The Joint Committee on Taxation of
The Canadian Bar Association

and

Chartered Professional Accountants of Canada

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June 30, 2022

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Dear Mr. McGowan:

Subject: Hybrid Mismatch Arrangements Proposals

This submission sets out comments of the Joint Committee on Taxation of the Canadian Bar Association and Chartered Professional Accountants of Canada ("Joint Committee") with respect to the Hybrid Mismatch Arrangements proposals that were included as part of the draft legislation that was released on April 29, 2022.

The Joint Committee gratefully acknowledges the willingness of the Department of Finance to engage in open discussions concerning these measures, and it is our hope that our dialogue will continue.

Members of the Joint Committee and others in the tax community participated in the discussion concerning this submission and contributed to its preparation, including:

- Bruce Ball – CPA Canada
- Byron Beswick – KPMG Law LLP
- Ian Bradley – PwC Law LLP
- David Bunn – Deloitte LLP
- Ian Crosbie – Davies Ward Phillips & Vineberg LLP
- Nik Diksic – EY Law LLP
- Glenn Ernst – Goodmans LLP
- Amanda Heale – Osler, Hoskin & Harcourt LLP
- Hugh Neilson – Kingston Ross Pasnak LLP
- Angelo Nikolakakis – EY Law LLP
- Sabrina Wong – KPMG Law LLP

If it would be helpful, members of the Committee would be pleased to discuss the issues in more detail.

Yours very truly,

David Bunn
Chair, Taxation Committee
Chartered Professional Accountants of Canada

Carrie Smit
First Vice-Chair, Taxation Section
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Cc:

- Shawn Porter, Associate Assistant Deputy Minister, Tax Legislation, Department of Finance

Submission of the Joint Committee on Taxation of The Canadian Bar Association and Chartered Professional Accountants of Canada

April 29, 2022 Draft Legislation on the Hybrid Mismatch Arrangements Proposals

This submission sets out our comments and recommendations on the draft legislative proposals to the *Income Tax Act* (Canada) (the "Act"), released on April 29, 2022, that would address hybrid mismatch arrangements.

In this submission, we provide our comments and recommendations on certain key elements of the proposals. Given the complex nature of the proposed rules and the limited consultation period, we have focused our comments on key areas with broad impact. We would be pleased to discuss the issues in more detail.

1. Effective Date

The proposed legislation released on April 29, 2022 represents the first of two legislative packages addressing hybrid mismatch arrangements. These two legislative packages were first described in the 2021 federal budget, as part of a proposal to introduce hybrid mismatch rules. The 2021 budget indicated that the hybrid mismatch rules would be consistent with the recommendations of Action 2 of the BEPS Action Plan, with appropriate adaptations for the Canadian tax context. It was also stated in the 2021 budget that the first legislative package, addressing mainly deduction/non-inclusion mismatches described in Chapters 1 and 2 of the BEPS Action 2 Report, including those arising from hybrid financial instruments, would be released for stakeholder comment in 2021, and would apply as of July 1, 2022. The second legislative package, addressing other hybrid mismatch arrangements, would be released for released for stakeholder comment after 2021, and would apply no earlier than 2023.

The anticipated timeline set out in the 2021 budget for the first legislative package of hybrid mismatch rules provided a period of more than six months between the introduction of the proposed legislation and its effective date. However, although the release of the proposed legislation occurred on April 29, 2022, the July 1 effective date had not been changed. Further, the deadline for submissions for the proposed legislation is June 30, one day before the effective date. This reduced comment period may not provide sufficient time for stakeholders to provide meaningful commentary on the proposed legislation, or for affected taxpayers to restructure their affairs to comply with this legislation.

While the implications raised by this short comment period are relevant for all elements of the proposed legislation, the issues are particularly acute for those elements that depart from the

recommendations of the BEPS Action 2 Report. The 2021 budget provided little detail on the structure of the proposed hybrid mismatch rules, aside from the above-noted reference to parts of the BEPS Action 2 Report. This reference provided some guidance for stakeholders, to the extent the proposed rules align with the Action 2 Report. However, the proposed rules go beyond the recommendations of the Action 2 Report in certain key respects. In particular:

- Proposed subsection 214(18) deems an interest payment that is non-deductible under proposed subsection 18.4(4) to be a dividend for withholding tax purposes; and
- Proposed subsection 18.4(9) generally deems a debt on which a notional interest deduction is available to be a hybrid mismatch arrangement (which is contrary to the approach to notional interest deductions proposed in the Action 2 Report).

We submit that it would be difficult for stakeholders to have anticipated the above measures, based on the information available before the release of the proposed legislation on April 29, 2022. Providing additional time to respond to these measures therefore seems particularly appropriate.

Recommendations:

1.1 The Department of Finance ("Department") should consider postponing the effective date of the proposed legislation, to provide more time for taxpayers and other stakeholders to respond to these proposals and provide comments, and for the Department to consider any necessary revisions.

1.2 If the effective date for the proposed legislation as a whole is not postponed, the Department should consider postponing the effective date of proposed subsections 18.4(9) and 214(18).

2. Recognition of Foreign Withholding Tax

Where proposed subsection 113(5) applies to a dividend received by a corporation resident in Canada from a foreign affiliate of the corporation, no deduction is available under subsection 113(1) for foreign withholding tax paid on the dividend. In addition, while a dividend subject to proposed subsection 113(5) is deemed not to be a dividend received by the corporation for the purposes of section 113, the dividend remains "income from a share of the capital stock of a foreign affiliate of the taxpayer", such that no foreign tax credit under subsection 126(1) nor deduction under subsection 20(12) is available in respect of foreign withholding tax paid on the dividend.

Given that the deduction of the dividend in the foreign country (which would trigger the application of proposed subsection 113(5)) would generally not reduce withholding tax on the

dividend, this result seems inappropriate. The result is particularly inappropriate where the foreign tax system provides a "dividends paid" deduction because equivalent tax is instead imposed at the shareholder level. Denying a deduction under section 113 in these circumstances would produce double taxation.

While the BEPS Action 2 report indicates that a payment should not be treated as included in ordinary income simply because it has been subject to withholding tax at source,[1] we do not believe that this is relevant to the availability of a credit or grossed-up deduction in the recipient country for withholding tax paid to the payer jurisdiction. The BEPS Action 2 Report is merely stating that withholding taxes do not neutralize hybrid mismatches and thus the primary rule to prevent deduction in the payer jurisdiction may still apply in cases in which the payer jurisdiction imposes withholding tax on the payment. Neither this statement nor Recommendation 2.1 of the BEPS Action 2 Report that proposed subsection 113(5) is intended to implement suggest that there should not be relief for double taxation. Where 113(5) applies, there should be relief for withholding tax paid on the dividends.

Where interest paid by a foreign affiliate to the Canadian taxpayer on an ordinary debt instrument without hybridity is deductible in computing the foreign affiliate's foreign income, the interest is included in the Canadian taxpayer's income, but the Canadian taxpayer is also entitled to relief from foreign withholding tax paid on such interest under either subsection 126(1) or subsection 20(12). We also note that such Canadian relief in respect of foreign withholding taxes is not intended to reduce Canadian Ordinary Income under subparagraph (a)(iii) of that definition in proposed subsection 18.4(1). Thus, we do not believe providing relief for foreign withholding tax paid on dividends that are subject to proposed subsection 113(5) would allow taxpayers to obtain more favourable tax treatment by using a hybrid instrument to finance a foreign affiliate.

Recommendations:

2.1 We recommend that relief be provided for foreign withholding tax paid on dividends that are subject to proposed subsection 113(5) by modifying proposed subsection 113(5) to allow grossed-up deductions for such withholding tax.

2.2 We suggest that it would be appropriate to provide such relief for all dividends subject to proposed subsection 113(5). Accordingly, we suggest that proposed subsection 113(5) include a rule that deems all dividends that are subject to proposed subsection 113(5) to be taxable surplus dividends received for the purposes of subparagraph 113(1)(c)(i), allowing the taxpayer to access the grossed-up deduction in subparagraph 113(1)(c)(i).

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[1] Paragraph 407 of the BEPS Action 2 Report.

3. Application to Foreign Affiliates

It is not entirely clear whether the proposed rules would be applicable in the context of transactions involving foreign affiliates of taxpayers resident in Canada (ignoring situations in which a foreign affiliate may itself be a non-resident taxpayer with Canadian-source income). In general, under paragraph 95(2)(f), a foreign affiliate is deemed to be a taxpayer resident in Canada for the purposes of computing, among other things, its income or loss from property, from a business other than an active business and from a non-qualifying business. This treatment does not apply to the extent otherwise provided or to the extent that the context otherwise requires. For example, under clause 95(2)(f.11)(ii)(A), the income imputation/attribution rules in subsection 17(1) and section 91 are specifically excluded, as are the thin-capitalization rules in subsection 18(4), among other provisions.

We believe that a similar approach should be taken in the context of the proposed hybrid mismatch rules. In particular, we understand that the purpose of these rules is primarily to protect the Canadian tax base. Thus, the application of these rules would seem to be inappropriate in relation to the computation of income from an active business, including income from property that is recharacterized as income from an active business under subsection 95(2). Furthermore, in the context of the computation of income from property, or other income, that is included in a foreign affiliate's foreign accrual property income (FAPI), we do not see any need for the application of these rules, in the sense that we are not aware of circumstances in which Canadian base erosion would arise as a result of any foreign hybrid mismatch outcomes. As FAPI is computed in accordance with Canadian rules and principles, the foreign tax treatment of a particular payment should not affect the computation of FAPI, and thus should not result in any Canadian base erosion risks.

Even in a circumstance where, for example, a FAPI-earning controlled foreign affiliate has issued a financial instrument that is treated as debt from a Canadian perspective and as equity from a foreign tax perspective, it seems to us to be inappropriate to deny a deduction in computing such FAPI through an extension to such context of the proposed hybrid mismatch rules. If that instrument had instead been treated as equity from a Canadian perspective, such that there would not have been any deduction in computing FAPI in respect of payments on that instrument, the existence of the instrument would have in any event resulted in a reduction of the Canadian taxpayer's participating percentage in respect of the affiliate, and thus a corresponding reduction of attributed FAPI.

This is consistent with the exclusion of subsection 18(4) mentioned above, in the sense that the thin-capitalization rules also reflect an effort to address the substitutability of debt for equity. Their application in the context of computing FAPI would result in the taxation of what could be regarded as phantom income – that is, income computed for tax purposes which does not reflect

a true and substantive economic entitlement held by a taxpayer resident in Canada. The same would be true with regard to the application of the proposed hybrid mismatch rules in the foreign affiliate context.

