating to financial instruments apply if either the entities do not deal at arm's length or a 25% ownership threshold is met). Structured arrangements are an exception to this general rule. Where there is a structured arrangement, a payment may be treated as arising under a hybrid mismatch arrangement, notwithstanding that the relevant entities may deal at arm's length and not meet the relevant ownership threshold. Among many other situations, the structured arrangement test can apply where a transaction or series of transactions is designed to avoid the application of the hybrid mismatch rules by manipulating ownership to avoid the relationship test.

The rules on hybrid financial instrument arrangements, hybrid transfer arrangements and the substitute payment arrangements can apply to payments arising under structured arrangements.

A structured arrangement is an arrangement where a payment gives rise to a deduction/non-inclusion mismatch and it can reasonably be considered, having regard to all the facts and circumstances, that any economic benefit arising from the deduction/non-inclusion mismatch is priced into the terms or conditions or the arrangement is otherwise designed to produce a mismatch. Whether a deduction/non-inclusion mismatch is reflected in the pricing or is a design feature of the transaction or series are objective tests.

The structured arrangement definition is modelled on the recommendations in Chapter 10 of the BEPS Action 2 Report and is intended to be interpreted consistently with the general definition of a structured arrangement in recommendation 10.1 and the list of factors in recommendation 10.2.

The examples in the BEPS Action 2 Report demonstrate that a deduction/non-inclusion mismatch can be reflected in the pricing of the transaction or series explicitly (see example 10.1, where the interest rate the borrower pays has been discounted over the term of the arrangement)

or implicitly (see example 10.2, which involves back-to-back lending through an unrelated intermediary where the tax benefit is returned to the parent through above-market pricing).

In addition, the following list of factors in recommendation 10.2, along with the examples demonstrating these considerations in practice (including, but not limited to, examples 1.31, 1.33, 6.1, 10.1.10.2, 10.3, 10.4 and 10.5), should be used as a guide when considering relevant facts and circumstances that may suggest that a transaction or series of transactions has been designed to result in a deduction/non-inclusion mismatch:

(a) an arrangement that is designed, or is part of a plan, to create a hybrid mismatch;
(b) an arrangement that incorporates a term, step or transaction used in order to create a hybrid mismatch;
(c) an arrangement that is marketed, in whole or in part, as a tax-advantaged product where some or all of the tax advantage derives from the hybrid mismatch;
(d) an arrangement that is primarily marketed to taxpayers in a jurisdiction where the hybrid mismatch arises;
(e) an arrangement that contains features that alter the terms under the arrangement, including the return, in the event that the hybrid mismatch is no longer available; or
(f) an arrangement that would produce a negative return absent the hybrid mismatch.

In considering whether or not a transaction or series of transactions can reasonably be considered to have been designed to result in a deduction/non-inclusion mismatch, the facts and circumstances surrounding the transaction or series must be considered objectively and in their full and proper context. While the determination will depend on the facts and circumstances, the following example involving convertible debentures demonstrates a deduction/non-inclusion mismatch which would generally not be considered a structured arrangement for the purposes of the hybrid mismatch rules.

Example

Assumptions

- *A taxable Canadian corporation (the "issuer") issues convertible debentures to arm's length parties, including Canadian residents, non-residents and tax-exempts.*
- *The payment of interest arising under the convertible debentures results in a deduction/non-inclusion mismatch when beneficially owned by certain non-resident holders.*
- *The convertible debentures are traded in the secondary market.*
- *The interest rate and conversion premium on the convertible debentures are the same for all holders (whether Canadian residents, non-residents, or tax-exempts), and are consistent with the market rates offered by comparable issuers of convertible debentures in the Canadian market.*
- *While there are no specific terms or conditions contained in the convertible debentures that were specifically included to create a deduction/non-inclusion mismatch (the terms and conditions of the convertible debentures are the same as other convertible debentures offered in the Canadian market), certain terms and conditions of the*

convertible debentures result in a deduction/non-inclusion mismatch in respect of holders resident in certain jurisdictions.

- *The convertible debentures are not primarily marketed to non-resident holders in those jurisdictions where a deduction/non-inclusion mismatch arises.*
- *The convertible debentures are not beneficially owned primarily by non-resident holders where a deduction/non-inclusion mismatch arises.*
- *The issuer, and the non-resident holders of the convertible debentures in those jurisdictions where a deduction/non-inclusion mismatch results, are aware of the deduction/non-inclusion mismatch.*

Analysis

The analysis of whether or not a transaction, or series of transactions (for example, the issuance of, the acquisition of an interest in, and the payment of interest on, the convertible debentures) is a structured arrangement is only relevant where a payment arises in respect of that transaction or series that results in a deduction/non-inclusion mismatch.

However, the fact that a deduction/non-inclusion mismatch may result from the payment of interest in respect of the convertible debentures does not mean that the transaction or series is a structured arrangement. It must also be reasonable to consider that any economic benefit arising from the deduction/non-inclusion mismatch is reflected in the pricing of the convertible debentures or that the convertible debentures were otherwise designed to result in the deduction/non-inclusion mismatch.

It is not expected that the payment of interest on the convertible debentures in this example would be considered to arise under, or in connection with, a structured arrangement.

The convertible debentures would not appear to have been designed to result in the deduction/non-inclusion mismatch since (i) the terms and conditions of the convertible debentures are the same for all holders and are the same as other convertible debentures offered in the Canadian market, (ii) the convertible debentures are not marketed primarily to holders that are resident in jurisdictions that give rise to a hybrid mismatch, and (iii) the convertible debentures are not beneficially owned primarily by holders resident in jurisdictions that give rise to a hybrid mismatch. Similarly, there is nothing in the facts that indicates that any economic benefit from the deduction/non-inclusion mismatch has been priced into the terms of the convertible debentures.

The fact that the issuer and non-resident holders in jurisdictions where a mismatch arises are aware of the mismatch does not, in itself, lead to a conclusion that there is a structured arrangement in this example.

Although this analysis is based on an objective consideration of the limited facts and circumstances outlined above for this example, in all cases, all available facts surrounding a particular transaction or series must be considered in their full and proper context.

transaction

The definition “transaction” includes an arrangement or event. This is the same definition used for, among other purposes, sections 245 and 247. This definition allows the hybrid mismatch rules to apply to the broad range of situations contemplated by the recommendations in the BEPS Action 2 Report.

Interpretation

ITA
18.4(2)

Subsection 18.4(2) provides an interpretive rule that applies for the purposes of this section, section 12.7 and subsection 113(5). These provisions implement the recommendations in, and are intended to be generally consistent with, the BEPS Action 2 Report. This is a key part of the context in which the text of the provisions is to be interpreted.

This subsection clarifies that, unless the context otherwise requires (such as where the hybrid mismatch rules clearly deviate from recommendations in the BEPS Action 2 Report), the hybrid mismatch rules should be interpreted consistently with the BEPS Action 2 Report published by the OECD (as amended from time to time), available at http://www.oecd.org/tax/beps/beps-actions/action2/.

For the purposes of providing interpretive guidance on the application of the recommendations in the BEPS Action 2 Report to hybrid mismatch arrangements, examples were included in Annex B of the BEPS Action 2 Report (and referenced throughout that report). Unless the context otherwise requires, these examples are instructive as to the intended scope and application of the hybrid mismatch rules.

Primary rule – conditions for application

ITA
18.4(3)

New subsection 18.4(3) sets out conditions for the application of subsection 18.4(4), the primary operative rule of the hybrid mismatch rules.

For subsection 18.4(4) to restrict a deduction in respect of a payment, three main conditions must be met. These conditions target the rule at payments arising under hybrid mismatch arrangements that give rise to deduction/non-inclusion mismatches (as determined under subsection 18.4(6)).

First, paragraph 18.4(3)(a) requires that an amount be deductible in respect of the payment in computing a taxpayer’s income from a business or property for a taxation year. There is no requirement that the taxpayer be the payer of the payment. In addition, for these purposes, whether an amount is deductible is determined without regard to the application of the hybrid mismatch rules (in order to prevent circularity), as well as the thin capitalization rule in

subsection 18(4) and the excessive interest and financing expenses limitation in section 18.2. Thus, subsection 18.4(4) applies in priority to those general interest restrictions.

Second, paragraph 18.4(3)(b) requires that the payment arise under a hybrid mismatch arrangement, which is defined in subsection 18.4(1) to comprise the various categories of arrangement to which the hybrid mismatch rules apply. For more information, see the commentary on that definition.

The final condition, also set out in paragraph 18.4(3)(b), requires that the amount that would otherwise be deductible in respect of the payment be the "deduction component" of the hybrid mismatch arrangement under which the payment arises. A deduction component of a hybrid mismatch arrangement essentially refers to an amount that is deductible, in respect of the payment, in computing income from a business or property under Part I of the Act, and that is taken into consideration in determining the deduction/non-inclusion mismatch. In other words, if the deduction side of the deduction/non-inclusion mismatch arising from the payment under the hybrid mismatch arrangement is a Canadian income tax deduction, there is a deduction component of the hybrid mismatch arrangement.

The existence of a deduction component is determined under paragraph 18.4(11)(b) (in respect of hybrid financial instrument arrangements), 18.4(13)(b) (in respect of hybrid transfer arrangements) or 18.4(15)(b) (in respect of substitute payment arrangements).

Subsection 18.4(4) is subject to subsection 18.4(5), which, in general terms, provides an exception in certain cases where a payment is otherwise within the scope of the hybrid mismatch rules because it arises under a "structured arrangement" (as defined in subsection 18.4(1)), but a taxpayer was neither aware of the deduction/non-inclusion mismatch nor shared in any economic benefit resulting from the mismatch. For more information, see the commentary on subsection 18.4(5).

Primary rule - consequences

ITA
18.4(4)

New subsection 18.4(4) is the primary operative hybrid mismatch rule, which neutralizes a deduction/non-inclusion mismatch arising from a payment under a hybrid mismatch arrangement by restricting the amount that is deductible in respect of the payment. It applies if the conditions in subsection 18.4(3) are met in respect of a payment.

The deduction is restricted to the extent of the "hybrid mismatch amount" (as defined in subsection 18.4(1)) in respect of the payment. The effect is that the amount deductible in respect of the payment is the amount that would otherwise have been deductible less the amount of the hybrid mismatch amount.

Very generally, in the case of any hybrid mismatch arrangement that involves a deduction/non-inclusion mismatch, the hybrid mismatch amount in respect of a payment arising under the arrangement represents the amount by which amounts deductible in respect of the payment

exceed income inclusions in respect of the payment, to the extent this excess is attributable to "hybridity" of the arrangement (other than in the case of a substitute payment arrangement, which does not require hybridity). The hybrid mismatch amount depends on the type of hybrid mismatch arrangement under which the payment arises. It is calculated under:

- paragraph 18.4(11)(a), if the payment arises under a hybrid financial instrument arrangement described in new subsection 18.4(10);
- paragraph 18.4(13)(a), if the payment arises under a hybrid transfer arrangement described in new subsection 18.4(12); or
- paragraph 18.4(15)(a), if the payment arises under a substitute payment arrangement described in subsection 18.4(14).

For more information, see the commentary on the definition "hybrid mismatch amount" and paragraph 18.4(7)(c).

If subsection 18.4(4) restricts a deduction in respect of only a portion of an amount in respect of an interest payment, a deduction in respect of the remaining portion may nonetheless be restricted under the thin capitalization rule in subsection 18(4) or the excessive interest and financing expenses limitation in section 18.2.

Structured arrangements – exception

ITA
18.4(5)

Broadly speaking, structured arrangements are an exception to the general rule that the relevant parties to a hybrid mismatch arrangement must meet a relationship test. Where there is a structured arrangement, a payment may be treated as arising under a hybrid mismatch arrangement notwithstanding that the relevant parties may deal at arm's length and may not meet the applicable ownership threshold in respect of one another. A structured arrangement is an arrangement where the deduction/non-inclusion mismatch is priced into the arrangement or that is otherwise designed to produce a mismatch. For more information, see the commentary on that definition in subsection 18.4(1).

Where an arrangement would, in the absence of new subsection 18.4(5), be within the scope of the hybrid mismatch rules because there is a structured arrangement, the relieving rule in subsection 18.4(5) provides an exception from the application of the hybrid mismatch rules. This exception does not apply if the parties to the arrangement meet the relationship test.

In general terms, the exception in subsection 18.4(5) applies if the taxpayer – and all entities that do not deal at arm's length with, or are specified entities in respect of, the taxpayer – are both unaware of the deduction/non-inclusion mismatch and derive no economic benefit from the mismatch. More specifically, paragraph 18.4(5)(b) requires that, at the time the taxpayer entered into – or acquired an interest in any part of – a transaction that is the structured arrangement, or that is part of the structured arrangement, it could not reasonably have been expected that the taxpayer was aware of the deduction/non-inclusion mismatch, or that any entity that is non-arm's length with or is a specified entity in respect of the taxpayer had such awareness. The reference

to “acquired an interest in any part of a transaction” is intended to ensure that in the case where, for example, an investor acquires securities in the secondary market, the “awareness” test applies at the time of this acquisition and not at the time of the original issuance.

Paragraph (c) requires that the taxpayer, and any entity that is non-arm’s length with or a specified entity in respect of the taxpayer, did not share in the value of any economic benefit arising from the deduction/non-inclusion mismatch.

Subsection 18.4(5) is intended to be interpreted consistently with recommendation 10.3 of the BEPS Action 2 Report, which excludes a taxpayer from the application of the structured arrangement rule if the taxpayer is not considered a “party” to the structured arrangement (where a taxpayer is generally a “party” if, based on the information available, the taxpayer or parties that meet a relationship test in relation to the taxpayer could reasonably have been expected to be aware of the mismatch or the taxpayer derives a benefit from it).

