

Proposed Second Package of Hybrid Mismatch Rules

Presenters:

- **Christopher Montes**
Co-Managing Partner, Felesky Flynn LLP
- **Simon Townsend**
Senior Manager, National Tax, RSM Canada LLP

Agenda

- 1. Background**
- 2. First package of anti-hybrid rules**
- 3. Second package of anti-hybrid rules**
 - a) Reverse hybrid arrangement**
 - b) Disregarded payment arrangement**
 - c) Hybrid payer arrangement**
 - d) Imported hybrid arrangement**
- 4. Questions**

Background



Young IFA Network

A brief history of anti-hybrid rules

- 2007 Protocol (effective 2010) – Article IV(7) of the Canada-US Tax Treaty
- 2015 – OECD BEPS Action 2 report
- 2018 – US anti-hybrid rules and changes to DCL rules
- 2019-2022 – EU ATAD 1 and ATAD 2 anti-hybrid rules
- 2022 – First package of Canadian anti-hybrid rules released
- 2024 – First package of Canadian anti-hybrid rules enacted (effective 2022)
- 2026 – Second package of Canadian anti-hybrid rules released

Article IV(7) of the Canada-US Tax Treaty

- Deals with entity hybridity (e.g., reverse hybrid entities, disregarded payments)
- Denies treaty benefits (e.g., reduced WHT rate)
- Does not deny deduction or require income inclusion

OECD BEPS Action 2 report

- Proposed rules to neutralize deduction / non-inclusion (“**D/NI**”) and double deduction (“**DD**”) outcomes
- Dealt with:
 - Financial instrument hybridity
 - Entity hybridity
 - Payments by hybrid entities, dual-resident entities, and partnerships/branches
 - Imported mismatches

First Package of Anti-Hybrid Rules



Young IFA Network

First package of Canadian anti-hybrid rules

- Draft legislation released April 29, 2022; revised draft legislation released on November 30, 2023
- Enacted June 20, 2024, but with general application to payments arising on or after July 1, 2022 (subject to certain exceptions)

First package of Canadian anti-hybrid rules

- Focused on D/NI outcomes (not DD outcomes) where hybridity relates to the terms of a financial instrument
- Also targeted notional interest deductions without a payment (which was not recommended by the OECD BEPS Action 2 report)
- Can apply in some circumstances to foreign affiliates
- Interpreted based on OECD BEPS Action 2 report, as amended from time to time

First package of Canadian anti-hybrid rules

- “Hybrid mismatch arrangement” includes
 - “Hybrid financial instrument arrangement”
 - “Hybrid transfer arrangement”
 - “Substitute payment arrangement”
- Each must involve a “deduction/non-inclusion mismatch”, which means the deduction for a payment in one jurisdiction exceeds the inclusion for the payment in the other jurisdiction
 - “Canadian ordinary income” and “foreign ordinary income”
- Payment must be between non-arm’s length parties, there must be a “specified entity” (25% votes or value) in respect of the recipient, or there must be a “structured arrangement”
- “Structured arrangement” is a transaction or series including a payment that gives rise to a D/NI mismatch, and:
 - It can reasonably be considered that an economic benefit of the mismatch is priced into the transaction/series, or
 - The transaction/series was designed to, directly or indirectly, give rise to the mismatch

First package of Canadian anti-hybrid rules

- Possible consequences
 - Primary rule – denial of deduction – s. 18.4(4)
 - If interest deduction is denied, deemed dividend subject to WHT – s. 214(18)
 - Timing differences – if subsequently included in income, the deduction is allowed and WHT is refunded later – s. 20(1)(yy), s. 227(6.3)
 - Secondary rule – income inclusion – s. 12.7(3)
 - Timing differences – no special rule, but the explanatory notes state no double inclusion under s. 12(3) and s. 248(28)
 - Dividend deduction denial (but deduction for foreign WHT allowed) – s. 113(5), (6)

Second Package of Anti-Hybrid Rules



Young IFA Network

Second package of Canadian anti-hybrid rules

- Draft legislation released January 29, 2026
- Focused on D/NI outcomes and DD outcomes for hybrid entities, dual-resident entities or partnerships/branches
- Proposed to apply to payments arising on or after July 1, 2026
- Joint Committee made submission to Finance on March 10, 2026

Second package of Canadian anti-hybrid rules

- “Hybrid mismatch arrangement” definition expanded to include
 - “Reverse hybrid arrangement”
 - “Disregarded payment arrangement”
 - “Hybrid payer arrangement”
- Also applies to an “imported hybrid mismatch”
- “Structured arrangement” definition amended to add reference to “double deduction mismatch”

