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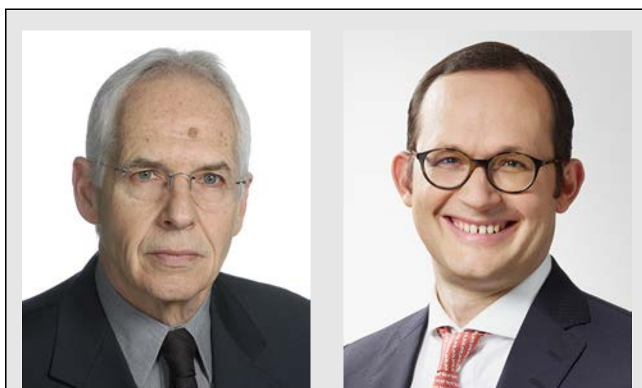

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In this article, Boidman and Kandev examine Canada's proposed implementation of the anti-hybrid recommendations in the final action 2 report from the OECD's base erosion and profit-shifting project and its likely effects on Canadian and foreign multinationals.

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On April 29 Canada released legislative proposals to address hybrid mismatch arrangements, following through on its 2021 budget promise to do so.[1] The new rules are the first of two installments intended to implement — somewhat belatedly — the recommendations in the OECD's 2015 final report on action 2 of the base erosion and profit-shifting project, titled "Neutralising the Effects of Hybrid Mismatch Arrangements." The amendments are to generally apply to payments arising on or after July 1, 2022, including payments under arrangements entered into before that date, leaving little if any time for the Canadian tax community to comment on them and plan for their impact. This article summarizes the proposals and comments on them.[2]

Background

According to Canada's announcement of the proposals:

> Hybrid mismatch arrangements are cross-border tax avoidance arrangements that exploit differences in the income tax treatment of business entities or financial instruments between two or more countries. These mismatches can result in "double non-taxation", which occurs when income is not subject to tax in any jurisdiction. This can significantly reduce overall tax paid and decrease tax revenues.

As noted above, hybrid mismatches were the subject of the BEPS final action 2 report. The two main forms of hybrid arrangements addressed therein are (1) deduction/noninclusion mismatches, which arise when a country allows a deduction for a cross-border payment whose receipt is not included in fully taxable income in the other country within a reasonable period; and (2) double deduction mismatches, which arise when a tax deduction is available in two or more countries for a single economic expense. The proposals address only the first category.

The action 2 final report also addressed imported mismatches, which generally arise when a payment is deductible by an entity resident in one country and included in the ordinary income of a recipient entity resident in a

[1] *See* Nathan Boidman and Michael N. Kandev, "Canada and BEPS: What Goes Around Comes Round," *Tax Notes Int'l*, June 28, 2021, p. 1815.

[2] *See also* Nik Diksic, "Canada's New Hybrid Mismatch Rules," 1(1) *Int'l Tax Highlights* 10-13 (2022).

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second country, but that income is set off by a deduction under a hybrid mismatch arrangement between the second entity and an entity resident in a third country. An action 2 supplement recommended additional rules to address branch mismatch arrangements, which generally produce mismatches similar to hybrid mismatch arrangements. The proposals do not address either category.

Although several countries have enacted anti-hybrid legislation — including, most notably, the United States as part of the 2017 Tax Cuts and Jobs Act[3] — Canada's Budget 2021 somewhat belatedly proposed to implement specific rules to address hybrid mismatch arrangements that involve Canadian taxpayers. Budget 2021 stated that those rules would be implemented in two stages (similar to the way the U.S. regulations under IRC section 267A were released). It contemplated a first package that would comprise rules to neutralize deduction/noninclusion mismatches arising from a payment for a financial instrument, which would be released for stakeholder comment later in 2021 and be applicable as of July 1, 2022. The second legislative package would be released for stakeholder comment after 2021, and those rules would apply no earlier than 2023. It would comprise rules consistent with the action 2 recommendations that were not addressed in the first package.

The Proposals

Overview

A year behind schedule, the first package of anti-hybrid legislation is now a reality. New sections 12.7, 18.4, and 113(5) of the Income Tax Act are the core provisions of the hybrid mismatch rules. The legislative amendments implement the recommendations in Chapter 1 of the action 2 report, addressing deduction/noninclusion mismatches that arise from payments under three types of defined arrangements: hybrid financial instrument arrangements, hybrid transfer arrangements, and substitute payment arrangements. The amendments also implement recommendation 2.1 in Chapter 2 of the final report by restricting the dividends received deduction in ITA section 113 to the extent the dividend is deductible for foreign income tax purposes.