In considering whether it can reasonably be considered that an entity was aware of a deduction/non-inclusion mismatch, and whether an entity shared in the value of any economic benefit resulting from a deduction/non-inclusion mismatch, the facts and circumstances surrounding the transaction or series must be considered objectively and in their full and proper context. In particular, whether the taxpayer and any relevant entities were aware of the deduction/non-inclusion mismatch is an objective test measured at the time that the taxpayer entered into, or acquired an interest, in any part of the transaction. This determination is based on the information that would reasonably be available at that time. This should not require a taxpayer to undertake any additional commercial due diligence beyond that of a reasonable person.

Sharing in the value of any economic benefit that arises from a deduction/non-inclusion mismatch would generally be expected to be reflected in the pricing of a structured arrangement, especially in an arrangement that is not on fair market value terms or conditions. For example, an economic benefit arising from a deduction/non-inclusion mismatch may be shared through the payment of a lower rate of interest than would otherwise be paid where a deduction/non-inclusion mismatch does not arise.

Conversely, if payments arising under a structured arrangement are at fair market value, it would be reasonable to conclude that the parties derive no benefit from the mismatch. However, the conditions in subsection 18.4(5) are conjunctive, such that even if the payments are at fair market value, the exception will not apply unless the other conditions – including the “awareness” condition in paragraph (b) – are met.

Where the structured arrangement definition has been met in respect of a financial instrument, it is not expected that the issuer would be able to rely on the exception in subsection 18.4(5). The issuer would be expected to be aware of the design (i.e., the structuring), such that it would be reasonable to conclude that the issuer was aware of the tax consequences.

The BEPS Action 2 Report includes an example that demonstrates circumstances where a holder may be able to rely on the exception in 18.4(5). In example 10.3, the initial purchaser subscribes

for bonds issued by an unrelated company where the interest payments give rise to a deduction/non-inclusion mismatch. In this case, there is a structured arrangement as the bonds are marketed as a tax-advantaged product and are primarily marketed in jurisdictions where the deduction/non-inclusion mismatch arises. The initial purchaser subsequently sells the bonds to an unrelated entity on arm's length terms. The analysis concludes that the initial purchaser is a party to the structured arrangement because it can reasonably be expected to have been aware of the tax consequences at the time it subscribed for the bonds (based, in part, on the description in the investment memorandum, which describes the tax consequences for the holder). The entity that purchases the bonds from the initial purchaser may not be a party to the structured arrangement, however, even if the entity is resident in a jurisdiction where a deduction/non-inclusion mismatch arises, as it may not be aware of the mismatch since it acquired the bonds on arm's length terms in the secondary market.

The exception in subsection 18.4(5) may be available to a purchaser in the secondary market on the facts described in example 10.3. However, the exception is not intended to be limited to the secondary market. Depending on the facts, the exception may also be available to taxpayers who subscribe for a financial instrument if the taxpayer and any relevant entities are unaware of the deduction/non-inclusion mismatch and derive no benefit from such mismatch.

Deduction/non-inclusion mismatch – conditions

ITA
18.4(6)

New subsection 18.4(6) sets out the conditions for determining if a payment gives rise to a deduction/non-inclusion mismatch.

Very generally, a payment gives rise to a deduction/non-inclusion mismatch if the total amount deductible in respect of the payment for Canadian income tax purposes exceeds the total amount included in respect of the payment in taxable income for foreign income tax purposes (more specifically, the total amount of "foreign ordinary income" in respect of the payment), or if the total amount deductible for foreign income tax purposes exceeds the total amount included for Canadian income tax purposes (more specifically, the total amount of "Canadian ordinary income" in respect of the payment).

Consistent with the BEPS Action 2 Report, subsection 18.4(1) includes an extended definition of the term "deductible", which essentially includes any relief that is broadly equivalent to a deduction. For more information, see the commentary to the definition of "deductible" in subsection 18.4(1).

"Foreign ordinary income" of an entity in respect of a payment is defined in subsection 18.4(1) as, essentially, an amount included in respect of the payment in the income of the entity that is taxable in a foreign country, without any offsetting relief (other than relief that applies generally and not specifically in respect of the payment). For more information, see the commentary on that definition.

“Canadian ordinary income” of a taxpayer in respect of a payment is essentially an amount included in respect of the payment in the taxpayer’s income (or its taxable income earned in Canada, if the taxpayer is a non-resident), without any offsetting relief (other than relief that applies generally and not specifically in respect of the payment). Special rules apply in determining if amounts included in partnership income or FAPI are Canadian ordinary income. For more information, see the commentary on the “Canadian ordinary income” definition.

That a payment gives rise to a deduction/non-inclusion mismatch is a precondition to the existence of a hybrid financial instrument arrangement (under paragraph 18.4(10)(d)), a hybrid transfer arrangement (under paragraph 18.4(12)(d)) and a substitute payment arrangement (under paragraph 18.4(14)(f)). Thus, such a mismatch is a precondition to the application of the operative rules in subsections 12.7(3) and 18.4(4). However, it is not sufficient condition, as several other conditions must be met before any of those rules apply.

A payment gives rise to a deduction/non-inclusion mismatch if either paragraph 18.4(6)(a) or (b) is satisfied.

Paragraph (a) is relevant where an amount is deductible in respect of a payment for Canadian income tax purposes. In that case, if the payment is determined to give rise to a deduction/non-inclusion mismatch under paragraph (a) (and meets the other conditions for a hybrid mismatch arrangement), the operative rule in subsection 18.4(4) neutralizes the mismatch by restricting all or part of the Canadian income tax deduction.

A payment gives rise to a deduction/non-inclusion mismatch under paragraph (a) if the amount determined for variable A exceeds the amount determined for variable B.

Variable A aggregates all amounts deductible in respect of the payment in computing the income of a taxpayer from a business or property for a taxation year (referred to as a “relevant year”) under Part I of the Act.

For the purposes of variable A, the application of the thin capitalization rules and the excessive interest and financing expenses limitation are disregarded in determining whether an amount is deductible. This ensures that the hybrid mismatch rules apply in priority to these general interest restriction rules.

Variable B essentially measures the total taxable income inclusions, if any, in respect of the payment for the purposes of Canadian or foreign income tax. More specifically, it aggregates all amounts in respect of the payment that

- can reasonably be expected to be, and actually are, “foreign ordinary income” of an entity (under subparagraph (i)); or
- are “Canadian ordinary income” of a taxpayer (under subparagraph (ii)).

An amount is not included under subparagraph (i) of variable B if it cannot reasonably be expected to be foreign ordinary income. This reflects the fact that, consistent with the BEPS Action 2 Report, deduction/non-inclusion mismatches are determined based on the expected characterization and treatment of payments under the relevant foreign tax laws, in light of the

terms or conditions of the financial instrument, or the transaction or series of transactions, under which the payment arises.

The identification of an amount as foreign ordinary income is, therefore, primarily a question of foreign law, requiring an analysis of the relevant foreign tax rules (e.g., foreign statutes, regulations and case law, as well as administrative positions of the relevant foreign tax authority) that apply in determining the foreign tax treatment, including the character, amount and timing of payments. If the relevant foreign tax laws are such that foreign ordinary income cannot typically be expected to arise in respect of a payment under a given arrangement, no amount is included under subparagraph (i) (regardless of whether there actually is foreign ordinary income).

This analysis requires knowing the identity of the relevant counterparty to a hybrid mismatch arrangement (typically, the recipient of the payment) and the rules that apply under the laws of the foreign country in which that counterparty is tax resident. However, neither taxpayers nor the Canada Revenue Agency need to know the foreign tax status of a relevant counterparty (e.g., if a recipient is tax-exempt under the relevant foreign tax laws) or review its foreign income tax return to identify a mismatch, since it is not necessary to know precisely how a specific payment was taken into account in computing an entity's foreign taxable income. Rather, if the payment cannot reasonably be expected to give rise to foreign ordinary income, this is sufficient to exclude the amount from variable B and can potentially result in a mismatch.

Whether an amount can reasonably be expected to be foreign ordinary income in respect of a payment is an objective test. This determination must be based on a correct understanding of the terms and conditions of the arrangement, transaction or series, as well as the relevant foreign laws and how they typically apply in relation to such arrangements, transactions or series.

Finally, it is possible that in some cases, foreign ordinary income may be reasonably expected to arise in respect of a payment but not actually arise. For example, this could occur where a payment is not included in taxable income due to an unforeseen outcome under the relevant foreign tax law, such as where a foreign taxpayer takes a filing position that is inconsistent with the prevailing interpretation of the foreign law or the published positions of the foreign tax administration. In this case, no amount is included under variable B. This is because subparagraph (i) requires that foreign ordinary income is not only reasonably expected to arise in respect of the payment, but actually does arise.

Subparagraph (ii) of variable B also allows for amounts of Canadian ordinary income in respect of a payment to be included in determining if there is a deduction/non-inclusion mismatch in respect of a payment that is deductible for Canadian income tax purposes. This may be relevant, for example, where a Canadian taxpayer makes a deductible payment to a controlled foreign affiliate that is not included in the affiliate's income that is subject to foreign income tax but is included in its FAPI attributable to the taxpayer or another taxpayer under subsection 91(1).

Payments between Canadian-resident taxpayers may give rise to a deduction/non-inclusion mismatch to the extent the Canadian income tax deduction exceeds Canadian ordinary income in respect of the payment. However, it is not expected that purely domestic mismatches would satisfy the causation test in paragraph 18.4(10)(d) (for hybrid financial instruments) or paragraph

18.4(12)(d) (for hybrid transfers) since those tests focus on differences in tax treatment between different countries.

Amounts are included in variable B only if they are foreign ordinary income of entities for foreign taxation years, or Canadian ordinary income of taxpayers for taxation years, that begin no more than 12 months after the end of the relevant year. Thus, variable B does not include any foreign ordinary income or Canadian ordinary income arising for a foreign taxation year or taxation year, respectively, that begins more than 12 months after the taxation year in which an amount was deductible in respect of the payment. However, paragraph 20(1)(yy) may provide relief in these circumstances. For more information, see the commentary on that paragraph.

Paragraph 18.4(6)(b) focuses on amounts deductible in respect of a payment in computing taxable income for foreign income tax purposes. If the payment arises under a hybrid mismatch arrangement and a taxpayer is a recipient of the payment, subsection 12.7(3) neutralizes a deduction/non-inclusion mismatch described under this paragraph by including an amount in the taxpayer's income.

A payment gives rise to a mismatch under paragraph 18.4(6)(b) if the amount determined for variable C (i.e., the foreign income tax deduction in respect of the payment) exceeds the amount determined for variable D (i.e., the taxable income in respect of the payment, for Canadian or foreign income tax purposes, to the extent it is not sheltered from tax by certain reliefs).

Variable C aggregates all amounts that – absent any "foreign expense restriction rule" (as defined in subsection 18.4(1)) – either would be deductible, or would reasonably be expected to be deductible, in respect of a payment in computing any entity's relevant foreign income or profits for a foreign taxation year (referred to as a "relevant foreign year"). For this purpose, "relevant foreign income or profits" is defined in subsection 18.4(1) and essentially refers to income in respect of which the entity is subject to an income or profits tax imposed by a foreign country.

An amount is included within variable C if it is taken into account as a deductible expense in calculating an entity's relevant foreign income or profits. For financial instruments, for example, this would include amounts deductible in respect of payments characterized as interest; issue discounts and redemption premiums; facilities and lending fees; and payments under derivative contracts.

Like paragraph 18.4(6)(a), paragraph (6)(b) identifies deduction/non-inclusion mismatches based on foreign tax outcomes that can reasonably be expected given the expected characterization and treatment of payments under the relevant foreign tax laws and in light of the terms or conditions of the arrangement, transaction or series of transactions at issue. Thus, an amount that may reasonably be expected to be deductible for foreign tax purposes is included under variable C.

Variable C tests whether there is a foreign income tax deduction available "in respect of" a payment and, in contrast to subsection 113(5), is not limited to foreign tax deductions by the payer of a payment (and entities with an equity interest in the payer or that include the payer's income in their income). For example, a deduction that is available to a transferor of a financial

instrument under a sale and repurchase transaction in respect of a return paid to the transferee by the issuer of the instrument would be within scope. For more information, see the commentary on paragraph 18.4(12)(c).

Consistent with the BEPS Action 2 Report, variable C is calculated without regard to any "foreign expense restriction rule", with the result that a restriction of a foreign income tax deduction under such a rule does not affect whether a payment gives rise to a mismatch and does not have any impact on the calculation of the mismatch amount under paragraph 18.4(7)(c). This ensures the hybrid mismatch rules apply with respect to "hybrid" arrangements that would generally be expected to result in mismatches in tax outcomes.

A foreign expense restriction rule is essentially a foreign tax rule that restricts the deductibility of expenses. This includes a rule that restricts deductions for interest or financing expenses based on a measure of excessive debt or excessive interest or financing expenses, relative to a given benchmark. For example, this includes thin capitalization rules that apply based on a ratio of debt to shareholder's equity or assets, and earnings-stripping rules that apply based on a ratio of interest to earnings. It also includes foreign tax rules that implement, or can reasonably be considered to be intended to implement, the Global Anti-Base Erosion Model Rules (Pillar Two), since the UTPR component of those rules may be implemented by way of a restriction of deductions for expenses. For further information, see the commentary on the definition "foreign expense restriction rule".

Variable D essentially measures the total taxable income inclusions, if any, in respect of the payment for the purposes of Canadian or foreign income tax. More specifically, it aggregates all amounts in respect of the payment that

- would be Canadian ordinary income of a taxpayer, determined without regard to the application of subsection 12.7(3) to avoid circularity (under subparagraph (i)); or
- can reasonably be expected to be, and actually are, foreign ordinary income of an entity (under subparagraph (ii)).

Variable D only includes Canadian ordinary income and foreign ordinary income for taxation years and foreign taxation years, respectively, that begin no more than 12 months after the end of the foreign taxation year in which the foreign income tax deduction arose.

In addition, under subparagraph (ii), foreign ordinary income of an entity is only included in variable D if the entity is a different entity from the entity that is entitled to a foreign tax deduction in respect of the payment. This may be particularly relevant in applying the hybrid transfer arrangement rule in subsection 18.4(12). For more information, see the commentary on paragraph (c) of that subsection.