Thus, we believe it would be preferable to simply exclude the application of proposed sections 12.7 and 18.4 from the foreign affiliate context.

If the proposed rules are to apply to foreign affiliates in certain circumstances, further discussion would be needed regarding the specific circumstances in which they apply, and the consequences of their application. A particular concern relates to the possibility of proposed section 12.7 and proposed subsection 18.4(9) applying in the foreign affiliate context. While proposed subsection 18.4(9) may deem a payment to have been made for certain purposes, these do not include the recharacterization rules in subsection 95(2). Thus, the application of proposed subsection 18.4(9) in the foreign affiliate context could result in FAPI even in circumstances in which no FAPI would arise if an actual payment had been made. One possibility in this context would be to extend the scope of the application of proposed subsection 18.4(9) to subsection 95(2). However, this could create inordinate complexity and inappropriate results in relation to the computation of surplus accounts and their consistency with the location of economic value within a foreign affiliate group. Other issues that should be discussed in this context include whether the proposed rules should apply in computing a foreign affiliate's income from a hybrid mismatch arrangement, in circumstances where, if the foreign affiliate received an interest payment under the arrangement, that payment would be included in active business income under paragraph 95(2)(a).

Recommendations

3.1 Clause 95(2)(f.11)(ii)(A) should be expanded to exclude the application of proposed sections 12.7 and 18.4 in computing a foreign affiliate's income from property, income from a business other than an active business and income from a non-qualifying business. A corresponding amendment should also be made in subparagraph (a)(iii) of the definition of "earnings" in subsection 5907(1) of the Income Tax Regulations.

3.2 If this recommendation is not accepted, further discussions should be conducted regarding the specific circumstances in which proposed sections 12.7 and 18.4 should apply in computing the income of a foreign affiliate, and the consequences of the application of proposed sections 12.7 and 18.4 in these circumstances. Among other things, we submit that it would be appropriate to extend the application of proposed subsection 18.4(9) to subsection 95(2), and to make any further adjustments as may be required so that the FAPI consequences arising therefrom would parallel those that would arise in the context of an actual payment, as well as any adjustments required to achieve appropriate surplus consequences.

4. "Canadian Ordinary Income" & "Foreign Ordinary Income" Definitions

Concerns have been raised with respect to certain aspects of the wording of the definitions of "Canadian ordinary income" and "foreign ordinary income" in proposed subsection 18.4(1).

Deductions in respect of Other Payments

With respect to the definition of Canadian ordinary income, one concern arises in relation to subparagraph (a)(iii), which is intended to reverse what would otherwise be counted as an income inclusion under paragraph (a), as follows:

> (iii) the amount can otherwise reasonably be considered to be excluded, reduced, offset or otherwise effectively sheltered from tax under this Part by reason of any exemption, exclusion, deduction, credit (other than a credit for a tax substantially similar to tax under Part XIII) or other form of relief under this Act that
>
> (A) applies specifically in respect of all or a portion of the amount and not in computing income generally, or
>
> (B) arises in respect of the payment;

In particular, the concern relates to the reference to a "deduction" in combination with the very broad references to "offset" and "effectively sheltered". For example, if a taxpayer borrows money at interest from a third party for the purpose of making an interest-bearing loan to a subsidiary, the taxpayer's interest revenues would be expected to result in Canadian ordinary income. However, concerns have been expressed that the taxpayer's interest expense relating to its third-party borrowings could be viewed as an item that results in a deduction that offsets or otherwise effectively shelters from tax its interest revenues, thereby eliminating its Canadian ordinary income. We acknowledge that this would not be the case unless the conditions in clause (A) or (B) are satisfied, and that is part of the uncertainty. The jurisprudence generally gives a very broad meaning to references to "in respect of", which appear in both clauses. While clause (A) also refers to "and not in computing income generally", which would seem to limit the preceding portion of that clause, there is no such limitation in clause (B) – for example, a reference to "and not in respect of a different amount" (i.e., the amount paid by the taxpayer, which is a different amount from the amount received).

The same concern arises under subparagraph (ii) of the description of A in paragraph (b) of this definition, and the description of G in paragraph (c) of this definition, which refer back to subparagraph (a)(iii) of this definition. Similarly, this concern arises under the description of D in the definition of foreign ordinary income.

Based on the discussion in the Explanatory Notes, the restrictions in subparagraph (a)(iii) of the definition of Canadian ordinary income and D in the definition of foreign ordinary income appear to be targeted at relief that is available by virtue of receiving a payment – e.g., a participation exemption or dividends received deduction that is provided to a parent company in respect of dividends received from a subsidiary. The scope of these restrictions could be clarified by replacing the phrase "arises in respect of the payment" with "arises by virtue of receiving the payment" (or a similar phrase). This change would confirm that in the example above, the interest payment received by the taxpayer from its subsidiary would be included in Canadian ordinary income, notwithstanding that the taxpayer also deducts its interest expense on the third party borrowing (as the deduction for the third party interest expense would not arise by virtue of the taxpayer receiving the interest payment from the subsidiary).

Payments Received by Tax Exempt Entities

There is also uncertainty relating to the interpretation of elements of the definition of foreign ordinary income in cases involving tax-exempt entities, entities located in jurisdictions that do not impose an income tax on entities, and entities that are located in jurisdictions that impose an income tax on entities at variable rates or at rates below the rates imposed on individuals or other types of entities.

In particular, we note the description of J in that definition, which refers to "the highest rate at which an income or profits tax imposed by the government of the country is charged in respect of an amount of income in respect of a financial instrument". It is not clear whether this description is intended to be satisfied where, for example, a jurisdiction imposes an income tax on individuals but a lower rate (or does not impose an income tax) on entities, or where the jurisdiction imposes an income tax on entities at a rate that depends on the overall amount of an entity's income for the year. In brief, while the Explanatory Notes indicate that the description of F is intended to identify preferential regimes in respect of financial instruments, they do not clarify this point and the operative language could be interpreted in a broader manner.

We also note an uncertainty as to whether the description of B in this definition could be satisfied where an entity is located in a jurisdiction that does not impose an income tax on the entity. The description and related Explanatory Notes refer to an entity being "subject to an income or profits tax that is charged at a nil rate". They do not clarify whether this would include an entity that is located in a jurisdiction that does not impose an income tax on the entity.

Recommendation:

4.1 The relevant portions of the definitions of Canadian ordinary income and foreign ordinary income (as noted above) should be clarified such that inclusions in respect

of a particular amount are not reversed as a result of any deductions or other relief that may be applicable as a result of other payments – that is, payments other than the payments that give rise to the included amounts. This could be achieved by replacing the phrase "arises in respect of the payment" in subparagraph (a)(iii) of the definition of Canadian ordinary income and D in the definition of foreign ordinary income with the phrase "arises by virtue of receiving the payment".

4.2 The relevant portions of the definition of foreign ordinary income should be clarified with respect to their application in relation to tax-exempt entities, entities located in jurisdictions that do not impose an income tax on entities, and entities that are located in jurisdictions that impose an income tax on entities at variable rates or at rates below those applied to individuals or other types of entities.

5. Proposed Subsection 18.4(2)

Proposed subsection 18.4(2) is an interpretive rule providing that, unless the context otherwise requires, proposed sections 18.4, 12.7 and subsection 113(5) (i.e., the primary rule, secondary rule and the foreign affiliate dividend deduction denial rule, respectively) are to be interpreted consistent with the BEPS Action 2 Report, as amended from time to time. The Explanatory Notes for subsection 18.4(2) further state that the examples in Annex B of the BEPS Action 2 Report are instructive as to the intended scope and application of the hybrid mismatch rules, again unless the context otherwise requires.

The proposed rules in sections 18.4 and 12.7 address the hybrid mismatch arrangements discussed in Chapter 1 and Recommendation 2.1 of the BEPS Action 2 Report; generally speaking, these are deduction/non-inclusion outcomes and similar outcomes relating to financial instruments. The BEPS Action 2 Report also addresses additional types of potential hybrid mismatch arrangements, such as hybrid entities and dual resident entities, and other types of outcomes, such as double deduction outcomes. Similarly, the examples in Annex B of the BEPS Action 2 Report are not limited to the types of hybrid mismatch arrangements addressed in the proposed hybrid mismatch rules. Consequently, the reference in proposed subsection 18.4(2) to the BEPS Action 2 Report (including Annex B) in its totality creates some confusion as to the scope of the proposed legislation. This is so particularly in light of the anti-avoidance rule in proposed subsection 18.4(20), which can result in the hybrid mismatch rules applying to outcomes that are "substantially similar" to a deduction/non-inclusion mismatch. We assume that proposed subsection 18.4(2) is currently intended to refer only to Chapter 1 and section 2.1 of Chapter 2 of the BEPS Action 2 Report, and that the context prevents other portions of that report from being relevant in interpreting the first package of proposed hybrid mismatch rules. However, we believe that it would be helpful to clarify the current scope of proposed subsection

18.4(2), and how this scope might change once the second package of proposed legislation is released.

Recommendation:

5.1 We recommend the Department revise proposed subsection 18.4(2) to state that proposed sections 18.4 and 12.7 and subsection 113(5) are to be interpreted consistent with Chapter 1 and section 2.1 of Chapter 2 of the BEPS Action 2 Report, with similar revisions to the Explanatory Notes. Alternatively, the scope of proposed subsection 18.4(2) could be clarified in the Explanatory Notes, particularly if proposed subsection 18.4(2) is to be relevant to the second package of hybrid mismatch legislation yet to be released.

6. Proposed Subsection 18.4(6): Application to Deductible Amounts

Variable "C" of proposed paragraph 18.4(6)(b) determines whether a payment gives rise to a deduction/non-inclusion mismatch by reference to whether the payment would be, or would reasonably be expected to be, in the absence of any foreign expense restriction rule, deductible in computing foreign income. It appears the test of "deductible" as opposed to a test of "deducted" could give rise to double taxation due to the application of proposed section 12.7 where there is in fact no deduction taken in the foreign jurisdiction. This issue is particularly relevant for the notional interest expense rule in proposed subsection 18.4(9), which does not require an actual payment.

Recommendations:

6.1 We recommend that the test of "deductible" be changed to a test of "deducted", at the very least, in proposed subsection 18.4(9).

6.2 Recognizing the Department's concerns with the administrative difficulties that may potentially result from a test based on actual deductions, as an alternative to changing the test from "deductible" to "deducted", we recommend that either:

- **a) the amount of hybrid mismatch amount included in the taxpayer's income under proposed subsection 12.7(3) be reduced to the extent the taxpayer demonstrates that an amount is not deducted in respect of the payment in the foreign jurisdiction; or**
- **b) similar to the approach taken in proposed paragraph 20(1)(yy), we recommend that the taxpayer be allowed to deduct an amount in computing its income, to the extent that the taxpayer demonstrates that**

all or a portion of the payment that is otherwise included in its income under proposed subsection 12.7(3) is not deducted in the foreign jurisdiction.

