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Canadian anti-hybrid tax legislation released in draft

MAY 4, 2022 9 MIN READ

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On April 29, 2022, the Department of Finance released the first of two packages of draft legislation to implement its proposals to eliminate the tax benefits of certain hybrid mismatch arrangements. These proposals were first announced in the 2021 Federal Budget and are generally aimed at situations where a payment is made under a hybrid arrangement that gives rise to a deduction for the payer but no corresponding income inclusion for the recipient (deduction/non-inclusion mismatch).

The legislation implements recommendations made in the first two chapters of the OECD's Report on Neutralising the Effects of Hybrid Mismatch Arrangements (the OECD Action 2 Report). The government had originally targeted the release of this first package of draft legislation in 2021. Although the draft legislation was released more than a year after Budget 2021, the government nevertheless intends for the new rules to apply to payments arising on or after July 1, 2022. The public is invited to comment on the draft legislation by June 30, 2022, only one day before the draft legislation is intended to apply.

The news release that accompanied the draft legislation indicated that the second package of draft legislation (which is intended to address the remaining recommendations in the OECD Action 2 Report) will be released "at a later date", and that it will not apply before 2023.

Main features

There are three main operative rules. The "primary rule" in proposed subsection 18.4(4) denies deductibility of certain payments made by a Canadian taxpayer to the extent of any "hybrid mismatch amount". This rule applies where the otherwise deductible payment is not included in computing the foreign income of a non-resident recipient.

A "secondary rule" in proposed section 12.7 requires a Canadian taxpayer to include any hybrid mismatch amount in computing income. This rule applies where the payment is deductible in computing the foreign income of a non-resident payer, but would otherwise not result in taxable income to the Canadian recipient. The secondary rule is intended not to apply where the payor is subject to a comparable primary rule that would deny deductibility of the payment in the foreign jurisdiction.

A third rule in proposed subsection 113(5) limits the ability of a Canadian taxpayer to claim a section 113 dividend received deduction on a dividend paid by a foreign affiliate to the extent the foreign affiliate benefits from a foreign income tax deduction in respect of the dividend. The secondary rule under section 12.7 and the denial of a dividend received deduction under subsection 113(5) are not intended to apply to the same payment.

"**Hybrid mismatch amount**" is the amount of certain "deduction/non-inclusion mismatches" (i.e., where there is a deduction for the payor but no corresponding income inclusion for the payee in the year or a subsequent tax year that begins no more than 12 months thereafter).

A hybrid mismatch amount can arise in one of three situations: a hybrid financial instrument arrangement, a hybrid transfer arrangement or a substitute payment arrangement. For purposes of these definitions, the following is a high-level summary of these three terms:

- **Hybrid financial instrument arrangement**: an arrangement where a payment relating to a financial instrument (broadly defined for the purposes of these rules), or related transactions, gives rise to a deduction/non-inclusion mismatch where it can reasonably be considered that the deduction/non-inclusion mismatch either
  - arises due to a difference in how the financial instrument (or related transactions) is treated for tax purposes under the laws of more than one country that is attributable to the financial instrument's terms or conditions (or transactions); or
  - would arise due to such a difference if any other reason for the deduction/non-inclusion mismatch were disregarded.

  A separate provision, subsection 18.4(9), governs mismatches relating to the deduction of a notional interest expense on a debt in a foreign country for purposes of the potential application of the hybrid financial instrument arrangement definition.

  The explanatory notes to the draft legislation provide examples of how the primary rule and secondary rule are intended to apply to hybrid financial instrument arrangements in the inbound and outbound contexts.

  - *Inbound example*: Forco is the parent of Canco and Newco, a foreign entity that is fiscally transparent under the relevant foreign law but considered a non-resident corporation under Canadian income tax law. Forco loans money to Canco, and Newco enters into a forward subscription agreement to acquire shares of Canco. Under a support agreement, Forco agrees to provide sufficient capital to Newco to allow Newco to satisfy its obligations under the forward subscription agreement. For Canadian tax purposes, Canco deducts interest paid on the loan owing to Forco. For foreign tax purposes, payments from Canco to Forco are treated as non-taxable stock dividends. The primary rule in section 18.4 is intended to apply to deny Canco the ability to deduct the interest paid to Forco.
  - *Outbound example*: Canco makes an interest-free loan to Forco, a controlled foreign affiliate (CFA), which uses the proceeds of the loan to earn income from an active business. If Forco is allowed for foreign tax purposes to deduct a notional amount of interest on the loan (such as under the transfer pricing rules in the relevant foreign jurisdiction), subsection 18.4(9) is intended to deem there to be a corresponding payment of interest on the loan. The secondary rule in section 12.7 is intended to apply to include that notional amount of interest in computing the income of Canco for Canadian tax purposes.
- **Hybrid transfer arrangement**: an arrangement where a payment relating to the transfer of all or part of a financial instrument (or related transactions), including a disposition, loan or other transfer, gives rise to a deduction/non-inclusion mismatch where it can

reasonably be considered that the deduction/non-inclusion mismatch arises due to any of

- a difference in how two countries treat the payment if it is made as compensation for a particular payment under the transferred financial instrument (namely, one country treats the payment as having the same character as the particular payment while another country treats the payment as a deductible expense);
- one country treating the transactions as equivalent to borrowing/other indebtedness while another country does not; or
- a difference in which entity two countries view as having made the payment due to a difference in how the countries treat one or more transactions included in the transfer arrangement, either alone or together.