Consistent with the action 2 report, new sections 12.7 and 18.4 apply 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,[4] or if they are specified entities, as defined in ITA section 18.4(1), with reference to section 18.4(17). In general terms, parties are specified entities if one has an interest in the other of at least 25 percent by vote or value, or a third entity has that interest in both.[5] An arrangement is a structured arrangement if its pricing reflects the hybrid mismatch or it is otherwise designed to produce a hybrid mismatch.[6]

While it is reasonable to expect that those anti-hybrid rules should apply to related-party arrangements, it is questionable whether lowering the bar to the 25 percent of vote or value standard is appropriate. A key feature of the rules is the implicit requirement that the taxpayer have substantial knowledge of the tax system and the treatment of the relevant payment in the counterparty foreign tax jurisdiction. Arguably, that level of knowledge would typically not be present other than among related parties.

The primary operative rule in proposed section 18.4(4) would apply to inbound situations that see Canada as the source country. It neutralizes a deduction/noninclusion mismatch arising from a payment under a hybrid mismatch arrangement by restricting a deduction for the payment.

A secondary "defensive" rule in proposed section 12.7(3) would apply to outbound scenarios that see Canada as the residence country. It neutralizes a deduction/noninclusion

[3]*See* Boidman and Kandev, "Expected Adverse Effects of Proposed U.S. Anti-Hybrid Regulations on Inbound Financing by Canadian MNEs," *Tax Notes Int'l*, Feb. 11, 2019, p. 623.

[4]ITA section 251(1) defines that concept, which is a function of relatedness and for corporations implies a relationship of control.

[5]That is broadly consistent with the relationship threshold applied in the context of Canada's thin capitalization interest limitation rule in ITA section 18(4)ff.

[6]However, even if a payment arises under a structured arrangement, ITA section 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 (for example, if the payment was at fair market value).

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mismatch arising from a payment under a hybrid mismatch arrangement by including an amount in the income of a Canadian recipient to the extent the mismatch is not otherwise neutralized via a deduction restriction under a foreign country's hybrid mismatch rules. A more specific rule in proposed section 113(5) would apply to outbound cases involving dividends from foreign affiliates that are deductible at source by denying the deduction in computing taxable income that would otherwise be available under the ITA.

Both the primary and secondary rules depend on the presence of a payment. Proposed section 18.4(1) defines that term broadly to include "any amount or benefit that any entity has an obligation to pay, credit or confer, either immediately or in the future and either absolutely or contingently, to an entity." In other words, a payment includes amounts actually paid, as well as accruals for payables, and extends to contingent amounts. In combination with the deemed dividend withholding tax treatment discussed below, that definition makes the rules' scope very broad.

ITA section 18.4(6) determines if a payment gives rise to a deduction/noninclusion mismatch. Essentially, that occurs if, in computing Canadian ordinary income, the total deductible amount for the payment exceeds the total amount included for the payment in computing foreign ordinary income — or, conversely, if the total amount deductible in computing foreign ordinary income exceeds the total amount included in Canadian ordinary income.

That simple concept is subject to some important qualifications. First, Canadian deductibility is determined by ignoring the hybrid mismatch rules, the thin capitalization rules in ITA section 18(4), and the excessive interest and financing expense limitation rules of section 18.2. Similarly, foreign deductibility is determined in the absence of a foreign expense restriction rule, defined to mean a rule substantially similar to the Canadian thin cap rules, excessive interest and financing expense limitation rules, and the rules enacting the BEPS pillar 2 proposals.

Second, the terms "Canadian ordinary income" and "foreign ordinary income" are both exhaustively defined and subject to some significant downward adjustments. Canadian ordinary income starts with Part I income, but it excludes deductible dividends from domestic corporations and foreign affiliates, as well as any amount that benefits from a targeted exclusion, reduction, or exemption.

Foreign ordinary income starts with income subject to mainstream taxation — that is, excluding final withholding taxes, taxes under a controlled foreign corporation or specified minimum tax regime (defined to mean the U.S. global intangible low-taxed income regime in IRC section 951A), any pillar 2 rules, or any qualified domestic minimum top-up tax rules as understood in the context of the pillar 2 rules. There are several reductions of that income amount, including for income taxed at a nil rate; income taxed under a foreign hybrid mismatch rule; and income eligible for a targeted exemption, exclusion, or reduction that is not generally applicable to all of the entity's foreign income.[7]

Targeted Arrangements

ITA section 18.4(10), (12), and (14) define the three types of targeted hybrid arrangements.