7. Proposed Subsection 18.4(7): *De Minimis* Exclusion

Proposed subsection 18.4(7) has three functions:

- Proposed paragraph 18.4(7)(a) establishes whether there is a "deduction component" of a deduction/non-inclusion mismatch, necessary for the conditions for the primary rule in proposed subsection 18.4(3) to be met;
- Proposed paragraph 18.4(7)(b) establishes whether there is a "foreign deduction component" of a deduction/non-inclusion mismatch, necessary for the conditions for the secondary rule in proposed subsection 12.7(2) to be met; and
- Proposed paragraph 18.4(7)(c) establishes the amount of a deduction/non-inclusion mismatch that is either denied under the primary rule in subsection 18.4(4) or included in income under the secondary rule in proposed subsection 12.7(3), by operation of the rules in proposed subsections 18.4(11), (13) and (15) and the definition of "hybrid mismatch amount" in proposed subsection 18.4(1).

In determining the amount of the deduction/non-inclusion mismatch in proposed paragraph 18.4(7)(c), clause (i)(A) of term 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% or less of the amounts deductible for Canadian income tax in respect of the payment. Clause (ii)(A) of term B has the same effect if the total of Canadian ordinary income and foreign ordinary income in respect of a payment represents 10% or less of the amounts deductible for foreign income tax in respect of the payment.

There are no other *de minimis* rules currently proposed for the hybrid mismatch arrangement legislation, in proposed subsection 18.4(7) or otherwise.

The following addresses two aspects of proposed subsection 18.4(7): the currently proposed *de minimis* rule and the lack of a broader *de minimis* rule.

Currently proposed de minimis rule

The justification for the current *de minimis* rule is not readily apparent. The effect of the rule, where it applies, would be to produce a hybrid mismatch amount that is larger than the actual mismatch – in other words, the potential for double taxation to the extent a Canadian deduction is denied where a corresponding amount is included in foreign or Canadian ordinary income, or to the extent there is a Canadian ordinary income inclusion with no corresponding foreign or

Canadian deduction. Such a result in our view is not warranted, as arrangements that produce a hybrid mismatch result may be commercially efficient and should not be disadvantaged relative to other financial alternatives (provided the tax benefit arising from the hybrid mismatch can be neutralized). Further, the *de minimis* rule does not appear to alleviate any administrative aspect of the hybrid mismatch rules for either a tax administration or a taxpayer, since a hybrid mismatch amount must be determined in any case to apply the primary or secondary rule. If and to the extent there are specific transactions or arrangements the current *de minimis* rule is intended to address, a more targeted rule could be introduced for those specific transactions or arrangements.

Broader de minimis rule

The cost and administrative burden to the CRA and taxpayers in applying complex hybrid mismatch rules to financing arrangements resulting in immaterial hybrid mismatch amounts does not seem justified. Introducing a broader *de minimis* exclusion for small hybrid mismatch amounts would be consistent with the approach to the back-to-back loan arrangement rules (e.g., in paragraphs 18(6)(d) and 212(3.1)(e)), and would allow the hybrid mismatch rules to more efficiently target arrangements of concern for tax administrations.

Recommendations:

7.1 We recommend the Department remove the current 10% *de minimis* carve-outs in clauses (i)(A) and (ii)(A) of term B in proposed paragraph 18.4(7)(c), as these carve-outs appear punitive without any corresponding administrative or other benefit.

7.2 We recommend the Department introduce a broader *de minimis* rule that would exempt immaterial hybrid mismatch amounts from the application of the hybrid mismatch rules. This broader *de minimis* rule could be implemented, for example, as a threshold dollar amount for term A in proposed paragraph 18.4(7)(c).

8. Proposed Subsection 18.4(9): Scope

The term “notional interest expense” as used in proposed subsection 18.4(9) is not defined, which could give that subsection a very uncertain scope. The Explanatory Notes state: “A notional interest expense is one that does not have corresponding legal obligation to pay interest. Thus proposed 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”.

Recommendations:

8.1 We recommend that the Department provide a definition of "notional interest expense", by way of legislation, or at the very least through more guidance in the Explanatory Notes.

9. Proposed Subsection 18.4(17) & Security Interests

The "specified entity" definition in proposed subsection 18.4(1) is relevant in determining whether the relationship tests in proposed subsections 18.4(10), (12) and (14) are satisfied. The term "specified entity" is similar to the terms "specified beneficiary" and "specified shareholder" in subsection 18(5). Generally speaking, these terms describe situations in which one entity (the "first entity") owns equity interests in another entity (the "second entity"), either alone or together with non-arm's length entities, which represent at least 25% of the fair market value of all equity interests in the second entity (or, where the second entity is a corporation, provide at least 25% of its shareholder voting rights).

Proposed subsection 18.4(17) expands the scope of the "specified entity" definition, by providing deeming rules that apply for purposes of this definition. In particular, proposed paragraph 18.4(17)(a) refers to rights described after paragraph (b) of the "specified shareholder" definition, or in paragraph (a) or (b) of the "specified beneficiary" definition, as well as similar rights in respect of partnerships or other entities. Generally speaking, these are rights (including contingent or future rights) to acquire equity interests, to cause the redemption of equity interests, or to control the voting rights in respect of equity interests. Proposed paragraph 18.4(17)(a) deems such rights to be absolute and immediate, and to have been exercised, for the purposes of the "specified entity" definition.

The "specified entity" rules (including the definition in proposed subsection 18.4(1) and the deeming rules in proposed subsection 18.4(17)) appear to target the same general types of relationships as those described in the "specified shareholder" and "specified beneficiary" rules in subsection 18(5). We assume that this reflects the similar role that these provisions serve within their respective legislative regimes – i.e., they each set out what types of connections between the parties to an arrangement must be present in order to bring that arrangement within the scope of the relevant legislative regime. It therefore seems appropriate to refer to the scope of the "specified shareholder" and "specified beneficiary" rules, when considering the appropriate scope of the "specified entity" rules.

There is an important limitation on the scope of the "specified shareholder" and "specified beneficiary" rules, which is not expressly referenced in the "specified entity" rules. Subsection 18(5.1) generally deems a person to not be a specified shareholder or specified beneficiary, where the following conditions are satisfied:

- The person would otherwise be a specified shareholder or specified beneficiary;

- The person would cease to be a specified shareholder or specified beneficiary upon the satisfaction of a condition (or the occurrence of an event) that it is reasonable to expect will be satisfied (or will occur); and
- The person became a specified shareholder or specified beneficiary for the purpose of safeguarding of rights or interests of that person (or a non-arm's length) in respect of any indebtedness owing to that person (or a non-arm's length person).

Essentially, subsection 18(5.1) provides relief from the "specified shareholder" and "specified beneficiary" tests in certain circumstances involving security for debt. For example, where a corporation receives a loan from an arm's length lender, the lender may receive a security interest in the corporation's shares (particularly if the loan is guaranteed by the shareholder). The lender would have a contingent right to acquire the shares, in the event that the corporation defaults on the loan (and the shareholder is unable to honour its guarantee). Absent subsection 18(5.1), the lender would be a specified shareholder of the corporation, and the thin capitalization rules could apply in respect of the loan, notwithstanding the absence of any other connection between the borrower and lender. Subsection 18(5.1) prevents this inappropriate result.

The limitation provided by subsection 18(5.1) appears to be equally relevant in the context of the "specified entity" rule. Just as it would be inappropriate for the thin capitalization rules to apply due to a security interest granted to an arm's length lender, it seems inappropriate for the hybrid mismatch rules (which are based on a similar relationship test) to apply in these circumstances (absent a structured arrangement). However, there is no explicit reference to subsection 18(5.1) in the proposed rules. Such a reference might be implicit in proposed subsection 18.4(17), since that provision references the "specified shareholder" and "specified beneficiary" definitions, and subsection 18(5.1) applies for the purposes of those definitions. The Federal Court of Appeal considered a similar issue in *Olsen v. R*,[2] which involved a reference in subsection 84.1(1) to corporations that were "connected" withing the meaning assigned by subsection 186(4). The Court held that subsection 186(2) (which deems one corporation to be controlled by another for the purposes of Part IV) was relevant in determining whether corporations were connected for the purposes of subsection 84.1(1). Similar reasoning might apply to incorporate the limitation in subsection 18(5.1) into the "specified entity" rules in proposed section 18.4, but there is uncertainty on this point.

We submit that it would be best to provide certainty on this issue, by expressly incorporating the subsection 18(5.1) limitation into the "specified entity" rules. This could be achieved by introducing a new provision in proposed section 18.4 that is equivalent to subsection 18(5.1), but refers to a "specified entity" (rather than a "specified shareholder" or "specified beneficiary").

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[2] 2002 DTC 6770 (F.C.A.) rev'g 2000 DTC 2121 (T.C.C.).

This could also be achieved by adding an express reference to subsection 18(5.1) in subsection 18.4(17) (e.g., proposed subsection 18.4(17) would not apply to a right described in the "specified shareholder" or "specified beneficiary" definitions, in circumstances where subsection 18(5.1) would prevent the relevant entity from being a specified shareholder of specified beneficiary).

Recommendation:

9.1 The "specified entity" rules should contain an express exclusion for arrangements that secure indebtedness, equivalent to the exclusion provided in subsection 18(5.1).

10. Timing Mismatches and Proposed Subsection 12.7(3)

Where a deduction in respect of a payment is denied under proposed subsection 18.4(4), an alternative deduction may be available in the future under proposed paragraph 20(1)(yy), to the extent there is foreign ordinary income in respect of the payment in the future. Proposed paragraph 20(1)(yy) provides relief for certain hybrid mismatch arrangements that result from timing mismatches, rather than permanent differences.

This relief is available only where the application of the hybrid mismatch rules results in the denial of a deduction under proposed subsection 18.4(4). No equivalent relief is available where these rules produce an income inclusion under proposed subsection 12.7(3) – i.e., if a payment under a hybrid mismatch arrangement produces a foreign tax deduction in a particular foreign taxation year, and produces Canadian ordinary income in a taxation year that begins more than 12 months after the end of the particular year. In these circumstances, the recipient of the payment would be required to include an amount in its income under proposed subsection 12.7(3), notwithstanding that an amount is also included in Canadian ordinary income under the general Canadian income tax rules.