The explanatory notes to the draft legislation provide an example of how the secondary rule is intended to apply to a hybrid transfer arrangement in the outbound context.

- *Outbound example*: Canco has two CFAs, Forco1 and Forco2, which are both resident in the same foreign country. Forco1 is the parent of Forco2. Forco1 sells Forco2's shares to Canco, and agrees to repurchase the shares after one year for a higher amount (a repo transaction). Canco receives dividends from Forco2 during the year. The repurchase price is reduced by the amount of any dividends received. For foreign tax purposes, the arrangement is treated as a secured loan such that Forco 1 is entitled to deduct the amount of dividends paid to Canco. For Canadian tax purposes, the payment received by Canco is treated as a dividend paid out of exempt surplus such that there is no net taxable income to Canco. The secondary rule in section 12.7 is intended to apply to include the amount of the dividends paid by Forco 1 in computing the income of Canco for Canadian tax purposes.

- **Substitute payment arrangement**: generally, an arrangement where a payment relating to an arrangement under which all or a portion of a financial instrument is disposed of, loaned or otherwise transferred by an entity to another entity where the payment relates to either another payment (the underlying return) arising under the financial instrument or revenue, profit, cash flow, commodity price or any other similar criterion.

Hybrid financial instrument arrangements, hybrid transfer arrangements and substitute payment arrangements must either involve participants who do not deal at arm's length or "structured arrangements", meaning transactions giving rise to a deduction/non-inclusion mismatch that are either priced to reflect the economic benefit of that mismatch or are otherwise designed to give rise (directly or indirectly) to the deduction/non-inclusion mismatch.

A limited exception to the application of proposed sections 12.7 and 18.4 is provided where a Canadian taxpayer enters into a structured arrangement and it is not reasonable to expect that the taxpayer — plus entities not acting at arm's length and "specified entities" (generally, owning at least 25% of votes or equity value) — were aware of the deduction/non-inclusion mismatch at the time, nor that any of them shared in any economic benefit arising from the mismatch.

Administration

Proposed subsection 18.4(2) provides that the three key anti-hybrid provisions — sections 18.4, 12.7 and 113(5) — should be interpreted consistently with the OECD Action 2 Report, as amended from time to time, "unless the context otherwise requires". This would seem to be the first time that the *Income Tax Act* (Canada) (the Act) directly invokes OECD materials as an interpretive aid for a taxing provision impacting the computation of taxable income. The reference to "unless the context otherwise requires" is likely intended to address — at least in part — the differences between the OECD Action 2 Report and the draft legislation. As set out in the explanatory notes, key differences include using Canadian income tax concepts for the relevant definitions, providing for the deduction of an amount denied under subsection 18.4(4) if the taxpayer is able to show that the amount was included in income for foreign tax purposes, the income inclusion under subsection 18.4(9) for a notional interest expense, and deeming an interest expense to be a dividend subject to withholding tax if its deduction is denied under section 18.4.

A specific anti-avoidance rule in proposed subsection 18.4(20) would eliminate a deduction/non-inclusion mismatch or other outcome that is "substantially similar to a deduction/non-inclusion mismatch" in certain circumstances. Notably, although one of the main purposes of the relevant transaction or series of transactions must be to avoid or limit the application of proposed subsections 12.7(3), 18.4(4) or 113(5), unlike the general anti-avoidance rule, subsection 18.4(20) does not require that there be any misuse or abuse of those provisions (or any others).

All of the proposed measures would apply to payments arising on or after July 1, 2022 — only two months after the draft legislation was released, and one day after the deadline for public feedback.

Commentary and next steps

The draft legislation is consistent with the intentions expressed in Budget 2021. The legislation is drafted broadly and will have to be carefully reviewed to determine its exact application. The clause that attempts to incorporate the OECD's intentions into the legislation by directing interpretations of the legislation to be consistent with the OECD Action 2 Report raises questions about the effectiveness of such clauses. In particular, the proposals effectively purport to delegate to the OECD the ability to amend the interpretation of Canadian law through the OECD's ability to amend the OECD Action 2 Report at any time.

The proposed legislation comes against the backdrop of the CRA challenging certain hybrid structures under existing transfer pricing rules in the Act, while the Department of Finance has announced its intention to consult on potential revisions to Canada's existing transfer pricing and anti-avoidance rules. Together with the international tax reform proposed by Canada and the other members of the G20/OECD Inclusive Framework, this could result in significant changes and uncertainty for multinational enterprises.

Taxpayers who are potentially affected by the proposed rules should review the draft legislation carefully, and consider making their voice heard by means of a submission by the June 30, 2022 deadline. If you have any questions or require additional analysis of the draft legislation or other Canadian tax matters, please contact any member of our National Tax Department.