Finally, as noted elsewhere in this commentary, one consequence of the broad "payment" definition in subsection 18.4(1) is that multiple payments may arise at different points in time in respect of the same payment obligation (e.g., when a contingent obligation to pay first arises and when the obligation to pay later crystallizes). Notwithstanding this breadth, it is expected that only one such payment would actually give rise to a deduction/non-inclusion mismatch. This is because, under paragraphs 18.4(6)(a) and (b), an amount must be deductible for Canadian or

foreign income tax purposes in respect of a payment in order for the payment to give rise to a mismatch. If, for example, a foreign tax deduction for a foreign taxation year is available in respect of an amount that is not actually paid and the amount is actually paid in a subsequent foreign taxation year, two payments exist (i.e., one payment arising at the time of the foreign tax deduction and another arising at the time of the actual payment), but the requirement in variable C would only be met in respect of the first payment.

Deduction/non-inclusion mismatch - application

ITA
18.4(7)

New subsection 18.4(7) is intended to essentially act as a "bridge" between subsection 18.4(6) and the provisions in subsections 18.4(11), (13) and (15), which, respectively, apply for hybrid financial instrument arrangements, hybrid transfer arrangements and substitute payment arrangements.

Subsections 18.4(6) and (7) can be understood as intermediate steps in determining whether the operative hybrid mismatch rules apply and, if so, the extent to which they do. Subsection 18.4(6) determines if a payment gives rise to a deduction/non-inclusion mismatch. Subsection 18.4(7) applies if a particular payment gives rise to a deduction/non-inclusion mismatch under subsection 18.4(6).

Paragraph 18.4(7)(a) is relevant if the deduction side of a deduction/non-inclusion mismatch arising from a payment is a Canadian income tax deduction. In that case, the amount determined for variable A under paragraph 18.4(6)(a) (i.e., the Canadian income tax deduction) is referred to as the "deduction component" of the mismatch.

The "deduction component" concept in paragraph 18.4(7)(a) is relevant for paragraphs 18.4(11)(b), (13)(b) and (15)(b), which, where applicable, result in a deduction component of a hybrid mismatch arrangement for the purpose of applying subsection 18.4(4). For example, if the payment arises under a hybrid financial instrument arrangement (as determined under subsection 18.4(10)), paragraph (11)(b) provides that the deduction component of the deduction/non-inclusion mismatch is the deduction component of the hybrid financial instrument arrangement. In that case, the condition in paragraph 18.4(3)(b) is met and subsection 18.4(4) restricts all or a portion of the deduction.

Paragraph 18.4(7)(b) is relevant if there is a foreign income tax deduction in respect of the payment. The foreign tax deduction element of a deduction/non-inclusion mismatch arising from the payment is the "foreign deduction component" of the mismatch. More specifically, the "foreign deduction component" of the deduction/non-inclusion mismatch is the amount determined for variable C under paragraph 18.4(6)(b) in respect of the payment.

The "foreign deduction component" in paragraph 18.4(7)(b) is relevant for paragraphs 18.4(11)(c), (13)(c) and (15)(c), which, where applicable, result in there being a foreign deduction component of a hybrid mismatch arrangement. This, in turn, results in the condition in

paragraph 12.7(2)(b) being met, such that an amount is included in income under subsection 12.7(3).

Paragraph 18.4(7)(c) determines the amount of the deduction/non-inclusion mismatch arising from a payment based on the formula A – B.

If there is a deduction component of the deduction/non-inclusion mismatch, which will be true in the case of a mismatch involving a Canadian income tax deduction, the amount of the deduction/non-inclusion mismatch is determined under subparagraph (i) of variables A and B. In general terms, the result is that the amount of the deduction/non-inclusion mismatch is the amount by which the total Canadian income tax deductions for a particular taxation year in respect of the payment exceed the total of the "foreign ordinary income" and "Canadian ordinary income" (as those terms are defined in subsection 18.4(1)) in respect of the payment for foreign taxation years and taxation years, respectively, that begin no more than 12 months after the particular year.

If there is a foreign deduction component of the deduction/non-inclusion mismatch, the amount of the mismatch is calculated under subparagraph (ii) of variables A and B. In general terms, the result is that the amount of the deduction/non-inclusion mismatch is the amount by which the total of the amounts deductible in respect of a payment in computing "relevant foreign income or profits" (as defined in subsection 18.4(1)) for a particular foreign taxation year exceed the total of the Canadian ordinary income and foreign ordinary income in respect of the payment for taxation years and foreign taxation years, respectively, that begin no more than 12 months after the particular year.

Because the formula in paragraph 18.4(7)(c), in effect, incorporates the variables from subsection 18.4(6), the rules and assumptions that apply in determining whether a deduction/non-inclusion mismatch arises under that subsection also apply in determining the amount of the mismatch. For example, where an interest deduction is restricted under subsection 18(4) or 18.2(2), or an income tax deduction is restricted under a "foreign expense restriction rule" (as defined in subsection 18.4(1)), the restriction is disregarded in measuring the amount of the deduction/non-inclusion mismatch.

In determining the amount of the deduction/non-inclusion mismatch, clause (i)(A) of variable B provides a *de minimis* rule that effectively disregards foreign ordinary income and Canadian ordinary income in respect of a payment if the total of those amounts represents 10 per cent or less of the Canadian income tax deductions in respect of the payment. Clause (ii)(A) of variable B has the same effect if the total of Canadian ordinary income and foreign ordinary income in respect of a payment represents 10 per cent or less of the foreign income tax deductions in respect of the payment.

Determining the amount of the deduction/non-inclusion mismatch arising from a payment is an intermediate step in determining the "hybrid mismatch amount" (as defined in subsection 18.4(1)) in respect of the payment, which is the amount of the adjustment under subsection 12.7(3) or 18.4(4). Once the amount of the deduction/non-inclusion mismatch is determined, the

hybrid mismatch amount is then determined under paragraph 18.4(11)(a), (13)(a) or (15)(a) (depending on the type of hybrid mismatch arrangement).

While the amount of the deduction/non-inclusion mismatch under paragraph 18.4(7)(c) provides the base for determining the hybrid mismatch amount, the hybrid mismatch amount can be less than the amount of the deduction/non-inclusion mismatch in certain cases. For more information, see the commentary on subsections 18.4(11), (13) and (15).

No double counting

ITA
18.4(8)

New subsection 18.4(8) is a rule against double counting, which applies where an amount has already been included in computing foreign ordinary income or Canadian ordinary income of an entity in respect of a payment. In that case, the amount cannot be included in computing foreign ordinary income or Canadian ordinary income of the same entity or any other entity in respect of the payment. Put differently, this rule clarifies that the same amount cannot be taken into consideration more than once in computing foreign ordinary income and Canadian ordinary income. The terms “foreign ordinary income” and “Canadian ordinary income” are defined in subsection 18.4(1).

This rule ensures, for example, that an amount included in foreign ordinary income or Canadian ordinary income of a particular entity is not also so included at the level of an investor, member or beneficiary of the particular entity.

This rule can apply, for example, where the same portion of a payment is included in the taxable income of more than one entity, or in a given entity’s taxable income under the income tax laws of more than one country. In these cases, the rule ensures that portion of the payment is only taken into consideration once in determining foreign ordinary income or Canadian ordinary income.

Notional interest expense – deemed payment

ITA
18.4(9)

New subsection 18.4(9) ensures that the rules for hybrid financial instrument arrangements, in subsections 18.4(10) and (11), apply where a foreign country allows an income tax deduction for a notional interest expense in respect of a debt and this results in a deduction/non-inclusion mismatch. A notional interest expense is one that does not have a corresponding legal obligation to pay interest. Thus, subsection 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.

Subsection 18.4(9) reflects a departure from the recommendations in the BEPS Action 2 Report. The BEPS Action 2 Report recommends that the hybrid financial instrument rule not apply where a country allows a deduction for deemed interest on a non-interest bearing debt, because there is no actual interest payment obligation under the financial instrument. From a policy perspective, however, it is arbitrary to distinguish between mismatches involving a deduction for a notional interest expense in respect of a debt, and those that involve a deduction for an actual interest expense in respect of a legal obligation to pay interest.

More specifically, subsection 18.4(9) applies if – on the assumption no "foreign expense restriction rules" (as defined in subsection 18.4(1)) applied – an amount would be deductible, or would reasonably be expected to be deductible, in respect of a notional interest expense on a debt in computing "relevant foreign income or profits" (as defined in subsection 18.4(1)). The reasons for disregarding the effect of any foreign expense restriction rules, and for testing whether an amount "can reasonably be expected to be" deductible for foreign income tax purposes, are the same as for the analogous test in subsection 18.4(6). For more information, see the commentary on that subsection.

Where these conditions are met, subsection 18.4(9) sets out several deeming rules. The deeming rules in paragraphs 18.4(9)(a) to (c) are principally relevant to the determination of whether there is a deduction/non-inclusion mismatch under subsection 18.4(6). They also deem a payment, which is a pre-requisite to the application of the operative rules in subsections 12.7(3) and 18.4(4). The overall effect is to deem a payment under the debt to the extent of the deductible amount. Paragraph (c) is intended to ensure that a mismatch is not considered to arise to the extent there is a corresponding inclusion in the creditor's taxable income in respect of notional interest income that is notionally accrued for the same period as the debtor's notional interest expense.

In addition, paragraph 18.4(9)(d) deems the payment to satisfy the causal condition in paragraph 18.4(10)(d), which may otherwise not be met in the case of such instruments because the mismatch results not from a difference in how two countries characterize or treat the instrument based on its terms or conditions, but rather, for example, from a difference in their respective transfer pricing rules.

Example

Assumptions

- *A taxable Canadian corporation ("Canco") makes a non-interest bearing loan to a controlled foreign affiliate ("CFA").*
- *CFA uses the borrowed money to earn income from an active business.*
- *CFA is 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 subsections 17(8) (from the deemed interest imputation rule in subsection 17(1)) and 247(7) (from the application of the transfer pricing rules).*

Analysis

The conditions in subsection 18.4(10) are met, such that the hybrid financial instrument rule in subsection 18.4(11) applies.

The deduction in respect of a notional interest expense in the debtor jurisdiction gives rise to a deduction/non-inclusion mismatch by operation of the deeming rules in subsection 18.4(9). Paragraph 18.4(9)(a) deems a payment equal to the deductible amount, and paragraph (b) deems the deductible amount to be in respect of the payment. Paragraph (c) does not apply in this case as Canco does not have an income inclusion in respect of the debt because of subsections 17(8) and 247(7). Thus, the deemed payment gives rise to a deduction/non-inclusion mismatch under paragraph 18.4(6)(b).

Paragraph 18.4(9)(d) deems the mismatch to meet the causal condition in paragraph 18.4(10)(d) (and the other conditions in subsection 18.4(10) are met), with the result that the deemed payment is considered to arise under a hybrid financial instrument arrangement and subsection 18.4(11) applies. Subsection 12.7(3) therefore applies to include an amount equal to the "hybrid mismatch amount" (in this case, equal to the deductible amount in respect of the notional interest expense on the debt) in respect of the deemed payment in computing Canco's income.

Hybrid financial instrument arrangement – conditions

ITA
18.4(10)

New subsection 18.4(10) sets out the conditions for determining if a payment arises under a hybrid financial instrument arrangement.

A hybrid financial instrument arrangement essentially is one where differences in the income tax treatment of payments under or in connection with a financial instrument under the tax laws of different countries give rise to a deduction/non-inclusion mismatch (as determined under subsection 18.4(6)).

Where all the conditions in subsection 18.4(10) are met, such that a payment is considered to arise under a hybrid financial instrument arrangement (and thus under a "hybrid mismatch arrangement", as defined in subsection 18.4(1)), the mismatch is neutralized under the operative hybrid mismatch rules. More specifically, if the payment is otherwise deductible for Canadian income tax purposes, subsection 18.4(4) restricts all or a portion of the deduction. If the payment is deductible for foreign income tax purposes (including, based on the definition of "deductible" in subsection 18.4(1), any relief that is broadly equivalent to a deduction), subsection 12.7(3) includes an amount in a recipient taxpayer's income.

A payment is considered to arise under a hybrid financial instrument arrangement if four conditions are met.

The first condition, in paragraph 18.4(10)(a), requires that the payment arise under or in connection with a financial instrument. For these purposes, a payment arises under or in connection with a financial instrument if the terms or conditions of the financial instrument create the obligation to pay, credit or confer the payment, or the payment is consideration for a release from an obligation under the instrument.

Subsection 18.4(1) defines "payment" broadly to include amounts or benefits that will become payable in the future, and amounts that are capable of being paid (e.g., contingent payment obligations). Given this breadth, the accrual of a future payment obligation under a financial instrument, for example, would satisfy paragraph (a). In addition, subsection 18.4(1) defines a "financial instrument" broadly as a debt, equity interest (or other right that effectively replicates rights under an equity interest) or any other arrangement that gives rise to a "financing or equity return" (also defined in subsection 18.4(1)). For more information, see the commentary on the definitions of "payment", "financial instrument" and "equity or financing return".

If a transaction or arrangement meets the "financial instrument" definition, paragraph 18.4(10)(a) can be satisfied even if the country of residence of a non-resident counterparty under the instrument does not consider there to be a financial instrument. For example, if there is a payment by a purchaser on an asset transfer that is considered, from a Canadian income tax perspective, to include an equity or financing return (e.g., a portion of the purchase price is treated as an interest expense), the payment satisfies the condition in paragraph (a), notwithstanding that the counterparty country subsumes the payment in the purchase price.

Paragraph 18.4(10)(a) is not met if a payment is described in paragraphs 18.4(14)(a) to (d) of the substitute payment arrangement rule, which pertain to certain payments in respect of transfers of financial instruments, where the payment represents an underlying return on the transferred instrument. This exception ensures that such payments are dealt with under the substitute payment arrangement rule in subsection 18.4(14) or the hybrid transfer arrangement rule in subsection 18.4(12), and not under subsection 18.4(10).