Example 1.22 in the Action 2 Report provides one example of such a timing mismatch. In Example 1.22, A Co 1 (a company resident in County A) makes a subordinated loan to B Co (a company resident in Country B), to finance a long-term investment in an infrastructure project. The loan has a 15-year term. Although interest accrues on the loan at a fixed rate, this interest is payable only at the end of the loan term (or at the discretion of B Co), and only if certain conditions relating to B Co's solvency are satisfied at that time. Due to differences between the tax laws of Countries A and B, B Co deducts this contingent interest in the year it accrues, but A Co 1 includes the interest in income only when it is paid. The Action 2 Report does not treat this timing difference as a hybrid mismatch, because it is reasonable to expect the interest to be paid (and the timing difference to resolve) within a reasonable period of time.

If Country A were Canada, it appears that A Co 1 would generally not include the interest in its income until it is paid (because A Co 1's right to the interest would be contingent until that time). However, the results under the proposed hybrid mismatch rules would be different than

those contemplated by the Action 2 Report. Because the "deduction / non-inclusion mismatch" test in proposed subsection 18.4(6) operates based on a fixed time window (rather than the "reasonable period of time" test proposed in the Action 2 Report), interest deductions claimed by B Co in the earlier years of this arrangement would give rise to hybrid mismatch amounts. These amounts would be included in A Co 1's income under proposed subsection 12.7(3). When A Co 1's right to the interest amounts becomes absolute (and the interest is paid), A Co 1 would need to consider whether these amounts must be included in its income again under subsection 12(3).

A Co 1 might not have a second income inclusion in this particular scenario. Subsection 12(3) only requires the inclusion of an interest amount in income for a particular year to the extent that interest has not been included in the taxpayer's income for a previous year. In this case, the proposed subsection 12.7(3) income might be considered an inclusion of the interest in income for a previous year, preventing subsection 12(3) from applying when the interest is paid. In certain circumstances, paragraph 248(28)(a) might also prevent a taxpayer from including an amount in income in respect of a payment, where an amount has already been included in the taxpayer's income in respect of that payment under proposed subsection 12.7(3). However, these provisions might not provide relief in all circumstances. In particular, relief would not be available where the taxpayer who has the income inclusion under proposed subsection 12.7(3) is different than the taxpayer who realizes income in a subsequent year.

We believe that the Department should consider introducing a relieving rule similar to proposed paragraph 20(1)(yy) for timing mismatches that produce income inclusions under proposed subsection 12.7(3). Multiple options are available for the design of this relieving rule. For example, where an amount has been included in a particular taxpayer's income in respect of a payment under proposed subsection 12.7(3), the relieving rule could allow the taxpayer to deduct an amount in a subsequent taxation year, to the extent the taxpayer can demonstrate that an amount in respect of that payment has been included in Canadian ordinary income of the particular taxpayer, or another taxpayer, in that year. This relieving rule might also apply where an amount in respect of the payment is subsequently included in foreign ordinary income in a subsequent taxation year (which could include situations where the foreign tax deduction is subsequently eliminated – e.g., due to a foreign tax reassessment).

We also note that the relieving rule in proposed paragraph 20(1)(yy) applies only where there is a foreign ordinary income inclusion in respect of the relevant payment, even though the deduction/non-inclusion mismatch test in subsection proposed 18.4(6) considers whether a payment produces Canadian ordinary income or foreign ordinary income. We submit that proposed paragraph 20(1)(yy), and the proposed relieving rule for subsection 12.7(3), should each apply to the extent that there is Canadian ordinary income or foreign ordinary income in respect of a payment.

Recommendation:

10.1 The Department should consider providing a relieving rule for timing mismatches that produce income inclusions under proposed subsection 12.7(3), similar to the reliving rule for deductions in proposed paragraph 20(1)(yy).

10.2 The Department should consider expanding the scope of proposed paragraph 20(1)(yy), so that this provision applies in respect of a payment to the extent the taxpayer can demonstrate that the payment gives rise to Canadian ordinary income or foreign ordinary income.

11. Proposed Paragraph 20(1)(yy) & Dividend Withholding Tax

Where proposed subsection 18.4(4) denies a deduction for an amount paid or credited as interest ("denied interest"), proposed subsection 214(18) deems such amount to have been paid as a dividend for purposes of non-resident tax under Part XIII of the Act. Where a deduction is subsequently provided for under proposed paragraph 20(1)(yy) (i.e., because the taxpayer demonstrates that such amount or a portion thereof is foreign ordinary income of an entity that has not previously been taken into account), the draft rules do not currently provide for any refund or reduction of the withholding tax that would result from such deemed dividend treatment.

Where the non-resident tax provided for under subsection 212(2) and proposed subsection 214(18) has been duly withheld and remitted by the Canadian payor of the denied interest, such relief could be accomplished by an expansion of subsection 227(6.1). Subsection 227(6.1) deals with refunds of Part XIII tax in circumstances where a shareholder loan treated as a deemed dividend because of subsection 15(2) and paragraph 214(3)(a) is subsequently repaid. That subsection could be expanded (or a parallel provision introduced) so as to provide, on application by the non-resident person on behalf of whom the tax was remitted, a refund of the difference between the Part XIII tax that was payable in respect of the deemed dividend or portion thereof that has become deductible, and the Part XIII tax that would have been payable on a like payment of interest.

In circumstances where the non-resident tax provided for (i.e., by virtue of subsection 15(2) and paragraph 214(3)(a)) has not been withheld or remitted—for example, because the taxpayer did not take the view that withholding was required, and the Minister subsequently takes a different view—there is an existing legislative gap in that the refund provided for in subsection 227(6.1) is disconnected from the liability for and assessment of non-resident tax. This can lead to anomalous and punitive results—in circumstances where the Act already provides for a penalty under subsection 227(8) and the amount at issue has already been repatriated.

For example, a Canadian taxpayer might make an advance to a non-resident that is subsequently repaid, in circumstances where the parties are of the view that there was no Part XIII tax exigible. If the Minister audits and assesses on the basis that there was liability for Part XIII tax on the advance—and does so two years and one day after the advance was repaid—no relief is

provided for the tax that would have become refundable under 227(6.1), simply because the application for refund is now out of time under subsection 227(6.1).

Anomalous outcomes can occur even if a taxpayer is alerted to the liability for tax and need to make a refund application within the 2-year period provided for in subsection 227(6.1). First, the process of assessing the Canadian taxpayer, collecting the tax, requiring the taxpayer to issue an NR4 reporting slip to the non-resident, and having the non-resident request a refund of the tax is cumbersome and unnecessary. In some circumstances, that process may even be difficult or impossible to navigate: the non-resident may have been dissolved and therefore no longer exist, or may no longer be related to and/or cooperative with the taxpayer.

Moreover, interest may continue to accrue for the Canadian taxpayer until the time that the Minister assesses the Part XIII tax due to the taxpayer's joint and several liability for the withholding and remittance that should no longer be required following repayment of the loan or advance. This is inconsistent with the outcome in a purely domestic situation: the "recipient" taxpayer would have an income inclusion when the advance is made, and a deduction in the year that it is repaid. All else being equal, where an assessment is made years later, the inclusion would result in a tax liability (and arrears interest) for the year of inclusion and a refund (and refund interest) for the year of deduction. The interest offset rules would allow the domestic taxpayer to eliminate any arrears interest that would otherwise accrue subsequent to the repayment year.

Rather than replicate these issues in the context of interest that is deemed to be a dividend under the hybrid mismatch arrangements rules, a provision could be introduced following subsection 215(6) that deems an amount to have been remitted on account of the Part XIII tax that was not withheld or remitted in circumstances where subsection 227(6.1) would provide for a refund of tax that was remitted.

Recommendation:

11.1 Subsection 227(6.1) should be expanded (or a parallel provision introduced) so as to provide, on application by the non-resident person on behalf of whom tax was remitted under subsection 214(18), a refund of the difference between the Part XIII tax that was payable in respect of the deemed dividend or portion thereof that has become deductible under proposed paragraph 20(1)(yy), and the Part XIII tax that would have been payable on a like payment of interest. We would be pleased to work with the Department to determine how this can be accomplished.

11.2 A provision should be introduced that deems an amount to have been remitted on account of the Part XIII tax that was not withheld or remitted, in circumstances where subsection 227(6.1) would provide for a refund of tax that was remitted. We would be pleased to work with the Department to determine how this can be accomplished.

12. Drafting Issues

There appear to be two typographical errors in the proposed legislation. First, proposed subsection 18.4(4) refers to "income from a business of property". Based on the context, we believe this is intended to refer to "income from a business or property". Second, proposed subsection 113(3) references the definition "foreign interest restriction rule" in proposed subsection 18.4(1). Since there is no such defined term in proposed subsection 18.4(1), we believe proposed subsection 113(3) is instead intended to refer to the definition "foreign expense restriction rule".

13. Interaction with Other Rules

The proposed hybrid mismatch rules are a detailed and complex set of rules that can have a fundamental impact on the treatment of certain financial instruments, transactions and other arrangements for Canadian tax purposes. As such, we believe it is important that consideration be given to the potential impact of the hybrid mismatch rules on other provisions within the Act, including how the hybrid mismatch rules interact with such provisions. The areas discussed below are not a comprehensive summary of other provisions that may be impacted by the hybrid mismatch rules, but rather an initial list of areas that warrant further consideration.

- **EIFEL Rules**: The consultation period for the proposed excessive interest and financing expenses limitation ("EIFEL") rules closed on May 5, 2022, and we understand that the Department is currently working on potential revisions to these rules. As noted in our submission on the EIFEL rules, there are certain aspects of the EIFEL rules and the hybrid mismatch rules that are interrelated, and therefore require specific coordination. In particular, we believe that if a taxpayer has an income inclusion under proposed subsection 12.7(3) in respect of a particular payment (including a deemed payment with respect to a notional interest expense covered by proposed subsection 18.4(9)), such amount should be included in the taxpayer's "interest and financing revenues" as defined in proposed subsection 18.2(1). While such payments do not have the legal character of interest income, they are effectively treated as interest income for Canadian tax purposes by virtue of proposed subsections 12.7(3) and 18.4(9), and for that reason it would be appropriate, in our view, to include these amounts in "interest and financing revenues" for purposes of the EIFEL rules.