Second package of Canadian anti-hybrid rules

- Greater clarity on timing, including expanding timing relief
 - More specific references to years
 - Deduction under s. 20(1)(zz) and (aaa) if later income inclusion
 - Discretionary rule in s. 18.4(19.1)
- Various additional rules for “hybrid payer arrangement” at investor level
- Depreciation / depletion deductions excluded from reverse hybrid arrangement and disregarded payment arrangement rules, but not from hybrid payer arrangement rules

Second package of Canadian anti-hybrid rules

- “Dual inclusion income” and “investor dual inclusion income” may provide relief in computing the amount of a:
 - “Disregarded payment mismatch”
 - “Hybrid payer mismatch”
- Generally, computed on an entity-by-entity level in respect to a:
 - “hybrid entity” resident in Canada
 - “dual resident”
 - “multinational entity”
- Joint Committee noted entity-by-entity calculation may cause non-recognition of “dual inclusion income” – recommended broader approach

Second package of Canadian anti-hybrid rules

Payment	Affected entity	Arrangement	Amount	Result
- Includes any amount or benefit that an entity has an obligation to pay, credit, confer, now or in the future, absolutely or contingently	- Hybrid payer - Dual resident - Hybrid entity - Multinational entity - Reverse hybrid entity	- Reverse Hybrid Arrangement - Disregarded Payment Arrangement - Hybrid Payer Arrangement - Imported Mismatch Arrangement	- Usually, the amount of the D/NI or DD mismatch attributable to the arrangement, exceeding dual inclusion income (if applicable)	- Denial of a deduction - Income inclusion - Deemed dividend (if interest) subject to WHT

Reverse Hybrid Arrangement



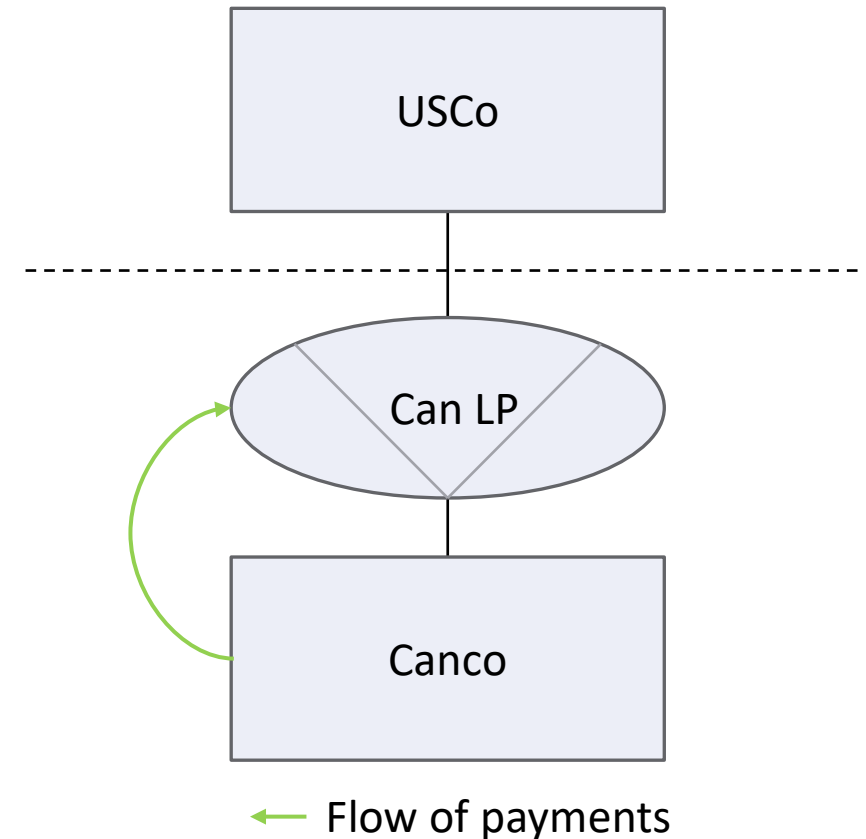
Young IFA Network

Reverse hybrid arrangement

- **Reverse hybrid entity**
 - An entity that is treated as fiscally transparent in one country and is treated as fiscally opaque in a country in which an equity interest holder is resident
- **(15.1) Conditions for a reverse hybrid arrangement:**
 - It is made to a **reverse hybrid entity**
 - A payer is **not at arm's length** with the reverse hybrid entity, or the payment arises under, or in connection with, a **structured arrangement**
 - The payment produces a **D/NI mismatch**
 - The mismatch exceeds that which would occur if the payment were made directly to the investors, and is not addressed under the first package
- **(15.2)** Amount is the portion of the D/NI mismatch that exceeds what would occur if the payment were made directly to the investors