Hybrid Financial Instrument Arrangement

ITA section 18.4(10) determines if a payment arises under a hybrid financial instrument arrangement, while section 18.4(11) determines the amount of the hybrid financial instrument mismatch and ensures that section 12.7(3) or 18.4(4) applies only to the extent that the deduction/noninclusion mismatch results from the "hybridity" of the arrangement. A hybrid financial instrument arrangement generally occurs if a payment under a financial instrument results in a deduction/noninclusion 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. Importantly, the rule applies not only to a financial instrument on its own, but also

[7]Presumably, a dividend or capital gains participation exemption.

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to "one or more transactions, either alone or together . . . that are part of a transaction or series of transactions that includes the payment or relates to the financial instrument."

The application of that broad notion is obvious from an example in the technical notes involving a hybrid financial instrument arrangement. It is consistent with the type of hybrid arrangement that was described in the Canada Revenue Agency's July 5, 2019, notice. In the example, a U.S.-owned Canadian subsidiary is capitalized with both debt and equity. The Canadian corporation funds the annual interest owed on the borrowing from its U.S. parent by entering into agreements for the forward sale of treasury shares with a disregarded U.S. limited liability corporation subsidiary of the U.S. parent. The Canadian corporation uses prepayments received from the LLC under the forward sale agreements (which are funded by annual contributions from the U.S. parent to the LLC under a support payment to the parent) to make interest payments to the U.S. parent.

In the 2019 notice, the CRA said it had resolved a taxpayer file involving that type of hybrid mismatch arrangement using ITA section 247(2)(b) and (d) and that transfer pricing penalties applied. Its loss before the Federal Court of Appeal (an appeal of which was denied by the Supreme Court) in *Cameco*,[8] a transfer pricing recasting case, made the basis for the CRA's position more tenuous than it might otherwise have been.[9] Hence, the proposals seem to focus primarily on transactions of that type.

Hybrid Transfer Arrangement

ITA section 18.4(12) determines if a payment arises under a hybrid transfer arrangement. That generally occurs if a payment under an arrangement for the transfer of a financial instrument gives rise to a deduction/noninclusion mismatch and the mismatch arises because countries' tax laws treat different entities as owing returns under the transferred financial instrument. Section 18.4(13) determines the amount of the hybrid transfer mismatch and is analogous in function to section 18.4(11).

The section 18.4(12) example in the technical notes describes a standard "repo" transaction.[10] While the popularity of repos into the United States was significantly limited by the 2017 enactment of IRC section 267A, the proposals seem to further discourage the use of those kinds of structures.

Substitute Payment Arrangement

ITA section 18.4(14) determines if a payment arises under a substitute payment arrangement. That generally occurs if a payment under or in connection with the transfer of a financial instrument functions as a substitute for returns under the instrument and gives rise to a deduction/noninclusion mismatch that would otherwise undermine the integrity of the rules on hybrid financial instrument arrangements and hybrid transfer arrangements in section 18.4(10)-(13). Section 18.4(15) determines the amount of the substitute payment mismatch and ensures that section 12.7(3) or 18.4(4) applies only if the deduction/noninclusion mismatch arises from the portion of the payment that is a substitute.

We could not think of a substitute payment arrangement relevant to Canada, and the technical notes accompanying the proposals do not provide an example.

Deemed Dividend for Withholding Tax Purposes

As a deviation from OECD norms, the proposed rules treat the interest expense of a corporation resident in Canada that is not deductible because of the hybrid mismatch rules as a deemed dividend for ITA Part XIII purposes. As such, the proposed rules piggyback on the 2012 changes to Canada's thin cap regime and related amendments that treat interest disallowed under those rules as dividends for withholding tax purposes. While that change is not an

[8] *Cameco Corp. v. Canada*, 2021 CanLII 10731 (SCC).

[9] *See* Boidman and Jesse Boretsky, "Supreme Court Confirms Cameco's Epic Transfer Pricing Victory," 50(4) *Tax Mgmt. Int'l J.* 199 (Apr. 2, 2021).

[10] Typically, a repo involves a sale of preferred shares issued by a foreign affiliate subject to a repurchase right. In Canada, that transaction would be seen to involve the ownership of the preferred shares by the Canadian parent, while in the United States, it would be treated as a form of secured financing giving rise to deductible interest.

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unreasonable added deterrent to the use of hybrid mismatch arrangements, notably, the proposal would extend the deemed payment rule in section 214(17) — which captures interest payable and has always been perceived as unfair because it goes against the principle that withholding tax applies only on actual payment — to new section 214(18).