- **Thin Capitalization Rules**: For purposes of the hybrid mismatch rules, the determination of whether an amount is deductible in the first instance (and therefore within the scope of the rules) is determined without regard to the application of the thin capitalization rules in subsection 18(4). As such, the hybrid mismatch rules take priority to the thin capitalization rules. As noted in the Explanatory Notes, if only a portion of an amount in respect of an interest payment is subject to the hybrid mismatch rules, the remaining

portion may nevertheless be restricted under thin capitalization rules. Under the definition of "outstanding debts to specified non-residents" in subsection 18(5), a debt is only treated as an outstanding debt to a specified non-resident, and therefore included in the debt-to-equity ratio for purposes of the thin capitalization rules, if, *inter alia*, any amount in respect of interest paid or payable on the debt is or would be, but for subsection 18(4), deductible in computing income for the year. As such, we understand that a debt whose interest is fully restricted under the hybrid mismatch rules (i.e., not deductible by virtue of subsection 18.4) would not be treated as an outstanding debt to a specified non-resident. However, if a portion, but not all, of the interest is restricted under the hybrid mismatch rules, then, as currently drafted, the entire debt would be treated as an outstanding debt to a specified non-resident. In such cases, it may be appropriate to instead prorate the debt such that only a portion of the debt is treated as an outstanding debt to a specified non-resident. Also, given that a debt whose interest is restricted under the hybrid mismatch rules is restricted because the debt is treated as equity from the holder's perspective, it may be appropriate to treat such debts as equity for purposes of thin capitalization rules (i.e., by introducing a new category within the "equity amount" definition in subsection 18(5)).

- **Foreign Tax Credit Generator Rules**: The foreign tax credit generator rules were first introduced in the 2010 Federal Budget. These rules deny the deduction of foreign tax credits and amounts for foreign accrual tax (FAT) and underlying foreign tax (UFT) in certain circumstances. The reason for introduction of the foreign tax credit generator rules was included in the Explanatory Notes that accompanied their introduction:

  > *…[the foreign tax credit generator rules] are intended to address tax schemes established by taxpayers with the intent of creating foreign tax credits and similar deductions for foreign tax the burden of which is not, in fact, borne by the taxpayer. The main thrust of all of these schemes is to exploit asymmetry as between the tax laws of Canada and those of a relevant foreign jurisdiction in the characterization of equity and debt instruments.*

  The foreign tax credit generator rules were introduced in Canada before the OECD's BEPS initiative commenced in 2013. The BEPS initiative ultimately led to a number of recommendations, including the Action 2 Report which is the basis for Canada's proposed hybrid mismatch rules. As discussed in the Explanatory Notes, the hybrid mismatch rules "…are intended to implement the recommendations in, and be generally consistent with, . . . [the Action 2 Report] . . . [which] recommends a number of specific rules for countries to implement in their domestic laws, which are intended to neutralize mismatches in tax resulting from 'hybrid mismatch arrangements'." Given the overlap between the hybrid mismatch rules and the foreign tax credit generator rules (i.e., both are intended to address asymmetry between the tax laws of Canada and those of a relevant foreign jurisdiction in the characterization of equity and debt instruments, in

certain circumstances), it would make sense in our view to consider whether the foreign tax credit rules could be repealed or, at least, considerably simplified (recognizing that simplification is an important aspect of any tax system). At minimum, we think it is important to ensure that the hybrid mismatch rules and the foreign tax credit generator rules interact with each other appropriately, and do not result in any unintended outcomes. We would be pleased to work with the Department on this.

Submission of the Joint Committee on Taxation of The Canadian Bar Association and Chartered Professional Accountants of Canada

April 29, 2022 Draft Legislation on the Hybrid Mismatch Arrangements Proposals

This submission sets out our comments and recommendations on the draft legislative proposals to the *Income Tax Act* (Canada) (the "Act"), released on April 29, 2022, that would address hybrid mismatch arrangements.

In this submission, we provide our comments and recommendations on certain key elements of the proposals. Given the complex nature of the proposed rules and the limited consultation period, we have focused our comments on key areas with broad impact. We would be pleased to discuss the issues in more detail.

1. Effective Date

The proposed legislation released on April 29, 2022 represents the first of two legislative packages addressing hybrid mismatch arrangements. These two legislative packages were first described in the 2021 federal budget, as part of a proposal to introduce hybrid mismatch rules. The 2021 budget indicated that the hybrid mismatch rules would be consistent with the recommendations of Action 2 of the BEPS Action Plan, with appropriate adaptations for the Canadian tax context. It was also stated in the 2021 budget that the first legislative package, addressing mainly deduction/non-inclusion mismatches described in Chapters 1 and 2 of the BEPS Action 2 Report, including those arising from hybrid financial instruments, would be released for stakeholder comment in 2021, and would apply as of July 1, 2022. The second legislative package, addressing other hybrid mismatch arrangements, would be released for released for stakeholder comment after 2021, and would apply no earlier than 2023.

The anticipated timeline set out in the 2021 budget for the first legislative package of hybrid mismatch rules provided a period of more than six months between the introduction of the proposed legislation and its effective date. However, although the release of the proposed legislation occurred on April 29, 2022, the July 1 effective date had not been changed. Further, the deadline for submissions for the proposed legislation is June 30, one day before the effective date. This reduced comment period may not provide sufficient time for stakeholders to provide meaningful commentary on the proposed legislation, or for affected taxpayers to restructure their affairs to comply with this legislation.

While the implications raised by this short comment period are relevant for all elements of the proposed legislation, the issues are particularly acute for those elements that depart from the

recommendations of the BEPS Action 2 Report. The 2021 budget provided little detail on the structure of the proposed hybrid mismatch rules, aside from the above-noted reference to parts of the BEPS Action 2 Report. This reference provided some guidance for stakeholders, to the extent the proposed rules align with the Action 2 Report. However, the proposed rules go beyond the recommendations of the Action 2 Report in certain key respects. In particular:

- Proposed subsection 214(18) deems an interest payment that is non-deductible under proposed subsection 18.4(4) to be a dividend for withholding tax purposes; and
- Proposed subsection 18.4(9) generally deems a debt on which a notional interest deduction is available to be a hybrid mismatch arrangement (which is contrary to the approach to notional interest deductions proposed in the Action 2 Report).

We submit that it would be difficult for stakeholders to have anticipated the above measures, based on the information available before the release of the proposed legislation on April 29, 2022. Providing additional time to respond to these measures therefore seems particularly appropriate.

Recommendations:

1.1 The Department of Finance ("Department") should consider postponing the effective date of the proposed legislation, to provide more time for taxpayers and other stakeholders to respond to these proposals and provide comments, and for the Department to consider any necessary revisions.

1.2 If the effective date for the proposed legislation as a whole is not postponed, the Department should consider postponing the effective date of proposed subsections 18.4(9) and 214(18).

2. Recognition of Foreign Withholding Tax

Where proposed subsection 113(5) applies to a dividend received by a corporation resident in Canada from a foreign affiliate of the corporation, no deduction is available under subsection 113(1) for foreign withholding tax paid on the dividend. In addition, while a dividend subject to proposed subsection 113(5) is deemed not to be a dividend received by the corporation for the purposes of section 113, the dividend remains "income from a share of the capital stock of a foreign affiliate of the taxpayer", such that no foreign tax credit under subsection 126(1) nor deduction under subsection 20(12) is available in respect of foreign withholding tax paid on the dividend.

Given that the deduction of the dividend in the foreign country (which would trigger the application of proposed subsection 113(5)) would generally not reduce withholding tax on the

dividend, this result seems inappropriate. The result is particularly inappropriate where the foreign tax system provides a "dividends paid" deduction because equivalent tax is instead imposed at the shareholder level. Denying a deduction under section 113 in these circumstances would produce double taxation.

While the BEPS Action 2 report indicates that a payment should not be treated as included in ordinary income simply because it has been subject to withholding tax at source,[1] we do not believe that this is relevant to the availability of a credit or grossed-up deduction in the recipient country for withholding tax paid to the payer jurisdiction. The BEPS Action 2 Report is merely stating that withholding taxes do not neutralize hybrid mismatches and thus the primary rule to prevent deduction in the payer jurisdiction may still apply in cases in which the payer jurisdiction imposes withholding tax on the payment. Neither this statement nor Recommendation 2.1 of the BEPS Action 2 Report that proposed subsection 113(5) is intended to implement suggest that there should not be relief for double taxation. Where 113(5) applies, there should be relief for withholding tax paid on the dividends.

Where interest paid by a foreign affiliate to the Canadian taxpayer on an ordinary debt instrument without hybridity is deductible in computing the foreign affiliate's foreign income, the interest is included in the Canadian taxpayer's income, but the Canadian taxpayer is also entitled to relief from foreign withholding tax paid on such interest under either subsection 126(1) or subsection 20(12). We also note that such Canadian relief in respect of foreign withholding taxes is not intended to reduce Canadian Ordinary Income under subparagraph (a)(iii) of that definition in proposed subsection 18.4(1). Thus, we do not believe providing relief for foreign withholding tax paid on dividends that are subject to proposed subsection 113(5) would allow taxpayers to obtain more favourable tax treatment by using a hybrid instrument to finance a foreign affiliate.

Recommendations:

2.1 We recommend that relief be provided for foreign withholding tax paid on dividends that are subject to proposed subsection 113(5) by modifying proposed subsection 113(5) to allow grossed-up deductions for such withholding tax.

2.2 We suggest that it would be appropriate to provide such relief for all dividends subject to proposed subsection 113(5). Accordingly, we suggest that proposed subsection 113(5) include a rule that deems all dividends that are subject to proposed subsection 113(5) to be taxable surplus dividends received for the purposes of subparagraph 113(1)(c)(i), allowing the taxpayer to access the grossed-up deduction in subparagraph 113(1)(c)(i).

[1] Paragraph 407 of the BEPS Action 2 Report.

3. Application to Foreign Affiliates

It is not entirely clear whether the proposed rules would be applicable in the context of transactions involving foreign affiliates of taxpayers resident in Canada (ignoring situations in which a foreign affiliate may itself be a non-resident taxpayer with Canadian-source income). In general, under paragraph 95(2)(f), a foreign affiliate is deemed to be a taxpayer resident in Canada for the purposes of computing, among other things, its income or loss from property, from a business other than an active business and from a non-qualifying business. This treatment does not apply to the extent otherwise provided or to the extent that the context otherwise requires. For example, under clause 95(2)(f.11)(ii)(A), the income imputation/attribution rules in subsection 17(1) and section 91 are specifically excluded, as are the thin-capitalization rules in subsection 18(4), among other provisions.

We believe that a similar approach should be taken in the context of the proposed hybrid mismatch rules. In particular, we understand that the purpose of these rules is primarily to protect the Canadian tax base. Thus, the application of these rules would seem to be inappropriate in relation to the computation of income from an active business, including income from property that is recharacterized as income from an active business under subsection 95(2). Furthermore, in the context of the computation of income from property, or other income, that is included in a foreign affiliate's foreign accrual property income (FAPI), we do not see any need for the application of these rules, in the sense that we are not aware of circumstances in which Canadian base erosion would arise as a result of any foreign hybrid mismatch outcomes. As FAPI is computed in accordance with Canadian rules and principles, the foreign tax treatment of a particular payment should not affect the computation of FAPI, and thus should not result in any Canadian base erosion risks.