Reverse hybrid arrangement

- Can LP is formed under Ontario law; it is fiscally transparent in Canada but treated as a corporation for US tax purposes
- Can LP receives an interest payment from Canco (deductible to Canco), which is not distributed to USCo
- Can LP is a reverse hybrid entity under proposed s.18.4(1); hybridity is the cause of a D/NI outcome; there would not be a D/NI if the amount were paid directly to USCo
- The Canadian deduction should be denied under s. 18.4(4)
- As this is interest, deemed to be a dividend subject to withholding tax under s. 214(18)
 - Can LP is deemed to be a non-resident person for Part XIII because of s. 212(13.1)



Disregarded Payment Arrangement



Young IFA Network

Disregarded payment arrangement

- **Hybrid entity**

- A hybrid entity is an entity that is tax resident (i.e., fiscally opaque) in one country and fiscally transparent in a second country

- **(15.3) Conditions for a disregarded payment arrangement:**

- The payer must be a **hybrid entity**
- The payer and recipient do **not deal at arm's length**, or the payment arises under, or in connection with, a **structured arrangement**
- The payment produces a **D/NI mismatch**
- The mismatch arises, at least in part, because the payment is disregarded in the recipient's jurisdiction—not taking into account other causes of the mismatch

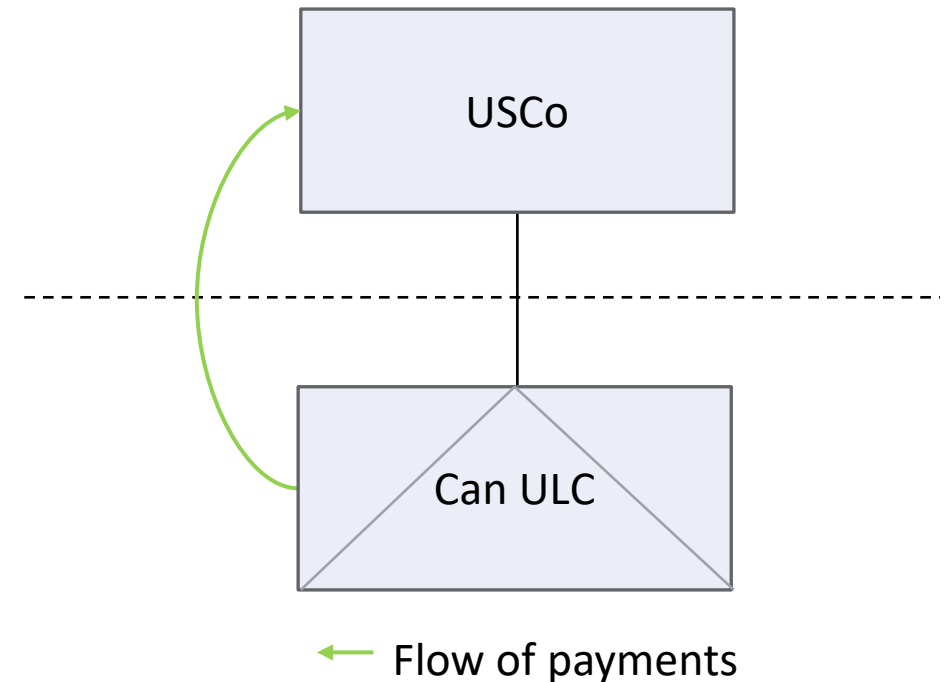
Disregarded payment arrangement

(15.4) Amount

A	-	B	-	C
The D/NI mismatch that arises because the payment is disregarded for the recipient, and is reasonably attributable to the year		The portion of "A" that is included in the amount of: <ul style="list-style-type: none">- A mismatch under the first package of HMA rules, or a reverse hybrid mismatch, and- Is already denied (under s. 18.4(4)) or included in income (under s. (12.7(3)))		If there is a Canadian deduction component: the dual inclusion income of the hybrid entity not otherwise taken into account If there is a foreign deduction component: the investor dual inclusion income not otherwise taken into account

Disregarded payment arrangement

- Can ULC is a **hybrid entity** - resident in Canada but fiscally transparent for US tax purposes
- Can ULC makes deductible payments (e.g., royalties) to USCo, but such payments are disregarded for US tax purposes
- Payment will not form part of USCo's foreign ordinary income within 12 months, causing a D/NI mismatch
- The disregarded payment is the reason for the D/NI mismatch
- Without dual inclusion income, Can ULC's deduction is denied under s. 18.4(4)