In general terms, paragraph 18.4(10)(b) requires that either the payer and the recipient of the payment satisfy a relationship test, or the payment arises under a structured arrangement.

The relationship test under subparagraph 18.4(10)(b)(i) is satisfied if the payer and the recipient either do not deal at arm's length with one another, or are "specified entities" in respect of one another. The relationship test is intended to be generally consistent with the recommendations in the BEPS Action 2 Report, but with certain adaptations to rely on existing concepts in the Act. In particular, this test uses the existing "non-arm's length" concept in Canadian income tax to approximate the relationships reflected in the recommendations under Chapter 11 of the BEPS Action 2 Report, which recommends that the hybrid financial instrument rule apply in respect of entities that are part of the same "control group" (defined by reference to effective control).

The "specified entities" concept is defined in subsection 18.4(1) and is met generally where either the payer or the recipient has a 25% equity interest in the other, or a third person has a 25% equity interest in both. This is consistent with the recommendation in the BEPS Action 2 Report to use a 25% equity threshold for the hybrid financial instrument arrangement rule. For

more information, see the commentary on the definition of “specified entity” in subsection 18.4(1).

The term “structured arrangement”, as referred to in subparagraph 18.4(10)(b)(ii), is defined in subsection 18.4(1) and essentially means an arrangement where the deduction/non-inclusion mismatch is priced into the terms or conditions of the arrangement, or that is otherwise designed to produce such a mismatch. For more information, see the commentary on that definition in subsection 18.4(1).

The third condition, in paragraph 18.4(10)(c), requires that the payment must give rise to a deduction/non-inclusion mismatch. For more information, see the commentary on subsection 18.4(6), which sets out the conditions for such a mismatch.

The final condition, in paragraph 18.4(10)(d), sets out a causal test to assess the “hybridity” of the mismatch. Under this test, a mismatch is considered hybrid if it arises because the terms of a financial instrument, or transactions that are related to the financial instrument, lead the instrument, or any of the related transactions, to be treated differently under the tax laws of different countries. The reference to “countries” excludes differences in tax treatment under the laws of sub-national governments (e.g., provincial or state tax laws).

The causal test involves a two-step analysis.

The first step asks if it can reasonably be considered that the deduction/non-inclusion mismatch arises, in whole or in part, because the tax laws of more than one country (including Canada) treat differently

- the financial instrument under which the payment arises; or
- one or more “transactions” (defined in subsection 18.4(1) to include an arrangement or event) that are part of a transaction or series of transactions that includes the payment or that relate to the financial instrument.

A transaction or series will be considered to “relate to” the financial instrument if it is legally, commercially or economically relevant to the financial instrument or the payment.

The causal test is met, for example, where a deduction/non-inclusion mismatch results from the fact that one country looks only at the terms and conditions of the financial instrument in characterizing it as a debt, while another country takes into consideration the terms or conditions of one or more transactions that relate to the financial instrument, or are part of the same series, in characterizing payments under the financial instrument as equity returns. The phrase “either alone or together” ensures that the causal test is met regardless of whether the difference in tax treatment is due to a difference in how two countries view a single transaction, or a difference in how they view a set of multiple transactions taken together.

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” of the financial instrument or other relevant transactions. This focuses on whether the terms of the instrument or relevant transactions are essential to the difference in tax treatment. In applying this step, regard should be had to both express and

implied terms of a financial instrument or a related transaction. An example of where this test could be met is where one country classifies an instrument as debt (and payments under the instrument as deductible interest) based on the instrument's terms, and another country classifies it as equity (and payments under the instrument as exempt dividends) based on the terms.

Consistent with the BEPS Action 2 Report, the causal test is not, however, limited to differences in classification of financial instruments. It can also be satisfied, for example, if the terms of a financial instrument are such that different principles for the computation of income or profit apply in respect of the same financial instrument under the tax laws of two different countries. This could occur, for example, if a financial instrument is viewed as a debt under the tax laws of both relevant countries but interest payments on the instrument are contingent, such that the laws of one country allow a payer to deduct the payments on an accrual basis but the laws of the other country allow a recipient to defer an income inclusion until actual payment. This difference in treatment is attributable to terms of the instrument, which provide for the contingent interest entitlement.

While the causal test is not satisfied in the case of a deduction/non-inclusion mismatch solely attributable to timing differences (e.g., where a payer's country of residence allows a deduction in respect of a payment on an accrual basis, but the recipient's residence country taxes on a cash basis in general, without regard to the terms of the particular instrument), it is met if a timing difference in the recognition of income and expenses between two countries results from the terms of an instrument. In this regard, the BEPS Action 2 Report includes examples where a timing difference is attributable to the terms of the financial instrument: example 1.21 (mismatch resulting from accrual of contingent interest liability) illustrates such a timing difference, and example 1.22 (no mismatch resulting from accrual of contingent liability) illustrates a timing difference that is not attributable to the terms.

Consistent with the BEPS Action 2 Report, subsection 18.4(6) in effect provides a 12-month safe harbor, ensuring that a deduction/non-inclusion mismatch is not considered to arise in the first instance because of short-term timing differences between countries in the recognition of payments under a financial instrument. If a payment gives rise to Canadian ordinary income or foreign ordinary income outside this 12-month period, however, it will be considered to give rise to a deduction/non-inclusion mismatch. It is then necessary to apply the causal test to determine if the timing difference is attributable to the terms of the financial instrument or relevant transactions. Thus, the hybrid mismatch rules do not adopt the recommendation at paragraphs 56 to 60 of the BEPS Action 2 Report to provide relief where the tax administration is satisfied that the payment is expected to be included in income within a reasonable period of time. Instead, paragraph 20(1)(yy) allows a deduction where subsection 18.4(4) has previously applied to deny a deduction and the taxpayer subsequently demonstrates that an amount has been included in foreign ordinary income.

The causal test will not be met if a deduction/non-inclusion mismatch is solely attributable to differences in valuation, including foreign exchange exposure that is attributable to a fluctuation in the value of a currency.

The treatment of a financial instrument or related transaction may depend in part on the relationship between the issuer and the holder of the instrument or the period over which it is

held (e.g., a participation exemption or comparable form of tax relief based on an equity interest threshold or minimum holding period). These surrounding factors do not limit the application of the causal test, which asks if it is reasonable to consider that the difference in tax treatment is attributable in whole or in part to the terms of the instrument or related transactions. As long as the terms of the instrument or related transactions play a role in the instrument being treated differently, the causal test is met. Thus, these surrounding circumstances are effectively treated as part of the terms of the instrument or related transaction.

Because the tax treatment of the financial instrument or related transactions must be linked to the terms, the causal test will not be met if a deduction/non-inclusion mismatch is solely attributable to the tax status of a recipient of payments under the instrument (e.g., a tax-exempt recipient). Such mismatches are attributable to how the law of the recipient's country of residence treats the recipient generally for tax purposes rather than the terms of the financial instrument or relevant transactions.

The same is true for mismatches solely attributable to the context in which an instrument is held. Such a mismatch could arise where the instrument is held through a tax-exempt permanent establishment (where a mismatch is attributable to a branch exemption), in a country with a purely territorial taxation regime (where a mismatch is attributable to the nature or residence of a payer of the payment, in that the country exempts a recipient of the payment from tax on foreign-source income) or in a tax-exempt savings account (where any mismatch is attributable to the fact that the relevant tax laws do not generally subject the account to tax).

Consistent with the recommendations in the BEPS Action 2 Report, however, as long as the terms of a financial instrument or related transactions are sufficient to cause a deduction/non-inclusion mismatch, the mismatch will meet the causal test. In other words, if the mismatch would have arisen from those terms, regardless of the status of the recipient of the payment or the context in which the instrument is held, then the causal test is satisfied. This principle is reflected in subparagraph 18.4(10)(d)(ii), which sets out a "multiple causation" rule that asks whether it is reasonable to consider that a deduction/non-inclusion mismatch would have arisen and been attributable to the terms of the instrument or related transactions if all other causes of the mismatch were disregarded. This test effectively adopts the "counterfactual test" recommended at paragraph 95 of the BEPS Action 2 Report.

Because the hybrid mismatch rules do not alter the tax status of the counterparties to a transaction, nor the context in which the instrument is held, the rules will not have a practical effect in all cases. For example, in the case of a payment to a tax-exempt recipient under a hybrid financial instrument arrangement, the approach to causation reflected in subparagraph 18.4(10)(d)(ii) can result in an income inclusion under subsection 12.7(3) that has no impact on the recipient's tax position if the recipient is a Canadian tax-exempt. If the payer under the instrument is a Canadian and the payee is a foreign tax-exempt entity, however, subsection 18.4(4) can apply to deny the payer a deduction in respect of the payment, despite the recipient being exempt from tax.

While the application of these rules will depend on the facts and circumstances of each case, the following example demonstrates the application of the conditions in 18.4(10) to an investment in a Canadian subsidiary by a foreign parent company.

Example

Assumptions

- *Forco, a corporation resident in Country X, is the parent corporation of Canco, a corporation resident in Canada. Forco is the sole shareholder of Newco, an entity that is disregarded as a separate entity from its owner and is thus fiscally-transparent under Country X income tax law, but is treated as a non-resident corporation under Canadian income tax law.*
- *Forco makes an interest-bearing loan (the "Loan") with a principal amount of $100 million to Canco, which Canco must repay on a fixed maturity date.*
- *Canco is obligated under the Loan to make periodic cash payments of interest to Forco on fixed payment dates (each, an "Interest Payment Date").*
- *The following transactions are entered into concurrently with the Loan*:
    - *Canco and Newco enter into a forward subscription agreement (the "Forward Agreement") requiring Newco to subscribe for Canco shares on each Interest Payment Date.*
    - *Forco and Newco enter into a capital support agreement (the "Support Agreement") requiring Forco to contribute capital to Newco on each Interest Payment Date to allow Newco to satisfy its obligations under the Forward Agreement.*
- *Under the tax laws of Country X, it can reasonably be expected that:*
    - *The Forward Agreement is treated as being between Canco and Forco.*
    - *Because the obligations under the Loan and the Forward Agreement effectively offset one another from an economic perspective, these agreements are treated as though they were a single instrument in the nature of an integrated equity investment.*
    - *As a result, the interest payments on the Loan are treated as stock dividends, which are not included in computing Forco's income on which it is subject to tax in Country X.*
- *Canco takes the position in its income tax return that, under Canadian income tax law, the Loan is treated as a debt and the periodic interest payments are deductible under paragraph 20(1)(c).*
- *On December 31, 2022:*
    - *Forco contributes $5 million in cash to the capital of Newco in satisfaction of its obligation under the Support Agreement.*
    - *Newco uses the $5 million contributed by Forco to subscribe for shares of the capital stock of Canco in satisfaction of its obligation under the Forward Agreement.*
    - *Canco pays $5 million in cash (the "Payment") as interest under the Loan to Forco.*

Analysis

The condition in paragraph 18.4(10)(a) is met because the Loan is a financial instrument and the Payment arises under the Loan since its terms provide for the periodic payments.

The condition in paragraph 18.10(b) is met because Canco, the payer, does not deal at arm's length with Forco, the recipient.

There are provisions in the Act (e.g., section 247) that apply in priority to the hybrid mismatch rules and which could deny Canco's deduction in respect of the Payment. The remainder of this analysis is based on the interpretation of Canadian income tax law reflected in Canco's filing position.

Based on Canco's filing position, the condition in paragraph 18.4(10)(c) is met because the Payment gives rise to a deduction/non-inclusion mismatch under paragraph 18.4(6)(a). Specifically, the $5 million that is deductible in respect of the Payment in computing Canco's income exceeds Forco's foreign ordinary income in respect of the Payment, which is nil since no amount in respect of the Payment is included in computing Forco's income that is subject to tax in Country X. The amount of the deduction/non-inclusion mismatch, as determined under paragraph 18.4(7)(c), is $5 million.

Any amount included, in respect of Canco's income, in the income of Forco or any other entity under a specified minimum tax regime in Country X does not result in foreign ordinary income in respect of the Payment. An income inclusion under such a regime would not be in respect of the Payment (since Canco is the payer, and not a recipient, of the Payment) and, in any event, is expressly excluded under variable A of the definition of "foreign ordinary income".

Based on Canco's filing position, the deduction/non-inclusion mismatch arising from the Payment meets the test in paragraph 18.4(10)(d). Canco's filing position is predicated on the Forward Agreement – which is part of a series of transactions that includes the Payment – and the Loan being treated differently under the tax laws of Canada and Country X. In particular, it assumes that Canada treats the Loan as a debt that is separate from the Forward Agreement and Country X treats these instruments as one integrated equity investment. All of the mismatch results from this difference, because the effect of Canadian tax law treating the Loan as a debt is that the Payment is characterized as deductible interest, while the effect of Country X tax law treating the Loan together with the Forward Agreement as an equity instrument is that Forco is treated as receiving a stock dividend that is not included in its income that is subject to tax in Country X.

This difference in tax treatment is attributable to the terms and conditions of the Loan and Forward Agreement. Canco's filing position assumes that the Loan is treated as a debt under Canadian tax law because the rights and obligations under the Loan are viewed in accordance with their legal substance and without regard to the terms of the Forward Agreement or any other transactions in the series. By contrast, the terms of the Loan, the Forward Agreement and other transactions in the series play an essential role in Country X characterizing the Loan,

together with the Forward Agreement, as an integrated equity investment according to their economic substance.

Accordingly, the Payment arises under a hybrid financial instrument arrangement, and subsection 18.4(4) denies Canco a deduction in respect of the Payment since the hybrid mismatch amount in respect of the Payment, as determined under paragraph 18.4(11)(a), is $5 million. In addition, subsection 214(18) deems the Payment to be a dividend the purposes of Part XIII of the Act (withholding tax).

Hybrid financial instrument arrangement – amount

ITA
18.4(11)

New subsection 18.4(11) is relevant in determining the extent to which the operative hybrid mismatch rules restrict a deduction, or include an amount in income, in respect of a payment arising under a hybrid financial instrument arrangement. It also provides rules that act as a "bridge" between subsection 18.4(10) and the operative hybrid mismatch rules.