Even in a circumstance where, for example, a FAPI-earning controlled foreign affiliate has issued a financial instrument that is treated as debt from a Canadian perspective and as equity from a foreign tax perspective, it seems to us to be inappropriate to deny a deduction in computing such FAPI through an extension to such context of the proposed hybrid mismatch rules. If that instrument had instead been treated as equity from a Canadian perspective, such that there would not have been any deduction in computing FAPI in respect of payments on that instrument, the existence of the instrument would have in any event resulted in a reduction of the Canadian taxpayer's participating percentage in respect of the affiliate, and thus a corresponding reduction of attributed FAPI.

This is consistent with the exclusion of subsection 18(4) mentioned above, in the sense that the thin-capitalization rules also reflect an effort to address the substitutability of debt for equity. Their application in the context of computing FAPI would result in the taxation of what could be regarded as phantom income – that is, income computed for tax purposes which does not reflect

a true and substantive economic entitlement held by a taxpayer resident in Canada. The same would be true with regard to the application of the proposed hybrid mismatch rules in the foreign affiliate context.

Thus, we believe it would be preferable to simply exclude the application of proposed sections 12.7 and 18.4 from the foreign affiliate context.

If the proposed rules are to apply to foreign affiliates in certain circumstances, further discussion would be needed regarding the specific circumstances in which they apply, and the consequences of their application. A particular concern relates to the possibility of proposed section 12.7 and proposed subsection 18.4(9) applying in the foreign affiliate context. While proposed subsection 18.4(9) may deem a payment to have been made for certain purposes, these do not include the recharacterization rules in subsection 95(2). Thus, the application of proposed subsection 18.4(9) in the foreign affiliate context could result in FAPI even in circumstances in which no FAPI would arise if an actual payment had been made. One possibility in this context would be to extend the scope of the application of proposed subsection 18.4(9) to subsection 95(2). However, this could create inordinate complexity and inappropriate results in relation to the computation of surplus accounts and their consistency with the location of economic value within a foreign affiliate group. Other issues that should be discussed in this context include whether the proposed rules should apply in computing a foreign affiliate's income from a hybrid mismatch arrangement, in circumstances where, if the foreign affiliate received an interest payment under the arrangement, that payment would be included in active business income under paragraph 95(2)(a).

Recommendations

3.1 Clause 95(2)(f.11)(ii)(A) should be expanded to exclude the application of proposed sections 12.7 and 18.4 in computing a foreign affiliate's income from property, income from a business other than an active business and income from a non-qualifying business. A corresponding amendment should also be made in subparagraph (a)(iii) of the definition of "earnings" in subsection 5907(1) of the Income Tax Regulations.

3.2 If this recommendation is not accepted, further discussions should be conducted regarding the specific circumstances in which proposed sections 12.7 and 18.4 should apply in computing the income of a foreign affiliate, and the consequences of the application of proposed sections 12.7 and 18.4 in these circumstances. Among other things, we submit that it would be appropriate to extend the application of proposed subsection 18.4(9) to subsection 95(2), and to make any further adjustments as may be required so that the FAPI consequences arising therefrom would parallel those that would arise in the context of an actual payment, as well as any adjustments required to achieve appropriate surplus consequences.

4. "Canadian Ordinary Income" & "Foreign Ordinary Income" Definitions

Concerns have been raised with respect to certain aspects of the wording of the definitions of "Canadian ordinary income" and "foreign ordinary income" in proposed subsection 18.4(1).

Deductions in respect of Other Payments

With respect to the definition of Canadian ordinary income, one concern arises in relation to subparagraph (a)(iii), which is intended to reverse what would otherwise be counted as an income inclusion under paragraph (a), as follows:

> (iii) the amount can otherwise reasonably be considered to be excluded, reduced, offset or otherwise effectively sheltered from tax under this Part by reason of any exemption, exclusion, deduction, credit (other than a credit for a tax substantially similar to tax under Part XIII) or other form of relief under this Act that
>
> (A) applies specifically in respect of all or a portion of the amount and not in computing income generally, or
>
> (B) arises in respect of the payment;

In particular, the concern relates to the reference to a "deduction" in combination with the very broad references to "offset" and "effectively sheltered". For example, if a taxpayer borrows money at interest from a third party for the purpose of making an interest-bearing loan to a subsidiary, the taxpayer's interest revenues would be expected to result in Canadian ordinary income. However, concerns have been expressed that the taxpayer's interest expense relating to its third-party borrowings could be viewed as an item that results in a deduction that offsets or otherwise effectively shelters from tax its interest revenues, thereby eliminating its Canadian ordinary income. We acknowledge that this would not be the case unless the conditions in clause (A) or (B) are satisfied, and that is part of the uncertainty. The jurisprudence generally gives a very broad meaning to references to "in respect of", which appear in both clauses. While clause (A) also refers to "and not in computing income generally", which would seem to limit the preceding portion of that clause, there is no such limitation in clause (B) – for example, a reference to "and not in respect of a different amount" (i.e., the amount paid by the taxpayer, which is a different amount from the amount received).

The same concern arises under subparagraph (ii) of the description of A in paragraph (b) of this definition, and the description of G in paragraph (c) of this definition, which refer back to subparagraph (a)(iii) of this definition. Similarly, this concern arises under the description of D in the definition of foreign ordinary income.

Based on the discussion in the Explanatory Notes, the restrictions in subparagraph (a)(iii) of the definition of Canadian ordinary income and D in the definition of foreign ordinary income appear to be targeted at relief that is available by virtue of receiving a payment – e.g., a participation exemption or dividends received deduction that is provided to a parent company in respect of dividends received from a subsidiary. The scope of these restrictions could be clarified by replacing the phrase "arises in respect of the payment" with "arises by virtue of receiving the payment" (or a similar phrase). This change would confirm that in the example above, the interest payment received by the taxpayer from its subsidiary would be included in Canadian ordinary income, notwithstanding that the taxpayer also deducts its interest expense on the third party borrowing (as the deduction for the third party interest expense would not arise by virtue of the taxpayer receiving the interest payment from the subsidiary).

Payments Received by Tax Exempt Entities

There is also uncertainty relating to the interpretation of elements of the definition of foreign ordinary income in cases involving tax-exempt entities, entities located in jurisdictions that do not impose an income tax on entities, and entities that are located in jurisdictions that impose an income tax on entities at variable rates or at rates below the rates imposed on individuals or other types of entities.

In particular, we note the description of J in that definition, which refers to "the highest rate at which an income or profits tax imposed by the government of the country is charged in respect of an amount of income in respect of a financial instrument". It is not clear whether this description is intended to be satisfied where, for example, a jurisdiction imposes an income tax on individuals but a lower rate (or does not impose an income tax) on entities, or where the jurisdiction imposes an income tax on entities at a rate that depends on the overall amount of an entity's income for the year. In brief, while the Explanatory Notes indicate that the description of F is intended to identify preferential regimes in respect of financial instruments, they do not clarify this point and the operative language could be interpreted in a broader manner.

We also note an uncertainty as to whether the description of B in this definition could be satisfied where an entity is located in a jurisdiction that does not impose an income tax on the entity. The description and related Explanatory Notes refer to an entity being "subject to an income or profits tax that is charged at a nil rate". They do not clarify whether this would include an entity that is located in a jurisdiction that does not impose an income tax on the entity.

Recommendation:

4.1 The relevant portions of the definitions of Canadian ordinary income and foreign ordinary income (as noted above) should be clarified such that inclusions in respect

of a particular amount are not reversed as a result of any deductions or other relief that may be applicable as a result of other payments – that is, payments other than the payments that give rise to the included amounts. This could be achieved by replacing the phrase "arises in respect of the payment" in subparagraph (a)(iii) of the definition of Canadian ordinary income and D in the definition of foreign ordinary income with the phrase "arises by virtue of receiving the payment".

4.2 The relevant portions of the definition of foreign ordinary income should be clarified with respect to their application in relation to tax-exempt entities, entities located in jurisdictions that do not impose an income tax on entities, and entities that are located in jurisdictions that impose an income tax on entities at variable rates or at rates below those applied to individuals or other types of entities.

5. Proposed Subsection 18.4(2)

Proposed subsection 18.4(2) is an interpretive rule providing that, unless the context otherwise requires, proposed sections 18.4, 12.7 and subsection 113(5) (i.e., the primary rule, secondary rule and the foreign affiliate dividend deduction denial rule, respectively) are to be interpreted consistent with the BEPS Action 2 Report, as amended from time to time. The Explanatory Notes for subsection 18.4(2) further state that the examples in Annex B of the BEPS Action 2 Report are instructive as to the intended scope and application of the hybrid mismatch rules, again unless the context otherwise requires.

The proposed rules in sections 18.4 and 12.7 address the hybrid mismatch arrangements discussed in Chapter 1 and Recommendation 2.1 of the BEPS Action 2 Report; generally speaking, these are deduction/non-inclusion outcomes and similar outcomes relating to financial instruments. The BEPS Action 2 Report also addresses additional types of potential hybrid mismatch arrangements, such as hybrid entities and dual resident entities, and other types of outcomes, such as double deduction outcomes. Similarly, the examples in Annex B of the BEPS Action 2 Report are not limited to the types of hybrid mismatch arrangements addressed in the proposed hybrid mismatch rules. Consequently, the reference in proposed subsection 18.4(2) to the BEPS Action 2 Report (including Annex B) in its totality creates some confusion as to the scope of the proposed legislation. This is so particularly in light of the anti-avoidance rule in proposed subsection 18.4(20), which can result in the hybrid mismatch rules applying to outcomes that are "substantially similar" to a deduction/non-inclusion mismatch. We assume that proposed subsection 18.4(2) is currently intended to refer only to Chapter 1 and section 2.1 of Chapter 2 of the BEPS Action 2 Report, and that the context prevents other portions of that report from being relevant in interpreting the first package of proposed hybrid mismatch rules. However, we believe that it would be helpful to clarify the current scope of proposed subsection

18.4(2), and how this scope might change once the second package of proposed legislation is released.

Recommendation:

5.1 We recommend the Department revise proposed subsection 18.4(2) to state that proposed sections 18.4 and 12.7 and subsection 113(5) are to be interpreted consistent with Chapter 1 and section 2.1 of Chapter 2 of the BEPS Action 2 Report, with similar revisions to the Explanatory Notes. Alternatively, the scope of proposed subsection 18.4(2) could be clarified in the Explanatory Notes, particularly if proposed subsection 18.4(2) is to be relevant to the second package of hybrid mismatch legislation yet to be released.