Hybrid Payer Arrangement



Young IFA Network

Hybrid payer arrangement

- **Hybrid payer**
 - A “dual resident”, “hybrid entity”, or “multinational entity”
- **(15.5) Conditions for a hybrid payer arrangement:**
 - A payer must be a **hybrid payer**
 - For payers that are **hybrid entities resident in Canada**, the entity is **not at arm’s length with an investor**—or the payment arises under or in connection with a **structured arrangement**—and no foreign hybrid payer mismatch rule applies in computing foreign income of at least one investor in the hybrid entity
 - For payers that are **multinational entities** resident outside of Canada, **no foreign hybrid payer mismatch rule applies**—i.e., intended to implement Chapters 6 or 7 of the OECD’s BEPS Action 2 report
 - The payment gives rise to a **DD mismatch**

Hybrid payer arrangement

- Amount of a hybrid payer mismatch is determined by a formulaic calculation in s. 18.4(15.6)
- Effectively the amount by which the double deduction exceeds the available prorated dual inclusion income
 - As a result, restriction is applied proportionally to each deductible amount

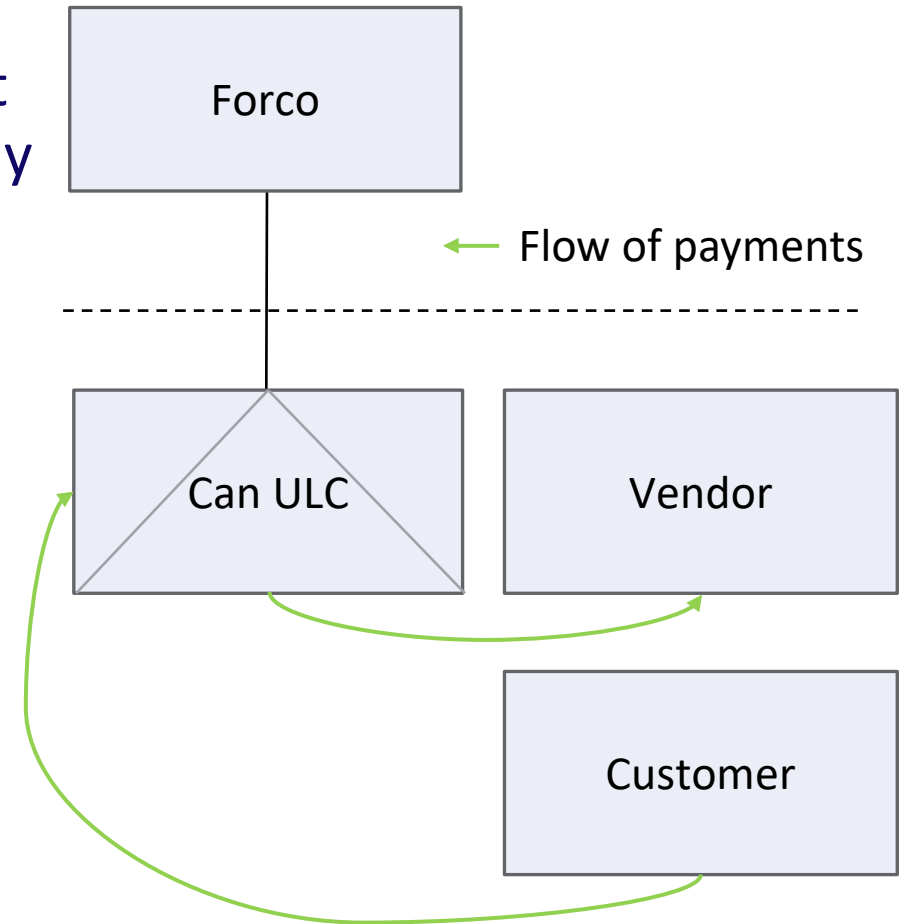
Hybrid payer arrangement

- Amount of an investor hybrid payer mismatch is determined by a formulaic calculation in s. 18.4(15.7)
- Applicable where the hybrid entity is viewed as a partnership and the investor in that hybrid entity is resident in Canada
- Effectively the amount by which the double deduction exceeds the available prorated investor dual inclusion income
- An investor hybrid mismatch amount is neutralized under proposed s. 12.7(4) by an income inclusion

Hybrid payer arrangement - 1

- The payer (Can ULC) is a **hybrid payer** because it is a **hybrid entity**—resident in Canada but fiscally transparent for foreign tax purposes
- Can ULC is in a taxable position and Forco's jurisdiction does not apply tax relief to dual inclusion income
- There is no hybrid payer arrangement amount because the double deduction is offset by dual inclusion income of Can ULC in the year

Can ULC's income	\$1000
Can ULC's expense	<u>(\$900)</u>
Can ULC's net income – recognized by Forco	\$100