Paragraph 18.4(11)(a) determines the amount included in income under subsection 12.7(3), or the amount by which a deduction is restricted under subsection 18.4(4), in the case of a payment arising under a hybrid financial instrument arrangement. It ensures these results apply only to the extent the deduction/non-inclusion mismatch arising from the payment is "hybrid" in nature.

The starting point is to determine the amount of the deduction/non-inclusion mismatch that arises from the payment. Under paragraph 18.4(7)(c), this mismatch is essentially the amount by which the amounts deductible in respect of the payment for Canadian or foreign income tax purposes exceed "Canadian ordinary income" and "foreign ordinary income" in respect of the payment (as defined in subsection 18.4(1)). For more information, see the commentary on subsection 18.4(7).

It is then necessary to determine the portion of the deduction/non-inclusion mismatch amount that can reasonably be considered to arise because of a difference in tax treatment described in paragraph 18.4(10)(d), or that would arise because of such a difference if all other reasons for the mismatch were disregarded. This portion is referred to as the "amount of the hybrid financial instrument mismatch" and, as a "hybrid mismatch amount" (as defined in subsection 18.4(1)), is the amount of the income inclusion under subsection 12.7(3), or the deduction restriction under 18.4(4), as the case may be. If all of the deduction/non-inclusion mismatch is attributable to the cause described in paragraph 18.4(10)(d), the entire amount of the mismatch is the amount of the hybrid financial instrument mismatch.

Paragraph 18.4(11)(b) links subsection 18.4(10) with the operative rule in subsection 18.4(4), ensuring that the operative rule will apply to restrict the amount deductible under Part I of the Act in respect of a payment arising under a hybrid financial instrument arrangement. This is achieved by labelling the amount that would otherwise be deductible under Part I in respect of the payment – which amount is referred to in paragraph 18.4(7)(a) as the "deduction component" of the deduction/non-inclusion mismatch – as the "deduction component of the hybrid financial instrument arrangement". This allows the conditions for the application of subsection 18.4(4) to

be satisfied, since that provision applies in respect of the deduction component of a “hybrid mismatch arrangement” (which is defined in subsection 18.4(1) to include a hybrid financial instrument arrangement).

Paragraph 18.4(11)(c) similarly links subsection 18.4(10) with the operative rule in subsection 12.7(3), by labelling any foreign income tax deduction in respect of a payment arising under a hybrid financial instrument arrangement as the “foreign deduction component” of the arrangement. This allows the condition in paragraph 12.7(2)(b) to be satisfied, resulting in an income inclusion under subsection 12.7(3) to the extent of the amount of the hybrid financial instrument mismatch.

Hybrid transfer arrangement - conditions

ITA
18.4(12)

New subsection 18.4(12) sets out the conditions for determining if a payment arises under a hybrid transfer arrangement.

A hybrid transfer arrangement is essentially a transaction or series of transactions involving a transfer of a financial instrument, where a deduction/non-inclusion mismatch (as determined under subsection 18.4(6)) typically results from different entities being treated as the owner of returns on the transferred instrument under the tax laws of different countries.

While hybrid transfer arrangements involve financial instruments, they differ from hybrid financial instrument arrangements in that the deduction/non-inclusion mismatches resulting from hybrid transfer arrangements typically are not caused by differences in the characterization or treatment of financial instruments, which may be characterized and treated the same way under the tax laws of all relevant countries. Rather, the mismatch typically results from a difference, under the tax laws of two or more countries, in the treatment of the transfer of the financial instrument or the series of transactions that includes the transfer, or of certain payments connected with the transfer or series.

The BEPS Action 2 Report treats hybrid transfers as a category of hybrid financial instrument on the basis that hybrid transfers can be viewed, in substance, as financial instruments rather than asset transfers. A sale and repurchase (or “REPO”) transaction, for example, can be viewed as a loan in substance. The approach under the hybrid mismatch rules in section 18.4 differs in form from the BEPS Action 2 Report in that, rather than subsume hybrid transfers into hybrid financial instruments, subsections 18.4(12) and (13) provide separate rules for hybrid transfer arrangements, including distinct causal (or “hybridity”) tests.

Although subsection 18.4(12) applies to other types of transfer arrangements resulting in deduction/non-inclusion mismatches, it is particularly targeted at REPOs and securities lending transactions, where the transfer generally does not materially alter the transferor’s economic exposure with respect to the transferred instrument.

A payment is considered to arise under a hybrid transfer arrangement if four conditions are met.

The first condition, in paragraph 18.4(12)(a), requires that the payment arise under, or in connection with, either a transaction or series of transactions (referred to as a "transfer arrangement") that includes the transfer of a financial instrument, or the transferred instrument itself. The transfer can take any form, including a loan of a financial instrument.

A payment that compensates a transferor (or an entity that does not deal at arm's length with a transferor) for a return (e.g., a dividend) under a transferred instrument is considered to arise under or in connection with a transfer arrangement. The application of subsection 260(2) to a "securities lending arrangement" (within the meaning of subsection 260(1)) would not affect this result. While that subsection deems certain securities to not to be disposed of by the transferor, these financial instruments are nevertheless considered to be loaned or transferred under such arrangements, such that the compensation payment arises under or in connection with a transfer arrangement.

Consideration paid to acquire a transferred instrument is also considered to arise under or in connection with a transfer arrangement. Further, since "transfer arrangement" is broadly defined to encompass a series of transactions that includes a transfer of a financial instrument, consideration paid for the repurchase of a transferred instrument under a REPO, for example, also constitutes a payment under or in connection with a transfer arrangement.

For information on when a payment is considered to arise under or in connection with a transferred instrument, see the commentary on the definition of "payment" in subsection 18.4(1) and on subsection 18.4(10).

The second condition, in paragraph 18.4(12)(b), requires either that a relationship test be met or that there is a structured arrangement.

The relationship test is satisfied if either the payer and the recipient, or the transferor and transferee: (i) do not deal at arm's length with one another, or (ii) are "specified entities" in respect of one another. For further information, see the commentary on the definition of "specified entity" in subsection 18.4(1) and on paragraph 18.4(10)(b).

The relevant relationships are tested throughout the period beginning with the first transaction or event in the series of transactions that includes the transfer of the transferred instrument, and ending with the last such transaction or event. Depending on the facts and circumstances, the relevant period may begin, for example, at the time of the structuring of the transfer arrangement and may end at the time the payment arises or beyond.

The term "structured arrangement" is defined in subsection 18.4(1) and essentially means an arrangement where the deduction/non-inclusion mismatch is priced into the terms or conditions of the arrangement, or that is otherwise designed to produce such a mismatch. For more information, see the commentary on that definition in subsection 18.4(1).

Consistent with example 1.33 in the BEPS Action 2 Report, a hybrid transfer arrangement is unlikely to be a structured arrangement if the parties are left in the same after-tax position as if

the transaction had not been entered into. In the context of a securities lending transaction, this may occur, for example, if the payer of a compensation payment in respect of an underlying return is taxable on the underlying return. As discussed below, however, the fact of the payer being taxable on the underlying return is not a relevant consideration in determining whether the hybrid transfer arrangement rule applies in the case of an arrangement between parties that satisfy a relationship test in subparagraph 18.4(12)(b)(i); in particular, that fact is not relevant in determining whether the arrangement gives rise to a deduction/non-inclusion mismatch.

The third condition, in paragraph 18.4(12)(c), requires that the payment give rise to a deduction/non-inclusion mismatch. This condition can be met even if the entity entitled to a deduction in respect of the payment is not the payer, since subsection 18.4(6) tests whether an amount would be deductible in respect of the payment, without regard to the identity of the deducting entity. This differs from subsection 113(5), which restricts a taxpayer's deduction in respect of a dividend received from a foreign affiliate only if it results in a foreign tax deduction in computing the affiliate's income or profits (or a foreign deduction to another entity because of a direct or indirect equity interest in the affiliate). This distinction is relevant, for example, in the case of a REPO, under which an amount in respect of a dividend payment on a transferred financial instrument may be deductible (as a financing expense) by the transferor rather than the issuer, with the result that the REPO may meet the condition in paragraph 18.4(12)(c) but not the requirements of subsection 113(5).

In determining whether a payment gives rise to a mismatch, not all amounts included, in respect of the payment, in income that is subject to foreign tax are taken into consideration. For example, in the context of a REPO, any amounts included in the foreign taxable income of a foreign transferor of a financial instrument, in respect of dividends received by the transferee on the instrument, are not relevant to the determination of the mismatch, since the transferor is not a recipient of the dividends and thus does not have "foreign ordinary income" (as defined in subsection 18.4(1)) in respect of the dividend payments. Moreover, the transferor under a REPO would generally be the entity entitled to a deduction in respect of the dividends, and under subparagraph (ii) of variable D of paragraph 18.4(6)(b), the entity entitled to a foreign income tax deduction in respect of the payment cannot have foreign ordinary income in respect of the payment.

Similarly, the determination of whether a mismatch arises from a payment by a transferee that compensates a transferor for an underlying return on a transferred instrument would not take into consideration any inclusion in the transferee's Canadian ordinary income or foreign ordinary income in respect of the underlying return. Such an inclusion is not in respect of the payment but rather in respect of the underlying return. This approach to the mismatch determination is consistent with the principle in the BEPS Action 2 Report that whether a payment gives rise to an inclusion in ordinary income should be determined without regard to whether the parties are taxable on the return on a transferred financial instrument, or whether funds obtained from the transfer have been invested in assets that generate a taxable return.

The fourth condition, in paragraph 18.4(12)(d), sets out three causal tests, each of which in effect assesses whether the deduction/non-inclusion mismatch results from the "hybridity" of the arrangement. It is met if any of the three causal tests is satisfied. To satisfy a particular causal

test, it need only be “reasonable to consider” that all or part of the mismatch arises for a reason described in the particular test. It is intended that this determination be made based on how instruments and arrangements with terms and conditions similar to those of the transferred instrument and the transfer arrangement, respectively, and payments under such instruments and arrangements, would reasonably be expected to be treated under the relevant tax laws. This approach is similar to the determination, under subsection 18.4(6), of whether an amount in respect of a payment can reasonably be expected to be deductible for foreign income tax purposes or included in an entity’s foreign ordinary income.

The parenthetical in the opening words of paragraph 18.4(12)(d) provides a “multiple causation” rule, the effect of which is that any causal test in the paragraph is met if it can reasonably be considered that all or part of the mismatch would satisfy the causal test if all other reasons for the mismatch were disregarded. For more information, see the commentary on paragraph 18.4(10)(d), which contains a similar rule.

The first causal test, in subparagraph 18.4(12)(d)(i), is aimed particularly at compensation payments under securities lending transactions. Generally under these arrangements, a transferee acquires a transferred financial instrument, and agrees to return it (or an identical property) at a later date and to compensate the transferor for underlying returns under the transferred instrument that arise over the course of the arrangement. These arrangements include, but are not limited to, “securities lending arrangements” within the meaning of subsection 260(1).

Subparagraph 18.4(12)(d)(i) is satisfied, in relation to a securities lending transaction, if a payment compensates for an underlying return under the transferred instrument and one country treats the compensation payment as a deductible expense but another country treats it as if it were the underlying return, with the result that a recipient of the compensation payment is effectively not taxable on the payment in the other country. A typical example is where a transferee makes a deductible compensation payment to a transferor for dividends received by the transferee on transferred shares, and the country where the transferor is resident exempts the compensation payment from tax as though it were a dividend.

To satisfy this causal test, it is sufficient that the tax laws of the other country treat the compensation payment as though it has the same character as, or represents, the underlying return; it is not necessary that the tax laws actually recharacterize the compensation payment or the transfer arrangement.

The second causal test, in clause 18.4(12)(d)(ii)(A), is met if the deduction/non-inclusion mismatch results because one country’s tax laws treat one or more transactions in the transfer arrangement, either alone or together, as a borrowing or other indebtedness – or treat all or a portion of the payment as arising under or in connection with a borrowing or other indebtedness – and another country’s tax laws do not treat those transactions or the payment, as the case may be, in that way. This test is aimed particularly at REPOs. Generally under these arrangements, a transferor sells a financial instrument to a transferee but concurrently agrees to repurchase it for a repurchase price that exceeds the original purchase price. Where the transferee is not required to compensate the transferor for returns (e.g., dividends) received by the transferee on the

instrument, the repurchase price may be reduced by the amount of the returns retained by the transferee.

In the case of a REPO, the tax laws of the country in which the transferor is resident may treat the arrangement as a borrowing secured by the transferred instrument, in accordance with its "economic substance". Thus, under those tax laws, the transferor may be considered to beneficially own, for example, dividends received by the transferee on the transferred instrument and may be entitled to a financial expense deduction corresponding to the dividends. In contrast, the tax laws of the country where the transferee is resident may treat the transfer arrangement as an asset transfer, in accordance with its legal form, and the transferee as the beneficial owner of the transferred instrument and the dividends on that instrument. If the dividends received by the transferee are exempt from tax (or eligible for other tax relief), the arrangement may give rise to a deduction/non-inclusion mismatch that meets the second causal test, in clause 18.4(12)(d)(ii)(A).

The second causal test is not limited to payments under the transferred instrument. Payments that do not represent returns on the instrument, but are payments under the transfer arrangement itself, also stand to be tested to the extent they give rise to a deduction/non-inclusion mismatch. For example, in the case of a REPO, this could occur if the tax laws of one country allow the transferor a deduction to the extent the repurchase price exceeds the original purchase price, on the basis that the transfer arrangement is in substance a borrowing, and the tax laws of another country do not view the transfer arrangement in this way and thus treat the transferee as having a capital gain on the sale of shares that is not fully taxable.

The final causal test, in clause 18.4(12)(d)(ii)(B), tests whether the deduction/non-inclusion mismatch arises because the tax laws of different countries take differing views as to who "derives" (i.e., beneficially owns) a payment arising under or in connection with the transfer arrangement or transferred instrument. This test is only met if the reason the countries treat different entities as deriving a given payment is due to a difference in how they treat one or more transactions included in the transfer arrangement. This ensures mismatches that are solely attributable to differences in how countries classify entities (i.e., "hybrid entities") are not addressed under the hybrid transfer arrangement rule.