6. Proposed Subsection 18.4(6): Application to Deductible Amounts

Variable "C" of proposed paragraph 18.4(6)(b) determines whether a payment gives rise to a deduction/non-inclusion mismatch by reference to whether the payment would be, or would reasonably be expected to be, in the absence of any foreign expense restriction rule, deductible in computing foreign income. It appears the test of "deductible" as opposed to a test of "deducted" could give rise to double taxation due to the application of proposed section 12.7 where there is in fact no deduction taken in the foreign jurisdiction. This issue is particularly relevant for the notional interest expense rule in proposed subsection 18.4(9), which does not require an actual payment.

Recommendations:

6.1 We recommend that the test of "deductible" be changed to a test of "deducted", at the very least, in proposed subsection 18.4(9).

6.2 Recognizing the Department's concerns with the administrative difficulties that may potentially result from a test based on actual deductions, as an alternative to changing the test from "deductible" to "deducted", we recommend that either:

a) the amount of hybrid mismatch amount included in the taxpayer's income under proposed subsection 12.7(3) be reduced to the extent the taxpayer demonstrates that an amount is not deducted in respect of the payment in the foreign jurisdiction; or

b) similar to the approach taken in proposed paragraph 20(1)(yy), we recommend that the taxpayer be allowed to deduct an amount in computing its income, to the extent that the taxpayer demonstrates that

all or a portion of the payment that is otherwise included in its income under proposed subsection 12.7(3) is not deducted in the foreign jurisdiction.

7. Proposed Subsection 18.4(7): *De Minimis* Exclusion

Proposed subsection 18.4(7) has three functions:

- Proposed paragraph 18.4(7)(a) establishes whether there is a "deduction component" of a deduction/non-inclusion mismatch, necessary for the conditions for the primary rule in proposed subsection 18.4(3) to be met;
- Proposed paragraph 18.4(7)(b) establishes whether there is a "foreign deduction component" of a deduction/non-inclusion mismatch, necessary for the conditions for the secondary rule in proposed subsection 12.7(2) to be met; and
- Proposed paragraph 18.4(7)(c) establishes the amount of a deduction/non-inclusion mismatch that is either denied under the primary rule in subsection 18.4(4) or included in income under the secondary rule in proposed subsection 12.7(3), by operation of the rules in proposed subsections 18.4(11), (13) and (15) and the definition of "hybrid mismatch amount" in proposed subsection 18.4(1).

In determining the amount of the deduction/non-inclusion mismatch in proposed paragraph 18.4(7)(c), clause (i)(A) of term 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% or less of the amounts deductible for Canadian income tax in respect of the payment. Clause (ii)(A) of term B has the same effect if the total of Canadian ordinary income and foreign ordinary income in respect of a payment represents 10% or less of the amounts deductible for foreign income tax in respect of the payment.

There are no other *de minimis* rules currently proposed for the hybrid mismatch arrangement legislation, in proposed subsection 18.4(7) or otherwise.

The following addresses two aspects of proposed subsection 18.4(7): the currently proposed *de minimis* rule and the lack of a broader *de minimis* rule.

Currently proposed de minimis rule

The justification for the current *de minimis* rule is not readily apparent. The effect of the rule, where it applies, would be to produce a hybrid mismatch amount that is larger than the actual mismatch – in other words, the potential for double taxation to the extent a Canadian deduction is denied where a corresponding amount is included in foreign or Canadian ordinary income, or to the extent there is a Canadian ordinary income inclusion with no corresponding foreign or

Canadian deduction. Such a result in our view is not warranted, as arrangements that produce a hybrid mismatch result may be commercially efficient and should not be disadvantaged relative to other financial alternatives (provided the tax benefit arising from the hybrid mismatch can be neutralized). Further, the *de minimis* rule does not appear to alleviate any administrative aspect of the hybrid mismatch rules for either a tax administration or a taxpayer, since a hybrid mismatch amount must be determined in any case to apply the primary or secondary rule. If and to the extent there are specific transactions or arrangements the current *de minimis* rule is intended to address, a more targeted rule could be introduced for those specific transactions or arrangements.

Broader de minimis rule

The cost and administrative burden to the CRA and taxpayers in applying complex hybrid mismatch rules to financing arrangements resulting in immaterial hybrid mismatch amounts does not seem justified. Introducing a broader *de minimis* exclusion for small hybrid mismatch amounts would be consistent with the approach to the back-to-back loan arrangement rules (e.g., in paragraphs 18(6)(d) and 212(3.1)(e)), and would allow the hybrid mismatch rules to more efficiently target arrangements of concern for tax administrations.

Recommendations:

7.1 We recommend the Department remove the current 10% *de minimis* carve-outs in clauses (i)(A) and (ii)(A) of term B in proposed paragraph 18.4(7)(c), as these carve-outs appear punitive without any corresponding administrative or other benefit.

7.2 We recommend the Department introduce a broader *de minimis* rule that would exempt immaterial hybrid mismatch amounts from the application of the hybrid mismatch rules. This broader *de minimis* rule could be implemented, for example, as a threshold dollar amount for term A in proposed paragraph 18.4(7)(c).

8. Proposed Subsection 18.4(9): Scope

The term "notional interest expense" as used in proposed subsection 18.4(9) is not defined, which could give that subsection a very uncertain scope. The Explanatory Notes state: "A notional interest expense is one that does not have corresponding legal obligation to pay interest. Thus proposed 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".

Recommendations:

8.1 We recommend that the Department provide a definition of "notional interest expense", by way of legislation, or at the very least through more guidance in the Explanatory Notes.

9. Proposed Subsection 18.4(17) & Security Interests

The "specified entity" definition in proposed subsection 18.4(1) is relevant in determining whether the relationship tests in proposed subsections 18.4(10), (12) and (14) are satisfied. The term "specified entity" is similar to the terms "specified beneficiary" and "specified shareholder" in subsection 18(5). Generally speaking, these terms describe situations in which one entity (the "first entity") owns equity interests in another entity (the "second entity"), either alone or together with non-arm's length entities, which represent at least 25% of the fair market value of all equity interests in the second entity (or, where the second entity is a corporation, provide at least 25% of its shareholder voting rights).

Proposed subsection 18.4(17) expands the scope of the "specified entity" definition, by providing deeming rules that apply for purposes of this definition. In particular, proposed paragraph 18.4(17)(a) refers to rights described after paragraph (b) of the "specified shareholder" definition, or in paragraph (a) or (b) of the "specified beneficiary" definition, as well as similar rights in respect of partnerships or other entities. Generally speaking, these are rights (including contingent or future rights) to acquire equity interests, to cause the redemption of equity interests, or to control the voting rights in respect of equity interests. Proposed paragraph 18.4(17)(a) deems such rights to be absolute and immediate, and to have been exercised, for the purposes of the "specified entity" definition.

The "specified entity" rules (including the definition in proposed subsection 18.4(1) and the deeming rules in proposed subsection 18.4(17)) appear to target the same general types of relationships as those described in the "specified shareholder" and "specified beneficiary" rules in subsection 18(5). We assume that this reflects the similar role that these provisions serve within their respective legislative regimes – i.e., they each set out what types of connections between the parties to an arrangement must be present in order to bring that arrangement within the scope of the relevant legislative regime. It therefore seems appropriate to refer to the scope of the "specified shareholder" and "specified beneficiary" rules, when considering the appropriate scope of the "specified entity" rules.

There is an important limitation on the scope of the "specified shareholder" and "specified beneficiary" rules, which is not expressly referenced in the "specified entity" rules. Subsection 18(5.1) generally deems a person to not be a specified shareholder or specified beneficiary, where the following conditions are satisfied:

- The person would otherwise be a specified shareholder or specified beneficiary;

- The person would cease to be a specified shareholder or specified beneficiary upon the satisfaction of a condition (or the occurrence of an event) that it is reasonable to expect will be satisfied (or will occur); and
- The person became a specified shareholder or specified beneficiary for the purpose of safeguarding of rights or interests of that person (or a non-arm's length) in respect of any indebtedness owing to that person (or a non-arm's length person).

Essentially, subsection 18(5.1) provides relief from the "specified shareholder" and "specified beneficiary" tests in certain circumstances involving security for debt. For example, where a corporation receives a loan from an arm's length lender, the lender may receive a security interest in the corporation's shares (particularly if the loan is guaranteed by the shareholder). The lender would have a contingent right to acquire the shares, in the event that the corporation defaults on the loan (and the shareholder is unable to honour its guarantee). Absent subsection 18(5.1), the lender would be a specified shareholder of the corporation, and the thin capitalization rules could apply in respect of the loan, notwithstanding the absence of any other connection between the borrower and lender. Subsection 18(5.1) prevents this inappropriate result.

The limitation provided by subsection 18(5.1) appears to be equally relevant in the context of the "specified entity" rule. Just as it would be inappropriate for the thin capitalization rules to apply due to a security interest granted to an arm's length lender, it seems inappropriate for the hybrid mismatch rules (which are based on a similar relationship test) to apply in these circumstances (absent a structured arrangement). However, there is no explicit reference to subsection 18(5.1) in the proposed rules. Such a reference might be implicit in proposed subsection 18.4(17), since that provision references the "specified shareholder" and "specified beneficiary" definitions, and subsection 18(5.1) applies for the purposes of those definitions. The Federal Court of Appeal considered a similar issue in *Olsen v. R*,[2] which involved a reference in subsection 84.1(1) to corporations that were "connected" withing the meaning assigned by subsection 186(4). The Court held that subsection 186(2) (which deems one corporation to be controlled by another for the purposes of Part IV) was relevant in determining whether corporations were connected for the purposes of subsection 84.1(1). Similar reasoning might apply to incorporate the limitation in subsection 18(5.1) into the "specified entity" rules in proposed section 18.4, but there is uncertainty on this point.

We submit that it would be best to provide certainty on this issue, by expressly incorporating the subsection 18(5.1) limitation into the "specified entity" rules. This could be achieved by introducing a new provision in proposed section 18.4 that is equivalent to subsection 18(5.1), but refers to a "specified entity" (rather than a "specified shareholder" or "specified beneficiary").

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[2] 2002 DTC 6770 (F.C.A.) rev'g 2000 DTC 2121 (T.C.C.).

This could also be achieved by adding an express reference to subsection 18(5.1) in subsection 18.4(17) (e.g., proposed subsection 18.4(17) would not apply to a right described in the "specified shareholder" or "specified beneficiary" definitions, in circumstances where subsection 18(5.1) would prevent the relevant entity from being a specified shareholder of specified beneficiary).

Recommendation:

9.1 The "specified entity" rules should contain an express exclusion for arrangements that secure indebtedness, equivalent to the exclusion provided in subsection 18(5.1).