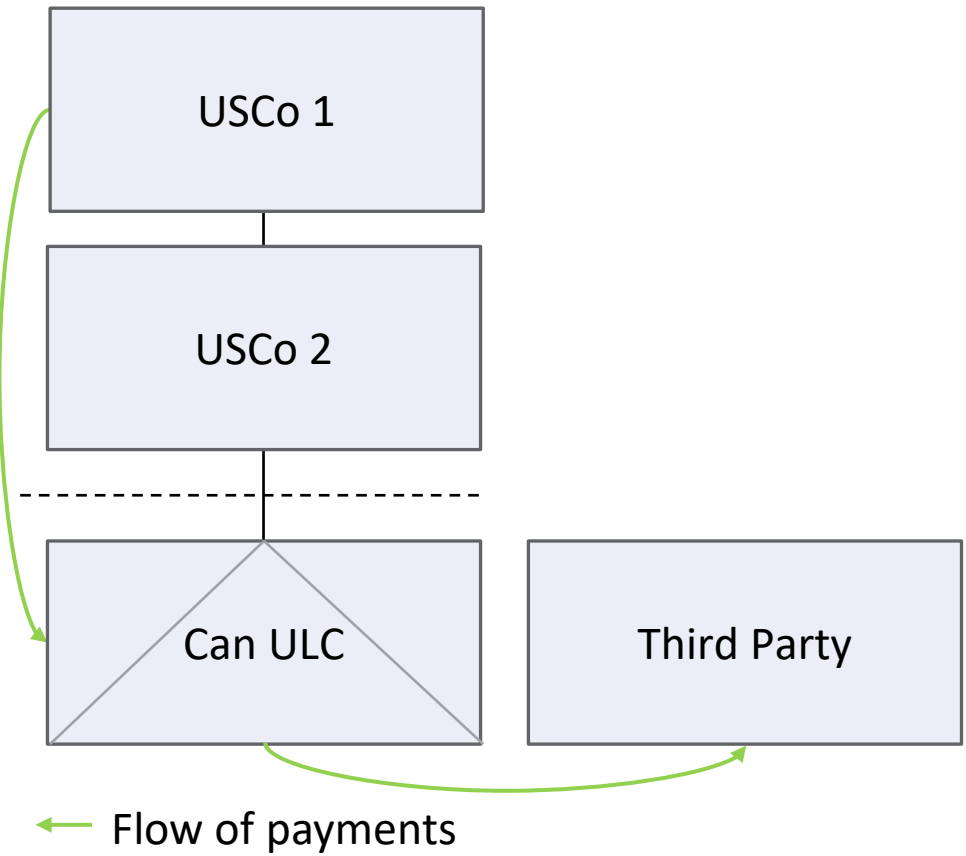


Joint committee feedback

- Unclear if amounts upon which foreign tax credits or s. 112 or 113 deductions have been claimed will be captured in the following definitions
 - **Dual inclusion income** = *amounts which are ordinary income for Canada and ordinary income of an investor in the entity in a foreign jurisdiction within 12 months*
 - **Ordinary income** \neq *amounts that can reasonably be considered to be excluded, reduced, offset or otherwise effectively sheltered from the income or profits tax under the laws of that country by reason of any exemption, exclusion, deduction, credit (other than a credit for tax payable under Part XIII or a substantially similar tax) or other form of relief the applies specifically in respect of all or a portion of the amount and not in computing the entity's income or profits general*
- Amounts subject to tax under CFC rules do not count