The causal test in clause 18.4(12)(d)(ii)(B) is closely modelled on the causal test for hybrid transfers recommended in the BEPS Action 2 Report. It is a "residual" test that addresses arrangements that may not meet the requirements of the other two causal tests, which contain conditions that do not correspond to the causal test recommended in the BEPS Action 2 Report and are tailored to reflect the specific features of certain securities lending transactions and REPOs. Many arrangements that satisfy the first or second causal test would also be expected to satisfy this residual test.

Example

Assumptions

- *Forco 1 is the sole shareholder of Forco 2. Forco 1 and Forco 2 are corporations that are resident for income tax purposes in Country X, a country with which Canada has a tax treaty, and controlled foreign affiliates of a corporation resident in Canada (Canco).*
- *Forco 1 and Canco enter into a series of transactions under which:*
    - *Forco 1 sells shares of Forco 2 to Canco for $100 million;*
    - *Forco 1 agrees to repurchase the shares of Forco 2 for $110 million one year after selling them to Canco (the Repurchase Date);*
    - *Canco will retain dividends paid on the shares of Forco 2 during the period when Canco holds the shares and is not obligated to compensate Forco 1 for these dividends; and*
    - *The repurchase price is reduced by the amount of any such dividends.*
- *Prior to the Repurchase Date, Forco 2 pays a $10 million dividend to Canco on the transferred shares.*
- *On the Repurchase Date, Forco 1 repurchases the transferred shares for $100 million (i.e., the repurchase price of $110 million minus the $10 million dividend received by Canco).*
- *Under the income tax laws of Country X:*
    - *The series of transactions is treated as a loan from Canco to Forco 1 that is secured by the transferred shares of Forco 2;*
    - *Forco 1 is considered to retain beneficial ownership of the transferred shares and the dividend;*
    - *Forco 1 is treated as having a $10 million deductible interest expense in respect of the dividend paid by Forco 2 to Canco.*
- *Although there are certain provisions and doctrines in Canadian income tax law that may result in Canco's tax treatment being otherwise, Canco takes the position in its income tax return that, under Canadian income tax law:*
    - *$10 million is included in Canco's income under subsection 90(1), in respect of the dividend; and*
    - *all $10 million of the dividend is prescribed to have been paid out of Forco 2's exempt surplus in respect of Canco, such that Canco may deduct $10 million under paragraph 113(1)(a) in computing its taxable income.*

Analysis

All the conditions in subsection 18.4(12) are met, with the result that the dividend paid by Forco 2 to Canada is considered to arise under a hybrid transfer arrangement.

The condition in paragraph 18.4(12)(a) is met. There is a "transfer arrangement", being the series of transactions that includes the transfer of the shares of Forco 2 (which is a financial instrument) by Forco 1 to Canco. The dividend is a payment arising under the transferred instrument.

The condition in subparagraph 18.4(12)(b) is met because Forco1, the transferor, does not deal at arm's length with Canco, the transferee. (This condition is also met because Forco2, the dividend payer, does not deal at arm's length with Canco, the dividend recipient.)

The condition in paragraph 18.4(12)(c) is met because the dividend gives rise to a deduction/non-inclusion mismatch, as determined under subsection 18.4(6). Specifically, Forco 1 is entitled to a $10 million interest deduction in Country X because of the dividend, and Canco has no "Canadian ordinary income" (as defined in subsection 18.4(1)) in respect of the dividend because it files its tax return on the basis it is entitled to a deduction under paragraph 113(1)(a). Any amounts included in respect of the dividend in computing Forco 1's income that is subject to tax in Country X would not constitute "foreign ordinary income" because: (1) Forco 1 is not a recipient of the dividends; and (2) subparagraph (ii) of variable D of paragraph 18.4(6)(b) requires that the entity with foreign ordinary income must be different from the one that is entitled to a foreign income tax deduction in respect of the payment.

As determined under paragraph 18.4(7)(c), the amount of the deduction/non-inclusion mismatch is $10 million, being the amount by which Forco 1's $10 million deduction in Country X exceeds nil, which is the total Canadian ordinary income and foreign ordinary income in respect of the dividend.

The causal test in clause 18.4(12)(d)(ii)(A) is met because Country X tax law treats certain transactions, which are included in the series that is the transfer arrangement, together as a borrowing or other financing, while Canco files on the basis that Canadian tax law does not treat them as such. Alternately, the causal test is met because, by treating the dividend as giving rise to an interest expense, Country X law treats the dividend as though it arises under a borrowing or other indebtedness, while Canco files on the basis that Canadian tax law does not.

Accordingly, the dividend arises under a hybrid transfer arrangement, and thus under a hybrid mismatch arrangement for the purposes of sections 12.7 and 18.4. The $10 million income tax deduction in Country X is a "foreign deduction component" of the hybrid mismatch arrangement. Thus, the conditions in subsection 12.7(2) for the application of subsection 12.7(3) in respect of the dividend are met. Notably, subsection 113(5) does not apply to deny Canco's deduction under paragraph 113(1)(a), since Forco 1's deduction under Country X income tax law does not arise because Forco 1 has an equity interest in Forco 2, but rather because Country X treats Forco 1 as the beneficial owner of the dividends paid by Forco 2.

Consequently, subsection 12.7(3) includes $10 million in Canco's income. This amount is the hybrid mismatch amount in respect of the dividend, as determined under paragraph 18.4(13)(a), since the entire $10 million deduction/non-inclusion mismatch arises because Country X law treats the transfer arrangement as a borrowing or other indebtedness.

Hybrid transfer mismatch – amount

ITA
18.4(13)

New subsection 18.4(13) is relevant in determining the extent to which the operative hybrid mismatch rules restrict a deduction, or include an amount in income, in respect of a payment arising under a hybrid transfer arrangement. It also provides rules that act as a "bridge" between subsection 18.4(12) and the operative hybrid mismatch rules.

Subsection 18.4(13) performs an analogous function in the context of the rules on hybrid transfer arrangements to that performed by subsection 18.4(11) in the context of the rules on hybrid financial instrument arrangements, with paragraphs (a) to (c) of subsection 18.4(13) being analogous to the corresponding paragraphs in subsection 18.4(11). Accordingly, the commentary on subsection 18.4(11) applies equally with respect to subsection 18.4(13), with such modifications as the context requires (in particular, substituting references to the causal test in paragraph 18.4(12)(d) for references in that commentary to the causal test in paragraph 18.4(10)(d)).

Substitute payment arrangement – conditions

ITA
18.4(14)

New subsection 18.4(14) sets out the conditions to determine if a payment arises under a substitute payment arrangement.

The rules on substitute payment arrangements, in subsections 18.4(14) and (15), address certain arrangements that, absent those subsections, would undermine the integrity of the rules on hybrid financial instrument arrangements and hybrid transfer arrangements, or foreign hybrid mismatch rules. The deduction/non-inclusion mismatch arising from a payment under a substitute payment arrangement, however, need not necessarily be "hybrid" in nature (i.e., the mismatch need not be attributable to a difference in how two countries treat the arrangement based on the terms and conditions of the arrangement or a financial instrument). In general terms, these arrangements involve a transfer of a financial instrument, where a payment made under, or in connection with, the transfer functions as a substitute for certain returns under the financial instrument.

Where a payment is considered to arise under a substitute payment arrangement (and thus under a "hybrid mismatch arrangement", as defined in subsection 18.4(1)), the mismatch otherwise resulting from the payment is neutralized under the operative hybrid mismatch rules. More specifically, if the payment is otherwise deductible for Canadian income tax purposes, subsection 18.4(4) restricts all or a portion of the deduction. If the payment is deductible for foreign income tax purposes, subsection 12.7(3) includes an amount in a recipient taxpayer's income.

A payment is considered to arise under a substitute payment arrangement if all the conditions in subsection 18.4(14) are met.

The first condition, in paragraph 18.4(14)(a), requires that the payment arise under or in connection with an arrangement under which a financial instrument is disposed of, loaned or otherwise transferred. The scope is sufficiently broad to include, for example, consideration paid or payable for the acquisition of the instrument, or a payment made by the transferee to the transferor as compensation for an underlying return under the transferred instrument. The terms "payment" and "financial instrument" are defined in subsection 18.4(1).

The second and third conditions, in paragraphs 18.4(14)(b) and (c), require that the transferee (or an entity non-arm's length with the transferee) and transferor (or an entity non-arm's length with the transferor) of the instrument be the payer and recipient of the payment, respectively. These

conditions ensure that subsection 18.4(14) focusses on payments that are relatively closely connected with the transfer of the instrument.

The fourth condition, in paragraph 18.4(14)(d), essentially tests whether the payment is a substitute payment. It requires that all or a portion of the payment can reasonably be considered to represent or otherwise reflect, or be determined by reference to:

- a payment (referred to as an "underlying return") that arises under, or in connection with, the transferred instrument; or
- revenue, profit, cash flow, commodity price or a similar criterion.

This condition is generally met if either: (1) it is, as a matter of fact, reasonable to consider that this is the case; or (2) the tax laws of the country of the transferee or the transferor treat the payment in this manner.

A payment arises "under, or in connection with," the transferred instrument if the terms or conditions of the instrument create the obligation to pay, credit or confer the payment (e.g., a dividend on a share or an interest coupon on a debt), or if the payment is consideration for a release from an obligation under the instrument.

Subparagraph 18.4(14)(d)(ii) describes amounts that are economically equivalent to, or proxies for, an equity return in that they are determined by reference to revenue, profit, cash flow, commodity price or any other similar criterion. This would be relevant, for example, if a transferor disposes of shares of a corporation to a transferee, and the transferee has a contingent obligation to pay an additional amount of consideration based on the corporation's earnings. If the purchase price is adjusted accordingly, the additional consideration is described in subparagraph 18.4(14)(d)(ii), as it represents or otherwise reflects, or is determined by reference to, profit.

The fifth condition, in paragraph 18.4(14)(e), requires that either a relationship test be met or there is a structured arrangement.

The relationship test under subparagraph 18.4(14)(e)(i) is satisfied if the payer and the recipient of the substitute payment – or the transferor and transferee of the transferred instrument – either do not deal at arm's length with one another, or are "specified entities" in respect of one another. For further information, see the commentary on paragraph 18.4(10)(b) and the "specified entity" definition.

The term "structured arrangement", as referred to in subparagraph 18.4(14)(e)(ii), is defined in subsection 18.4(1) and essentially means an arrangement where the deduction/non-inclusion mismatch is priced into the terms or conditions of the arrangement, or that is otherwise designed to produce such a mismatch. For more information, see the commentary on that definition in subsection 18.4(1).

The sixth condition, in paragraph 18.4(14)(f), focusses on whether the substitute payment gives rise to a deduction/non-inclusion mismatch.

In determining if this condition is met, subparagraph 18.4(14)(f)(i) asks if the substitute payment would give rise to a deduction/non-inclusion mismatch if any Canadian ordinary income and any foreign ordinary income, in respect of the substitute payment, were limited to the portion of those amounts that can reasonably be considered to relate to the portion of the substitute payment that represents, or otherwise reflects, or is determined by reference to, an underlying return or a criterion in subparagraph 18.4(14)(d)(ii). This limitation ensures that the deduction/non-inclusion mismatch is determined only by reference to the portion of a payment that is a substitute payment.

For example, assume $10 of a $100 payment from a Canadian transferee to a non-resident transferor represents an underlying return, and the transferor has $50 of foreign ordinary income in respect of the payment. In this case, only $5 of the transferor's foreign ordinary income can reasonably be considered to relate to the portion of the payment that constitutes the substitute payment. As a result, the mismatch is measured on the basis the transferor has $5 of foreign ordinary income in respect of the payment.

The condition in paragraph 18.4(14)(f) can be met in certain circumstances where a substitute payment does not in fact give rise to a deduction/non-inclusion mismatch, but an amount is deductible to the transferee in respect of the underlying return on the transferred instrument. In this regard, subparagraph 18.4(14)(f)(ii) sets out a hypothetical test, asking if the condition in subparagraph 18.4(14)(f)(i) would be met if an amount that is deductible in respect of the underlying return were instead deductible in respect of the substitute payment. These deductible amounts are, however, relevant only if they are deductible by the transferee because the underlying return accrues (or is considered to accrue) before the transfer of the financial instrument. This would be the case, for example, where a debt instrument bearing accrued interest is transferred, and the transferee is entitled to a deduction when the accrued interest is paid or payable to the transferee.

The final condition, in paragraph 18.4(14)(g), broadly describes the three scenarios in which a deduction/non-inclusion mismatch arising from a substitute payment would, in the absence of the rules on substitute payment arrangements, undermine the integrity of the hybrid mismatch rules or a foreign hybrid mismatch rule.

The first such scenario is covered by subparagraphs 18.4(14)(g)(i) and (ii), which, in general terms, target cases where a substitute payment is deductible by the transferee but the underlying return is not fully included in its Canadian ordinary income or foreign ordinary income (or would not be so included, were the transferee a recipient of the underlying return). This contrasts with the approach under the rule on hybrid transfer arrangements in subsection 18.4(12), which applies regardless of whether an underlying return is taxable.

More specifically, subparagraph 18.4(14)(g)(i) is relevant if the transferee (or an entity non-arm's length with the transferee) is a recipient of the underlying return or, if the substitute payment is determined by reference to any of the criteria in subparagraph 18.4(14)(d)(ii), a distribution under the transferred instrument. The condition in subparagraph 18.4(14)(g)(i) is met if the amount of the underlying return or the distribution, as the case may be, exceeds the total of the Canadian ordinary income and foreign ordinary income of the recipient that would

reasonably be expected to arise – and actually does arise – from the underlying return or the distribution, respectively. For more information on the "reasonably be expected" test, see the commentary on subsection 18.4(6), which uses a similar concept.