Limitation of Dividends Received Deduction

Consistent with recommendation 2.1 of the BEPS action 2 report, ITA section 113(5) restricts a taxpayer's ability to deduct specific amounts under section 113 for dividends the taxpayer receives from a foreign affiliate's exempt, hybrid, taxable, and pre-acquisition surpluses. That restriction is generally limited to the extent a foreign income tax deduction is available for the dividend to the affiliate or some other entities. Notably, that proposed rule does not require a hybrid mismatch arrangement because one is effectively assumed to exist should dividends be deductible at source.

A simple example of a situation that would presumably trigger new section 113(5) is that of mandatorily redeemable preferred shares that were previously commonly issued by a Luxembourg affiliate to a Canadian parent corporation. Those shares would give rise to deductible debt interest in Luxembourg, while Canada would treat them as exempt surplus dividends from a foreign affiliate. While structures with those kinds of shares involving the financing of U.S. acquisitions and operations have generally become extinct since the enactment of IRC section 267A and regulations thereunder, proposed ITA section 113(5) would create a further impediment to their use.

Supporting and Interpretive Rules

As an explicit departure from the action 2 report, ITA section 18.4(9) ensures the hybrid mismatch rules address deduction/noninclusion mismatches arising because of an income tax deduction under foreign law for a notional interest expense for a debt. A notable example would be interest-free debt financings of a Luxembourg subsidiary whereby Luxembourg would attribute an interest expense under its transfer pricing rules but Canada would not include a corresponding amount.[11] The proposed rules would reverse that treatment.[12]

Section 18.4(20) is a type of "one of the main purposes" antiavoidance rule intended to capture situations that in substance meet the essential characteristics of a hybrid mismatch arrangement, even if some of the precise technical requirements of the hybrid mismatch rules are not met.

Finally, the legislative package contains an unusual interpretive rule. Section 18.2(2) provides that the hybrid mismatch rules are to be interpreted consistently with the action 2 report, unless the context requires otherwise (such as when the hybrid mismatch rules depart from recommendations in the final report). The validity and usefulness of that is unclear. It seems unlikely that a Canadian court will use an OECD report — which has no force of law in Canada — to override an interpretive result that it would otherwise have reached through a textual, contextual, and purposive interpretation of the relevant legislation.[13]

Conclusion

It is ironic that while Canada has been at the center of hybrid mismatch tax planning since its inception in the 1980s — that is, by benefiting from the advent of LLC finance companies that were the target of IRC section 894(c) and then seeing the first extensive anti-hybrid-entity rules in its treaty with the United States — it is only now adopting comprehensive domestic anti-hybrid rules.

The first package of anti-hybrid amendments generally addresses deduction/noninclusion mismatches that arise from inbound and outbound payments under hybrid financial instrument arrangements, hybrid transfer arrangements, and substitute payment arrangements. As noted, the clear priority of those proposals is to eliminate specific inbound hybrid financial instrument arrangements from the United States that have been popular in the past.

[11] That is consistent with the example in the technical notes.

[12] Importantly, the proposed rules do not seem to apply to notional deductions or charges against equity.

[13] Obviously, in considering the rules' context and purpose, a Canadian court would most likely take into account the action 2 report and related OECD materials.

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Even so, the scope of the rules is much broader, in keeping with the underlying BEPS final action 2 report.

What is covered in the package is as important as what is not. First, the proposal does not address hybrid entity arrangements. That may be because hybrid entities are mainly a creation of U.S. tax law, and the 2010 changes to the Canada-U.S. tax treaty limited the use of the types of hybrid entity mismatch arrangements that were historically popular.[14]

Second, the proposals do not address imported mismatches, which, as noted, generally arise when a payment is deductible by an entity resident in one country and included in the ordinary income of a recipient entity resident in a second country, but that income is set off by a deduction under a hybrid mismatch arrangement between the second entity and an entity resident in a third country. At the finance roundtable of the 2022 IFA Canada International Tax Seminar, the Canadian Department of Finance said that type of arrangement will be addressed in the second package of anti-hybrid rules.

Third, the legislative package does not address branch mismatch arrangements, which generally produce mismatches similar to hybrid mismatch arrangements.

It remains to be seen what will be in the second package of proposals and to what extent it will be in keeping with Canada's historical tax policy of allowing Canadian multinationals to minimize their foreign tax burden. In any event, the rules will likely be of limited direct relevance because many countries, including the United States, have already implemented anti-hybrid legislation that has severely curtailed the use of hybrid mismatch arrangements. While most recent cross-border financings have stayed away from those arrangements, the breadth of the proposals will likely be a source of many unexpected traps for the unwary. ■

[14]The TCJA changes to the dual consolidated loss regulations also limited the use of hybrid entity tower structures.

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