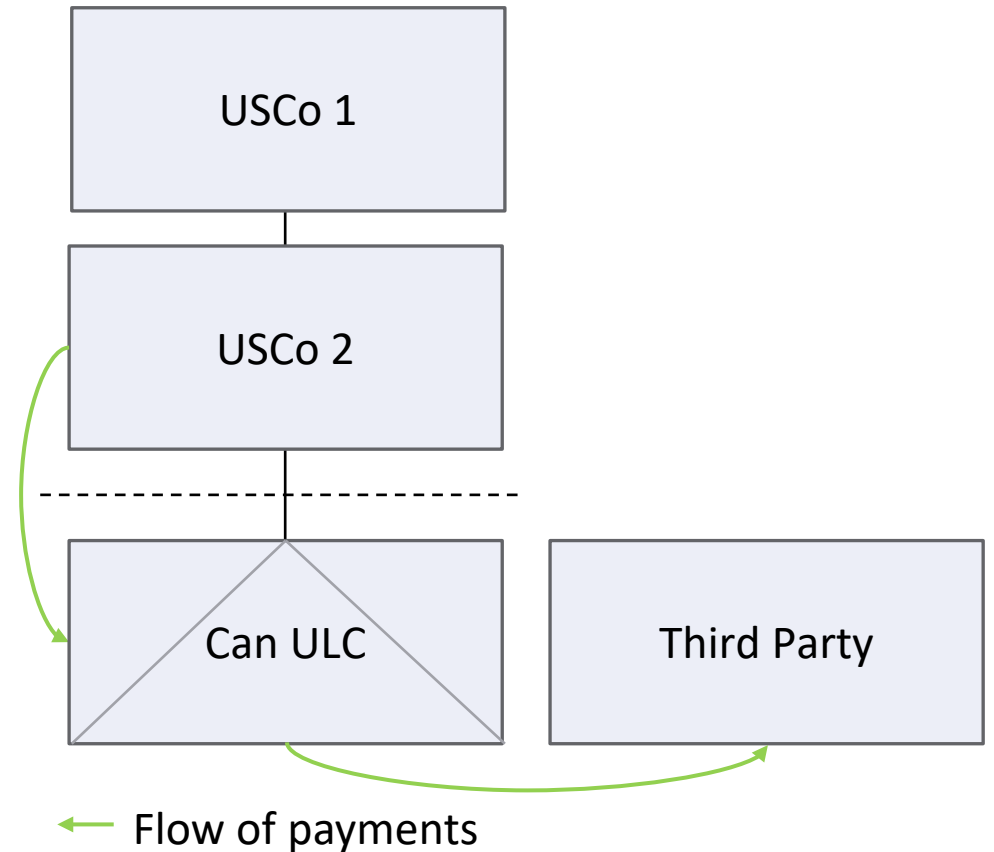
Hybrid payer arrangement – 2 (Joint Committee)

- Consider that USCo 1 and USCo 2 are part of a consolidated group for US tax purposes
- USCo 1 makes a service fee payment of \$100 to Can ULC
- Can ULC makes deductible R&D expense payment of \$90 to Third Party in Canada
- \$90 is the double deduction amount, and the service fee of \$100 is dual inclusion income
- There is no hybrid payer mismatch amount as the double deduction does not exceed the dual inclusion income of the year



Hybrid payer arrangement – 3 (Joint Committee)

- USCo 2 makes a service fee payment of \$100 to Can ULC
- Can ULC makes a deductible R&D expense payment of \$90 to Third Party in Canada
- \$90 is the double deduction amount
- There is no dual inclusion income as the receipt by Can ULC from USCo 2 is disregarded for US tax purposes
- There is a hybrid payer mismatch amount as the double deduction exceeds the dual inclusion income
- In Canada, there is an income inclusion for the service fee but no deduction for the expense payment by Can ULC



Imported Hybrid Arrangement



Young IFA Network

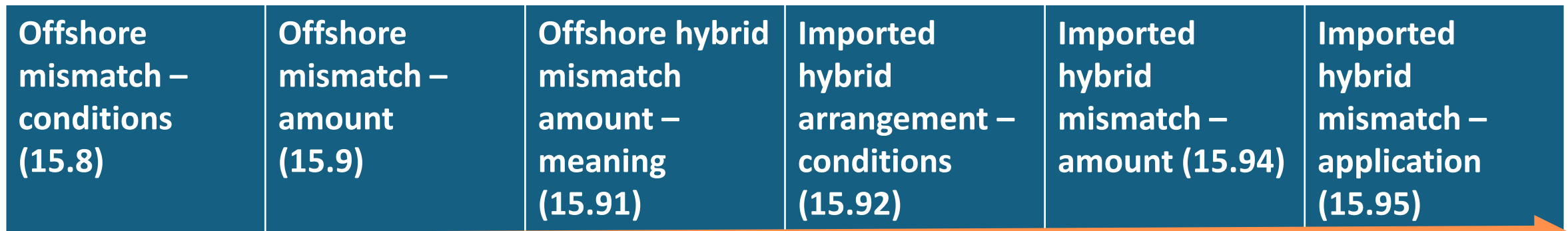
Imported hybrid arrangement

Step 1: Determine offshore mismatch (D/NI or DD mismatch if those concepts applied to non-Canadian entities)

Step 2: Determine whether the offshore mismatch is caused by “hybridity”

Step 3: Link an offshore hybrid mismatch amount to a deductible payment (importing payment) of a Canadian taxpayer and determine amount

Step 4: Deems the denial rule in s. 18.4(4) to apply to the importing payment



Imported hybrid arrangement

- **(15.8) Offshore mismatch – conditions**

- There is a D/NI mismatch that is not neutralized, considering only mismatches involving deductions under foreign tax law, or
- There is a DD mismatch that is not neutralized, taking into considerations deductions in two different foreign jurisdictions

- **(15.9) Offshore mismatch – amount**

- D/NI offshore mismatch amount:
 - Amount by which the deductions in respect of the payment exceed all inclusions
- DD offshore mismatch amount:
 - The lesser of the aggregate amount deductible in either country in respect of the payment