If the condition in subparagraph 18.4(14)(g)(i) is not met (e.g., because neither the transferee, nor an entity non-arm's length with the transferee, is a recipient of the underlying return or distribution under the transferred instrument), subparagraph 18.4(14)(g)(ii) becomes relevant. It is met if the condition in subparagraph 18.4(14)(g)(i) would have been met had the transferee been a recipient of the underlying return or a distribution under the transferred instrument, as the case may be.

While the tests in subparagraphs 18.4(14)(g)(i) and (ii) focus on the transferee, those in subparagraph 18.4(14)(g)(iii) focus on the transferor. They essentially cover the two additional scenarios where substitute payment arrangements raise integrity concerns with respect to the hybrid mismatch rules.

Clause 18.4(14)(g)(iii)(A) addresses the scenario where, by transferring the financial instrument and receiving the substitute payment, the transferor obtains a more favourable income tax outcome than if it had retained the instrument and received the underlying return or, where subparagraph 18.4(14)(d)(ii) applies, a distribution under the instrument. More specifically, this condition is met if the receipt of the underlying return or distribution, as the case may be, by the transferor would reasonably be expected to result in foreign ordinary income or Canadian ordinary income of the transferor.

Clauses 18.4(14)(g)(iii)(B) and (C) address the scenario where, absent the rules on substitute payment arrangements, the transfer of the financial instrument would effectively enable the avoidance of the hybrid mismatch rules or a foreign hybrid mismatch rule. The condition in clause 18.4(14)(g)(iii)(B) is met if the underlying return (or, where subparagraph 18.4(14)(d)(ii) applies, a distribution under the transferred instrument) would have arisen under a hybrid mismatch arrangement had the transferor been a recipient of the underlying return (or the distribution). The condition in clause 18.4(14)(g)(iii)(C) is met if a foreign hybrid mismatch rule would reasonably have been expected to apply in respect of the underlying return (or, where subparagraph 18.4(14)(d)(ii) applies, a distribution under the transferred instrument) had the transferor been a recipient of the underlying return (or the distribution). This test is met if a foreign hybrid mismatch rule would have restricted a foreign income tax deduction, included an amount in "relevant foreign income or profits" (as defined in subsection 18.4(1)) or restricted a participation exemption (or other tax relief) in respect of a dividend.

Substitute payment mismatch – amount

ITA
18.4(15)

New subsection 18.4(15) is relevant in determining the extent to which the operative hybrid mismatch rules restrict a deduction, or include an amount in income, in respect of a payment arising under a substitute payment arrangement. It also provides rules that act as a "bridge" between subsection 18.4(14) and the operative hybrid mismatch rules.

Paragraph 18.4(15)(a) determines the amount of the substitute payment mismatch, which is also a "hybrid mismatch amount" (as defined in subsection 18.4(1)). This is the amount that is included in income under subsection 12.7(3), or the amount by which a deduction is restricted under subsection 18.4(4), as the case may be, with respect to a payment arising under a substitute payment arrangement. The amount of the substitute payment mismatch is the lesser of:

- the amount of the deduction/non-inclusion mismatch arising from the payment; and
- the portion of the payment described in paragraph 18.4(14)(d). This refers to the portion (which can be the entire payment, depending on the facts) that can reasonably be considered to represent or otherwise reflect, or be determined by reference to, either an underlying return on the transferred financial instrument or one of the criteria listed in subparagraph 18.4(14)(d)(ii), as the case may be.

For these purposes, the amount of the deduction/non-inclusion mismatch arising from the payment is determined under paragraph 18.4(7)(c), but is based on the assumptions in paragraph 18.4(14)(f). Thus, the same hypothetical tests that apply in determining under subparagraph 18.4(14)(f)(i) or (ii) if a deduction/non-inclusion mismatch arises from a payment also apply in determining the amount of the deduction/non-inclusion mismatch. For more information, see the commentary on paragraph 18.4(14)(f).

Paragraphs 18.4(15)(b) and (c) perform an analogous function in the context of the rules on substitute payment arrangements to that performed by paragraphs 18.4(11)(b) and (c), respectively, in relation to hybrid financial instrument arrangements. Accordingly, the commentary on paragraphs 18.4(11)(b) and (c) applies equally with respect to paragraphs 18.4(15)(b) and (c), with such modifications as the context requires.

Paragraph 18.4(15)(d) applies where subparagraph 18.4(14)(f)(ii) applies. That subparagraph generally applies where a substitute payment represents an underlying return under a financial instrument and an amount is deductible by the transferee in respect of the underlying return because the return accrues before the instrument is transferred.

Where applicable, paragraph 18.4(15)(d) deems, for the purposes of the hybrid mismatch rules in section 12.7 and subsections 18.4(3) and (4), the amount deductible by the transferee in respect of the underlying return to instead be deductible by the transferee in respect of the substitute payment. This is intended to ensure, for example, that subsection 18.4(4) can apply to restrict a Canadian-resident transferee's deduction in respect of the underlying return, notwithstanding that the deduction is not actually in respect of the substitute payment itself.

Substituted instruments

ITA
18.4(16)

New subsection 18.4(16) ensures that taxpayers cannot avoid the hybrid mismatch rules by replacing one financial instrument with another. This rule does not contain an "avoidance purpose" test, but rather applies without regard to the reason for the substitution.

This rule ensures, for example, that the rules on hybrid transfer arrangements are not avoided by virtue of a different financial instrument being substituted for a transferred instrument at a time after the transfer and before any payments are made on or in respect of the instrument. In these circumstances, the substitution will not result in a failure to meet the causal test in paragraph 18.4(12)(d), since a payment made on, or as compensation for a return on, the substituted instrument will be considered to be made on, or as compensation for a return on, the transferred instrument.

It is intended that the provisions in subsection 248(5), which include a rule applicable in the case of a succession of substitutions of property, apply in connection with subsection 18.4(16).

Specified entity – deeming rules

18.4(17)

The deeming rules in new subsection 18.4(17) apply in determining the equity interests owned, directly or indirectly, by an entity (referred to as the "first entity") in another entity (referred to as the "second entity") for purposes of the definition of "specified entity" in subsection 18.4(1). These rules deem certain rights, including contingent or future rights, to have been exercised by the first entity when determining its equity interest in the second entity.

In general terms, pursuant to the definition "specified entity", two entities will be treated as specified entities if one entity, directly or indirectly, has a 25% equity investment in the other entity, or a third entity, directly or indirectly, has a 25% equity investment in both. For the purpose of determining whether the 25% threshold has been met, by virtue of subsection 18.4(17), an entity is, in effect, deemed:

- To own any shares or control any voting rights that the entity has the right to acquire or control. Further, any shares that the entity has the right to require a corporation to redeem, acquire or cancel (other than shares held by the entity or non-arm's length persons) are considered to have been so redeemed, acquired or cancelled.
- To have exercised any rights to acquire beneficial interests in a trust. Further, any beneficial interests that the entity has the right to require a trust to redeem, acquire or terminate (other than those held by the entity or non-arm's length persons) are considered to have been so redeemed, acquired or terminated. Where an entity has a discretionary interest in a trust, paragraph 18.4(17)(b) ensures that, in determining whether the 25% threshold has been met, the entity is considered to have the maximum possible interest it could have in the trust if the discretion were exercised.
- To own any similar interests or control any similar rights in respect of a partnership or any other entity that it has the right to acquire or control. Any interests that the entity has the right to require the partnership or other entity to redeem, acquire or terminate (other than those held by the entity or non-arm's length persons) are considered to have been so redeemed, acquired or terminated.

These deeming rules also apply to rights held by persons not dealing at arm's length with the entity.

Tiered partnerships

ITA
18.4(18)

New subsection 18.4(18) provides a “look-through” rule to deal with cases where a partnership (i.e., an upper-tier partnership) is a member of another partnership (i.e., a lower-tier partnership), for the purposes of determining if a person or partnership is a member of the other partnership and the extent of the person or partnership’s rights to the income or capital of the other partnership.

This subsection is mainly relevant to calculating the Canadian ordinary income in respect of a payment (as defined in subsection 18.4(1)) of a taxpayer that is a lower-tier partnership. The amount included in the partnership’s Canadian ordinary income is limited to the share that is allocable to Canadian resident members of the partnership and non-resident members who are taxable in Canada on their relevant income from the partnership. For example, where a non-resident person is a member of an upper-tier partnership that holds a direct or indirect interest in the lower-tier partnership, the non-resident’s share of the lower-tier partnership’s income (determined on a “look-through” basis) will not contribute to Canadian ordinary income of the lower-tier partnership if the non-resident member is not taxable in Canada on that income. Similarly, a reduction in computing the lower-tier partnership’s Canadian ordinary income will occur if an amount is deductible under section 112 or 113 by a member of the upper-tier partnership in respect of the payment of which the lower-tier partnership is a recipient.

Multiple recipients

ITA
18.4(19)

New subsection 18.4(19) applies, for the purposes of sections section 12.7 and 18.4, if there would otherwise be multiple recipients of a particular payment and operates to, in effect, split the particular payment into separate payments, each corresponding to the portion of the particular payment that arises to a particular recipient. By deeming each such portion of the particular payment to be a separate payment arising to a particular recipient for the purposes of the hybrid mismatch rules, each particular recipient is treated as being a recipient of an amount equal to its actual share of the particular payment. This ensures, for example, that the particular recipient does not have an excessive income inclusion under subsection 12.7(3), and that the determination of any hybrid mismatch amount in respect of a separate payment is based on the actual tax treatment of the recipient’s corresponding portion of the particular payment.

This subsection is relevant especially in the case of fiscally transparent entities. For example, assume a $100 payment is made to an entity (which includes an arrangement) that is disregarded as a separate entity from its two equal investors for Canadian income tax purposes. The $100 payment is deemed, for the purposes of the hybrid mismatch rules, to be two $50 payments, one to each investor. Thus, in determining whether either of the deemed $50 payments gives rise to a deduction/non-inclusion mismatch, amounts of Canadian ordinary income and foreign ordinary

income are determined separately in respect of each deemed payment, and amounts deductible for Canadian or foreign income tax purposes in respect of the $100 payment are apportioned pro rata to each deemed payment. Accordingly, if the $100 payment is fully deductible to the payer, $50 is considered to be deductible in respect of each of the deemed $50 payments. If, for example, the deemed payment to one investor gives rise to a deduction/non-inclusion mismatch that is within the scope of the hybrid mismatch rules, but the deemed payment to the other investor does not, the hybrid mismatch rules will apply to neutralize the mismatch only with respect to the deemed payment to the first investor.

Anti-avoidance

ITA
18.4(20)

New subsection 18.4(20) is an anti-avoidance rule that is intended to prevent the avoidance of the hybrid mismatch rules. In general terms, it applies where one of the main purposes of a transaction or series of transactions is to avoid the application of subsection 12.7(3), 18.4(4) or 113(5), or to limit the consequences of any of those provisions, and certain other conditions are met. These other conditions are intended to capture situations that, in substance, meet the essential characteristics of hybrid mismatch arrangements, notwithstanding that one or more of the precise technical requirements of the rules is not met. Where applicable, subsection 18.4(20) is intended to ensure that a transaction is subject to the same consequences as if the avoided hybrid mismatch rule had applied.

The avoidance test in paragraph 18.4(20)(a) recognizes that there may be multiple main purposes for a transaction or series of transactions. For example, where one of the main purposes of a transaction or series is to avoid subsection 12.7(3), 18.4(4) or 113(5), other main purposes of the transaction or series may include avoiding the application of a foreign hybrid mismatch rule or obtaining some other foreign tax benefit, making or restructuring a cross-border investment, or reducing overall financing costs. The existence of any other main purpose does not preclude a concurrent main purpose of avoiding one of the hybrid mismatch rules.

As noted, the other conditions in subsection 18.4(20) are intended to capture the essential characteristics of hybrid mismatch arrangements, informed by the BEPS Action 2 Report.

The first of these other conditions is that a payment gives rise to a deduction/non-inclusion mismatch, or an outcome that is substantially similar to a deduction/non-inclusion mismatch. It is intended that subsection 18.4(20) can apply, for example, where a payment gives rise to a deduction/non-inclusion mismatch (as determined under subsection 18.4(6)), but the taxpayer avoids another technical requirement of the hybrid mismatch rules. In addition, the reference to a “substantially similar” outcome is intended to capture cases where the technical requirements for a deduction/non-inclusion mismatch under subsection 18.4(6) are not met, but a transaction or series nonetheless gives rise to an outcome that is, in substance, the type of mismatch that the hybrid mismatch rules are, in policy terms, intended to prevent.

As provided under subsection 18.4(2), the intended policy rationale and the scope of the targeted mismatches are to be interpreted consistently with the BEPS Action 2 Report. In general terms,

the targeted mismatches occur where the total amount "deductible" (which includes the extended meaning of that term in subsection 18.4(1)) in respect of a payment under Canadian or foreign income tax law exceeds the total resulting Canadian and foreign taxable income that is not effectively sheltered from income or profits tax.

The other condition, in paragraph 18.4(20)(b), reflects that, consistent with the BEPS Action 2 Report, the hybrid mismatch rules are intended to address deduction/non-inclusion mismatches only where they are caused by certain factors. Paragraph 18.4(20)(b) describes the types of deduction/non-inclusion mismatches or other outcomes that are within the scope of subsection 18.4(20). More specifically:

- Subparagraph 18.4(20)(b)(i) is relevant mainly for mismatches involving dividend payments by non-resident entities that avoid the technical requirements of subsection 113(5).
- Subparagraph 18.4(20)(b)(ii) reflects the policy that the hybrid mismatch rules (other than subsection 113(5)) generally target mismatches that result from differences in the income tax treatment of arrangements under the laws of two or more countries that are grounded in the terms or conditions of the arrangement. Although this subparagraph uses language similar to the "causal test" in paragraph 18.4(10)(d) of the rule on hybrid financial instrument arrangements, it is intended to apply more broadly, including to arrangements that avoid the rule on hybrid transfer arrangements in subsection 18.4(12).
- Subparagraph 18.4(20)(b)(iii) ensures that if the terms or conditions of a transaction or series were sufficient to cause the mismatch, the requirements of paragraph 18.4(20)(b) are met, regardless of any other reasons for the mismatch. This principle is reflected in the causal tests throughout the hybrid mismatch rules.