Imported hybrid arrangement

(15.91) Offshore hybrid mismatch – amount

- Determines if an offshore mismatch is caused by hybridity
- If there is an offshore mismatch that is a D/NI mismatch:
 - The amount of the mismatch that would be determined under mismatch rules contained in the first package of HMA rules or under reverse hybrid or disregarded payment mismatches, reading the rules with various alterations
- If there is an offshore mismatch that is a DD mismatch:
 - The amount of the mismatch that would be determined under a hybrid payer mismatch, reading the rules with various alterations

Imported hybrid arrangement

(15.92) Imported hybrid mismatch – conditions

- The “importing payment” would be deductible in computing income from a business or property in Canada
- The recipient of the importing payment is not a resident in Canada
- The payer of the mismatch payment is either the recipient of the importing payment, or recipient of another payment included in a series of payments that includes the importing payment
- Payers of the mismatch payment and the importing payment do not deal at arm’s length, or those payments arise under or in connection with a foreign structured arrangement

Imported hybrid arrangement

(15.94) Imported hybrid mismatch – amount

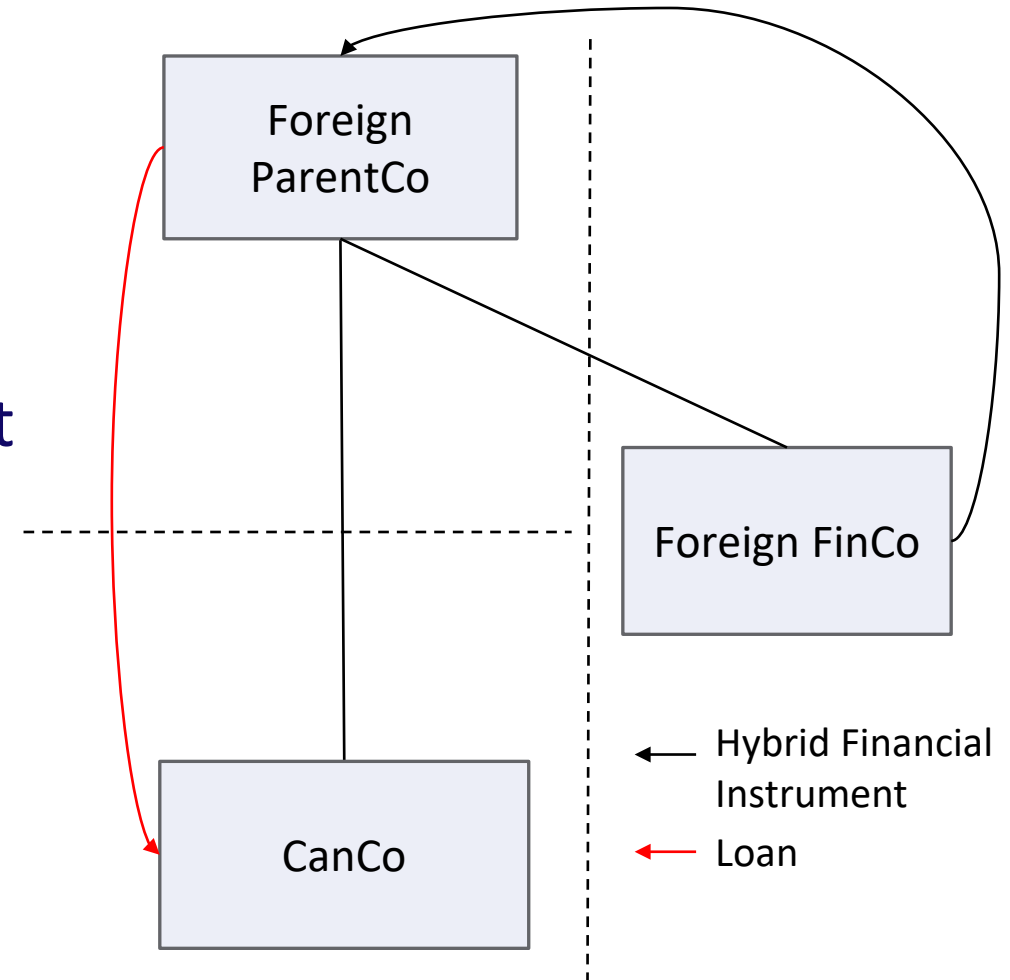
- The lesser of:
 - The offshore hybrid mismatch amount minus the amount that is already denied as a deduction under the Canadian imported hybrid mismatch rule or a substantially similar foreign rule, and
 - The offshore hybrid mismatch amount, or if there is a series of payments, the least of the amounts deductible by any entity in the series of payments

(15.95) Imported hybrid mismatch – application

- Deems s. 18.4(4) to apply to the importing payment, and attributes an imported hybrid mismatch amount to a particular tax year

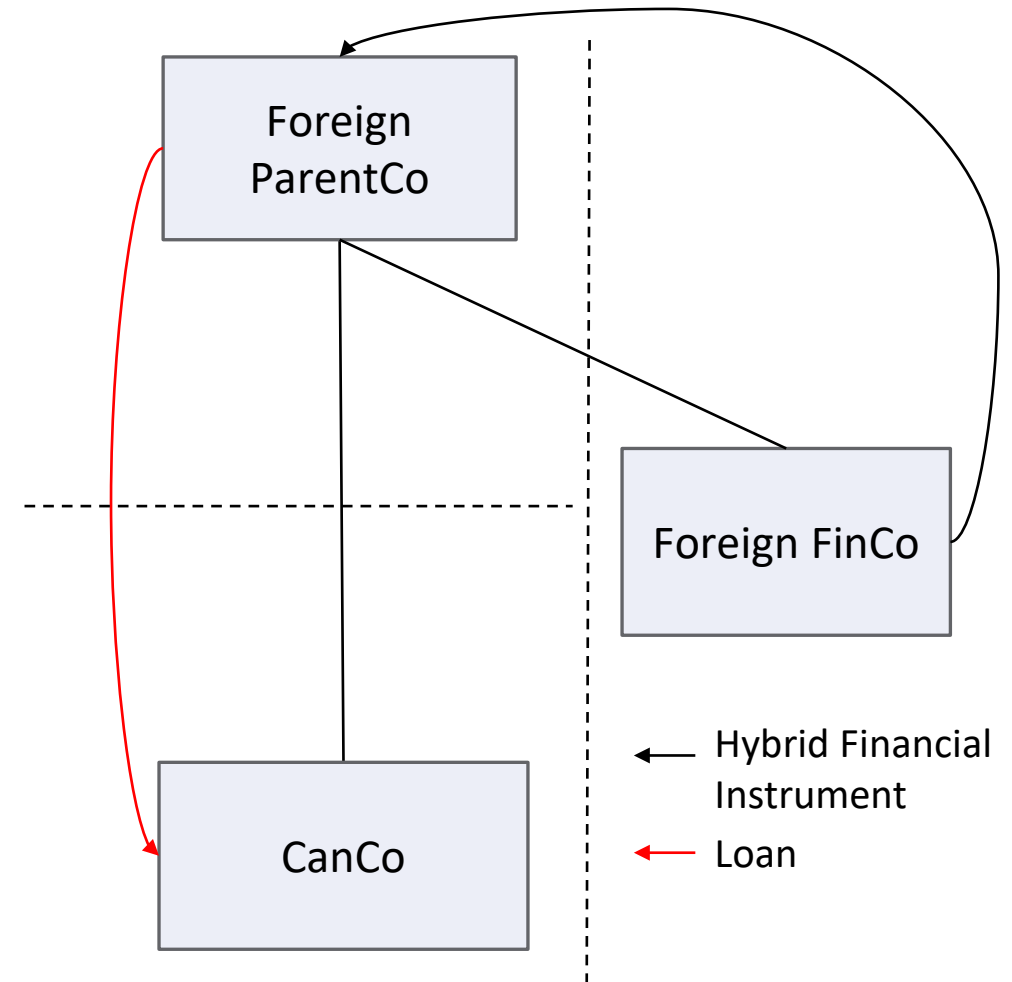
Imported hybrid mismatch

- Foreign FinCo intends to lend to CanCo under a hybrid instrument (equity to Foreign FinCo; debt to CanCo)
- Instead, Foreign ParentCo is used as an intermediary, as its jurisdiction does not have anti-hybrid rules
- Foreign FinCo lends to Foreign ParentCo under hybrid instrument; Foreign ParentCo lends to CanCo
- CanCo and Foreign ParentCo have deductible payments



Imported hybrid mismatch

- The imported hybrid mismatch rules require determining whether hybridity in a foreign jurisdiction leads to a D/NI or DD outcome in foreign jurisdictions
- If the deduction is not denied in the foreign jurisdiction, it should be denied in Canada



Things to watch for

- D/NI and DD outcomes anywhere in the structure
- Hybrid entities, dual-resident entities, branches, partnerships
 - Including ULCs and LLCs
- Hybrid financial instruments
- Foreign consolidated groups
- Partial ownership of hybrid entities
- Tax relief that takes income out of “ordinary income”
- Broad anti-avoidance rule
- Revised draft legislation

Questions?



Young IFA Network