Where all the conditions of application are met, subsection 18.4(20) provides that the Minister shall determine the tax consequences of the transaction or series in order to deny a tax benefit, but only to the extent necessary to eliminate any deduction/non-inclusion mismatch or substantially similar outcome. For these purposes, the terms "tax consequences" and "tax benefit" are defined in subsection 245(1). The intention is that the tax consequences of the transaction are, in effect, those that would have resulted had the avoided hybrid mismatch rule applied, since the general effect of subsections 12.7(3), 18.4(4) and 113(5) is to eliminate a mismatch. For example, if subsection 18.4(20) applies in respect of a payment by a resident of Canada to a non-resident that is deductible for Canadian income tax purposes, the tax benefit to be denied is the Canadian tax deduction, to the extent of the mismatch resulted from a factor set out in paragraph (b).

Clause 3

Hybrid mismatch arrangements

ITA
20(1)(yy)

New paragraph 20(1)(yy) provides a deduction in computing a taxpayer's income for a taxation year from a business or property, generally where:

- Subsection 18.4(4) has applied to deny the taxpayer a deduction in respect of a payment for the year or a preceding taxation year, and
- The taxpayer demonstrates (by providing the relevant foreign tax returns and any other relevant supporting documentation to the Canada Revenue Agency) that an amount is foreign ordinary income of an entity in respect of the payment for a foreign taxation year that ends within 12 months of the end of the taxpayer's year for which the amount is deducted under paragraph 20(1)(yy). To prevent double counting, this amount of foreign ordinary income must not have already been taken into account in determining the deduction/non-inclusion mismatch, and thus the denial under subsection 18.4(4), in the first instance, nor in determining the amount of a previous deduction under paragraph 20(1)(yy).

The computation of the deductible amount, under subparagraph 20(1)(yy)(i), ensures that, where there are multiple applications of paragraph 20(1)(yy), the total amount deductible under this paragraph cannot exceed the amount of the deduction originally denied under subsection 18.4(4).

In addition, subparagraph 20(1)(yy)(ii), by deeming the deduction under paragraph 20(1)(yy) to be in respect of the payment, ensures the deduction takes the character of the payment. Thus, if the payment in question is treated as interest for Canadian income tax purposes, for example, an amount that is deductible in respect of the payment by virtue of paragraph 20(1)(yy) will still be subject to any other applicable restrictions in the Act, such as the thin capitalization rules and the excessive interest and financing expenses limitation in section 18.2.

There are several different circumstances where a deduction may be available under paragraph 20(1)(yy). For example, if a deduction/non-inclusion mismatch arises from a payment in the narrow circumstances where the hybrid mismatch rules apply in respect of timing differences (e.g., where an amount is deductible by a taxpayer in Canada when the payment accrues, but is not included in foreign ordinary income of a recipient until it is actually paid, and this difference in treatment is related to the terms and conditions of the arrangement), paragraph 20(1)(yy) may allow a deduction for an amount of foreign ordinary income arising in a later foreign tax year.

Deductions may also be available under paragraph 20(1)(yy) where, following a denial of a deduction in respect of a payment under subsection 18.4(4), a foreign tax authority is successful in reassessing a non-resident recipient of the payment to include an amount in its income subject to foreign income tax (although, if the taxation year for which the deduction was denied in the first instance remains open, alternatively, the taxpayer may be able to amend its return for that year and take the deduction on the basis that there was no deduction/non-inclusion mismatch in the first place and thus the hybrid mismatch rules did not apply).

Clause 4

Definitions

ITA
113(3)

Subsection 113(3) of the Act defines various terms that apply for the purposes of section 113.

Subsection 113(3) is amended to add the definitions “deductible”, “entity”, “equity interest”, “foreign hybrid mismatch rule”, “foreign expense restriction rule”, “foreign taxation year” and “relevant foreign income or profits”, so that the definitions of these terms in subsection 18.4(1) apply for the purposes of section 113.

These amendments are consequent on the introduction of subsection 113(5), as the new definitions are relevant in applying that subsection.

Deduction restriction

ITA
113(5)

New subsection 113(5), in effect, restricts a taxpayer’s ability to deduct under section 113 certain amounts in respect of dividends received by the taxpayer from a foreign affiliate out of the affiliate’s exempt, hybrid, taxable and pre-acquisition surpluses, generally to the extent the dividend is deductible for foreign income tax purposes.

Subsection 113(5) implements Recommendation 2.1 of the BEPS Action 2 Report, which recommends that countries restrict dividend exemptions (or equivalent tax relief) for payments that are treated as deductible by the payer. Accordingly, pursuant to subsection 18.4(2), subsection 113(5) is to be interpreted consistently with that report (unless the context otherwise requires), as amended from time to time. For more information, see the commentary on subsection 18.4(2).

Where a deduction is provided under foreign income tax law in respect of a dividend paid by a foreign affiliate, this effectively results in the distributed income not being included in taxable income for foreign income tax purposes. Subsection 113(5) ensures that the income is not, in effect, also excluded from taxable income for Canadian income tax purposes.

More specifically, subsection 113(5) treats a dividend received by a Canadian-resident corporation from a foreign affiliate as not being a dividend so received for the purposes of section 113, to the extent an amount is deductible in respect of the dividend in computing income or profits of the affiliate (or certain other entities described in the commentary below) that are subject to foreign income tax. To the extent the dividend is deemed not to be a “dividend received”, it will not meet the conditions for deductibility under subsection 113(1) or (2), and only the portion, if any, that is not so deemed will result in a deduction.

Given its purpose, subsection 113(5) is necessarily focussed on amounts that are considered to be dividends for the purposes of section 113. For these purposes, the question of whether an amount is a dividend is determined under Canadian income tax law (including subsection 90(2)) and not foreign income tax principles.

Subsection 113(5) applies only for the purposes of section 113 and, by extension, the provisions of the *Income Tax Regulations* (the “Regulations”) that are relevant in applying that section. Accordingly, an amount that is deemed under subsection 113(5) to not be a “dividend received”

for the purposes of section 113 is still considered to be an amount received as a dividend on a share of the capital stock of a non-resident corporation for the purposes of section 90, and is therefore fully included in computing a taxpayer's income.

Where subsection 113(5) deems all or a portion of a dividend not to be a dividend received on a share of a foreign affiliate, that portion is still considered to be a dividend paid by the affiliate on its shares. This is relevant for certain provisions of the Regulations that apply for the purposes of section 113 (including section 5901, and the definitions of "exempt surplus" and "whole dividend" in subsection 5907(1)), and is intended to ensure that the payment of the dividend reduces the affiliate's applicable surplus balances, notwithstanding that subsection 113(5) restricts a deduction in respect of the dividend under section 113.

Under paragraph 113(5)(a), the portion of the dividend that is deemed not to be a "dividend received" is equal to the total of all amounts that are, or can reasonably be expected to be, deductible in computing:

- relevant foreign income or profits of
    - the affiliate, or
    - another entity because it has a direct or indirect equity interest in the affiliate; or
- income or profits of the affiliate that are taken into account in determining relevant foreign income or profits of another entity.

The term "relevant foreign income or profits" (defined in subsection 18.4(1)) essentially refers to income or profits in respect of which an entity is subject to tax imposed by a country other than Canada. Subsection 113(3) provides that the terms "entity" and "equity interest" also take on their definitions from subsection 18.4(1).

Consistent with the BEPS Action 2 Report, subsection 113(3) incorporates an extended definition of the term "deductible" from subsection 18.4(1), which essentially includes any relief that is broadly equivalent to a deduction.

Where a dividend is paid to multiple shareholders, only the portion of a deduction in respect of the dividend that relates to the amount of the dividend received by the taxpayer is included in calculating the amount deemed under subsection 113(5) to not be a dividend received by the taxpayer. For example, assume the taxpayer owns 25% of the common shares of the affiliate. If the affiliate pays a $100 dividend on its common shares and is entitled to deduct 50% of the dividend amount under the foreign tax law, assuming the foreign income tax deduction does not depend on the status or attributes of any shareholders, the amount calculated under paragraph (a) in respect of the taxpayer will be $12.50 (being 25% of the $50 deduction).

Subsection 113(5) restricts a deduction under section 113 if an amount is deductible, or can reasonably be expected to be deductible, in respect of the dividend for foreign income tax purposes. For further information on how this test is intended to be applied, see the commentary on subsection 18.4(6), which uses a similar test.

Unlike the hybrid mismatch rules in sections 12.7 and 18.4, subsection 113(5) requires the foreign tax deduction in respect of the dividend to be available in any of three specific scenarios set out in paragraph 113(5)(a).

The first scenario, in clause 113(5)(a)(i)(A), is where the dividend-paying affiliate is entitled to deduct an amount in respect of the dividend in computing income or profits in respect of which the affiliate is subject to foreign tax.

The second scenario, in clause 113(5)(a)(i)(B), is where the dividend gives rise to a deduction in computing income or profits of another entity that are subject to foreign income tax, and the reason for the foreign deduction is that the other entity has a direct or indirect equity interest in the foreign affiliate that pays the dividend. This test would typically not be met where, for example, the other entity has transferred shares of the dividend-paying foreign affiliate subject to a sale and repurchase ("REPO") agreement, and the other entity is entitled to a foreign tax deduction because the foreign tax law treats the dividends as a deductible financing expense of the other entity. Such arrangements are generally within the scope of the hybrid transfer rule in subsection 18.4(12) and not the rule in subsection 113(5), and result in an income inclusion under subsection 12.7(3), since the reason for the foreign tax deduction in these cases is not because the other entity has an equity interest in the payer affiliate, but rather because the foreign tax law treats the other entity as a borrower under the arrangement. For further information, see the commentary on subsections 12.7(2) and (3) and 18.4(12).

The third scenario, in subparagraph 113(5)(a)(ii), is where an amount is deductible in computing income or profits of the foreign affiliate that pays the dividend, and the income or profits are taken into account in computing another entity's income or profits on which the other entity is subject to foreign income tax. This could occur, for example, if the affiliate is treated as fiscally transparent under the relevant foreign tax law, such that the affiliate's income or profits are allocated to another entity.

While subsection 113(5) is narrower than the hybrid mismatch rules in sections 12.7 and 18.4 in requiring the foreign tax deduction to arise in one of the three scenarios described above, it is broader than those rules in another respect: it is not limited to "hybrid mismatch arrangements" (as defined in subsection 18.4(1)). While subsection 113(5) can apply in respect of payments under those types of arrangements, its application does not turn on whether the mismatch – that is, the foreign tax deduction in respect of the dividend in combination with the deduction otherwise available under section 113 – is attributable to the "hybridity" of the financial instrument or arrangement under which the dividend is paid. Put differently, for subsection 113(5) to apply, the dividend need only be deductible by a relevant entity for foreign income tax purposes, without regard to the reason for the mismatch in treatment between the foreign and Canadian income tax laws (e.g., whether it is due to a difference in how a financial instrument or arrangement is treated for income tax purposes in Canada and a foreign country).

Paragraph 113(1)(b) ensures that subsection 113(5) applies in priority to a "foreign hybrid mismatch rule" (as defined in subsection 18.4(1)), by disregarding such rules. In effect, if a foreign country's hybrid mismatch rules apply to restrict a deduction to a foreign affiliate for a dividend paid by the affiliate to a taxpayer, this restriction is disregarded (i.e., the amount is

considered deductible) and thus subsection 113(5) applies. This approach is consistent with the BEPS Action 2 Report, which recommends that rules, such as subsection 113(5), implementing Recommendation 2.1 apply in priority to the "primary" hybrid mismatch rule of the dividend payer's country. Thus, in accordance with the BEPS Action 2 Report, the latter country should not apply its hybrid mismatch rules to deny a deduction in the first instance where a rule such as subsection 113(5) applies to deny relief to the dividend recipient.

Finally, paragraph 113(5)(b) also, in effect, requires that any foreign expense restriction rules be disregarded in determining whether a dividend paid by a foreign affiliate is deductible. As defined in subsection 18.4(1), "foreign expense restriction rule" refers to certain general interest deductibility restrictions under foreign tax law, as well as foreign tax rules that can reasonably be considered to be intended to implement the Global Anti-Base Erosion Model Rules (Pillar Two). For further information, see the commentary on subsection 18.4(6), which uses similar concepts.

Clause 5

Deemed interest payments

ITA
214(17)

Subsection 214(17) provides rules that apply for the purposes of subsection 214(16), which generally treats interest that is not deductible because of the thin capitalization rules as a deemed dividend for the purposes of Part XIII of the Act.

In particular, paragraph 214(17)(a) deems interest (other than compound interest) that is payable in respect of a corporation's taxation year to have been paid at the end of that year and not at any other time (i.e., not to have been paid or credited when it is actually paid or credited). Paragraph 214(17)(b) ensures that the deemed dividend under subsection 214(16) cannot be avoided by transferring a debt obligation in the circumstances described in either subsection 214(6) or (7).

Consequent on the introduction of new subsection 214(18), subsection 214(17) is amended to extend its application to cases where subsection 214(18) applies to treat interest that is not deductible because of the hybrid mismatch rule in subsection 18.4(4) as a deemed dividend for the purposes of Part XIII of the Act. For more information, see the commentary on subsection 214(18).

This amendment applies in respect of payments arising on or after July 1, 2022.

Hybrid mismatch arrangements – deemed dividend

ITA
214(18)

New subsection 214(18) deems interest paid or credited by a corporation resident in Canada, that is not deductible because of the hybrid mismatch rule in subsection 18.4(4), to be a dividend and

not interest for the purposes of Part XIII of the Act. This rule is analogous to paragraph 214(16)(a) in the thin capitalization context.

This rule, in effect, aligns 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.

This amendment applies in respect of payments arising on or after July 1, 2022.