10. Timing Mismatches and Proposed Subsection 12.7(3)

Where a deduction in respect of a payment is denied under proposed subsection 18.4(4), an alternative deduction may be available in the future under proposed paragraph 20(1)(yy), to the extent there is foreign ordinary income in respect of the payment in the future. Proposed paragraph 20(1)(yy) provides relief for certain hybrid mismatch arrangements that result from timing mismatches, rather than permanent differences.

This relief is available only where the application of the hybrid mismatch rules results in the denial of a deduction under proposed subsection 18.4(4). No equivalent relief is available where these rules produce an income inclusion under proposed subsection 12.7(3) – i.e., if a payment under a hybrid mismatch arrangement produces a foreign tax deduction in a particular foreign taxation year, and produces Canadian ordinary income in a taxation year that begins more than 12 months after the end of the particular year. In these circumstances, the recipient of the payment would be required to include an amount in its income under proposed subsection 12.7(3), notwithstanding that an amount is also included in Canadian ordinary income under the general Canadian income tax rules.

Example 1.22 in the Action 2 Report provides one example of such a timing mismatch. In Example 1.22, A Co 1 (a company resident in County A) makes a subordinated loan to B Co (a company resident in Country B), to finance a long-term investment in an infrastructure project. The loan has a 15-year term. Although interest accrues on the loan at a fixed rate, this interest is payable only at the end of the loan term (or at the discretion of B Co), and only if certain conditions relating to B Co's solvency are satisfied at that time. Due to differences between the tax laws of Countries A and B, B Co deducts this contingent interest in the year it accrues, but A Co 1 includes the interest in income only when it is paid. The Action 2 Report does not treat this timing difference as a hybrid mismatch, because it is reasonable to expect the interest to be paid (and the timing difference to resolve) within a reasonable period of time.

If Country A were Canada, it appears that A Co 1 would generally not include the interest in its income until it is paid (because A Co 1's right to the interest would be contingent until that time). However, the results under the proposed hybrid mismatch rules would be different than

those contemplated by the Action 2 Report. Because the "deduction / non-inclusion mismatch" test in proposed subsection 18.4(6) operates based on a fixed time window (rather than the "reasonable period of time" test proposed in the Action 2 Report), interest deductions claimed by B Co in the earlier years of this arrangement would give rise to hybrid mismatch amounts. These amounts would be included in A Co 1's income under proposed subsection 12.7(3). When A Co 1's right to the interest amounts becomes absolute (and the interest is paid), A Co 1 would need to consider whether these amounts must be included in its income again under subsection 12(3).

A Co 1 might not have a second income inclusion in this particular scenario. Subsection 12(3) only requires the inclusion of an interest amount in income for a particular year to the extent that interest has not been included in the taxpayer's income for a previous year. In this case, the proposed subsection 12.7(3) income might be considered an inclusion of the interest in income for a previous year, preventing subsection 12(3) from applying when the interest is paid. In certain circumstances, paragraph 248(28)(a) might also prevent a taxpayer from including an amount in income in respect of a payment, where an amount has already been included in the taxpayer's income in respect of that payment under proposed subsection 12.7(3). However, these provisions might not provide relief in all circumstances. In particular, relief would not be available where the taxpayer who has the income inclusion under proposed subsection 12.7(3) is different than the taxpayer who realizes income in a subsequent year.

We believe that the Department should consider introducing a relieving rule similar to proposed paragraph 20(1)(yy) for timing mismatches that produce income inclusions under proposed subsection 12.7(3). Multiple options are available for the design of this relieving rule. For example, where an amount has been included in a particular taxpayer's income in respect of a payment under proposed subsection 12.7(3), the relieving rule could allow the taxpayer to deduct an amount in a subsequent taxation year, to the extent the taxpayer can demonstrate that an amount in respect of that payment has been included in Canadian ordinary income of the particular taxpayer, or another taxpayer, in that year. This relieving rule might also apply where an amount in respect of the payment is subsequently included in foreign ordinary income in a subsequent taxation year (which could include situations where the foreign tax deduction is subsequently eliminated – e.g., due to a foreign tax reassessment).

We also note that the relieving rule in proposed paragraph 20(1)(yy) applies only where there is a foreign ordinary income inclusion in respect of the relevant payment, even though the deduction/non-inclusion mismatch test in subsection proposed 18.4(6) considers whether a payment produces Canadian ordinary income or foreign ordinary income. We submit that proposed paragraph 20(1)(yy), and the proposed relieving rule for subsection 12.7(3), should each apply to the extent that there is Canadian ordinary income or foreign ordinary income in respect of a payment.

Recommendation:

10.1 The Department should consider providing a relieving rule for timing mismatches that produce income inclusions under proposed subsection 12.7(3), similar to the reliving rule for deductions in proposed paragraph 20(1)(yy).

10.2 The Department should consider expanding the scope of proposed paragraph 20(1)(yy), so that this provision applies in respect of a payment to the extent the taxpayer can demonstrate that the payment gives rise to Canadian ordinary income or foreign ordinary income.

11. Proposed Paragraph 20(1)(yy) & Dividend Withholding Tax

Where proposed subsection 18.4(4) denies a deduction for an amount paid or credited as interest ("denied interest"), proposed subsection 214(18) deems such amount to have been paid as a dividend for purposes of non-resident tax under Part XIII of the Act. Where a deduction is subsequently provided for under proposed paragraph 20(1)(yy) (i.e., because the taxpayer demonstrates that such amount or a portion thereof is foreign ordinary income of an entity that has not previously been taken into account), the draft rules do not currently provide for any refund or reduction of the withholding tax that would result from such deemed dividend treatment.

Where the non-resident tax provided for under subsection 212(2) and proposed subsection 214(18) has been duly withheld and remitted by the Canadian payor of the denied interest, such relief could be accomplished by an expansion of subsection 227(6.1). Subsection 227(6.1) deals with refunds of Part XIII tax in circumstances where a shareholder loan treated as a deemed dividend because of subsection 15(2) and paragraph 214(3)(a) is subsequently repaid. That subsection could be expanded (or a parallel provision introduced) so as to provide, on application by the non-resident person on behalf of whom the tax was remitted, a refund of the difference between the Part XIII tax that was payable in respect of the deemed dividend or portion thereof that has become deductible, and the Part XIII tax that would have been payable on a like payment of interest.

In circumstances where the non-resident tax provided for (i.e., by virtue of subsection 15(2) and paragraph 214(3)(a)) has not been withheld or remitted—for example, because the taxpayer did not take the view that withholding was required, and the Minister subsequently takes a different view—there is an existing legislative gap in that the refund provided for in subsection 227(6.1) is disconnected from the liability for and assessment of non-resident tax. This can lead to anomalous and punitive results—in circumstances where the Act already provides for a penalty under subsection 227(8) and the amount at issue has already been repatriated.

For example, a Canadian taxpayer might make an advance to a non-resident that is subsequently repaid, in circumstances where the parties are of the view that there was no Part XIII tax exigible. If the Minister audits and assesses on the basis that there was liability for Part XIII tax on the advance—and does so two years and one day after the advance was repaid—no relief is

provided for the tax that would have become refundable under 227(6.1), simply because the application for refund is now out of time under subsection 227(6.1).

Anomalous outcomes can occur even if a taxpayer is alerted to the liability for tax and need to make a refund application within the 2-year period provided for in subsection 227(6.1). First, the process of assessing the Canadian taxpayer, collecting the tax, requiring the taxpayer to issue an NR4 reporting slip to the non-resident, and having the non-resident request a refund of the tax is cumbersome and unnecessary. In some circumstances, that process may even be difficult or impossible to navigate: the non-resident may have been dissolved and therefore no longer exist, or may no longer be related to and/or cooperative with the taxpayer.

Moreover, interest may continue to accrue for the Canadian taxpayer until the time that the Minister assesses the Part XIII tax due to the taxpayer's joint and several liability for the withholding and remittance that should no longer be required following repayment of the loan or advance. This is inconsistent with the outcome in a purely domestic situation: the "recipient" taxpayer would have an income inclusion when the advance is made, and a deduction in the year that it is repaid. All else being equal, where an assessment is made years later, the inclusion would result in a tax liability (and arrears interest) for the year of inclusion and a refund (and refund interest) for the year of deduction. The interest offset rules would allow the domestic taxpayer to eliminate any arrears interest that would otherwise accrue subsequent to the repayment year.

Rather than replicate these issues in the context of interest that is deemed to be a dividend under the hybrid mismatch arrangements rules, a provision could be introduced following subsection 215(6) that deems an amount to have been remitted on account of the Part XIII tax that was not withheld or remitted in circumstances where subsection 227(6.1) would provide for a refund of tax that was remitted.

Recommendation:

11.1 Subsection 227(6.1) should be expanded (or a parallel provision introduced) so as to provide, on application by the non-resident person on behalf of whom tax was remitted under subsection 214(18), a refund of the difference between the Part XIII tax that was payable in respect of the deemed dividend or portion thereof that has become deductible under proposed paragraph 20(1)(yy), and the Part XIII tax that would have been payable on a like payment of interest. We would be pleased to work with the Department to determine how this can be accomplished.

11.2 A provision should be introduced that deems an amount to have been remitted on account of the Part XIII tax that was not withheld or remitted, in circumstances where subsection 227(6.1) would provide for a refund of tax that was remitted. We would be pleased to work with the Department to determine how this can be accomplished.

12. Drafting Issues

There appear to be two typographical errors in the proposed legislation. First, proposed subsection 18.4(4) refers to "income from a business of property". Based on the context, we believe this is intended to refer to "income from a business or property". Second, proposed subsection 113(3) references the definition "foreign interest restriction rule" in proposed subsection 18.4(1). Since there is no such defined term in proposed subsection 18.4(1), we believe proposed subsection 113(3) is instead intended to refer to the definition "foreign expense restriction rule".

13. Interaction with Other Rules

The proposed hybrid mismatch rules are a detailed and complex set of rules that can have a fundamental impact on the treatment of certain financial instruments, transactions and other arrangements for Canadian tax purposes. As such, we believe it is important that consideration be given to the potential impact of the hybrid mismatch rules on other provisions within the Act, including how the hybrid mismatch rules interact with such provisions. The areas discussed below are not a comprehensive summary of other provisions that may be impacted by the hybrid mismatch rules, but rather an initial list of areas that warrant further consideration.

- **EIFEL Rules**: The consultation period for the proposed excessive interest and financing expenses limitation ("EIFEL") rules closed on May 5, 2022, and we understand that the Department is currently working on potential revisions to these rules. As noted in our submission on the EIFEL rules, there are certain aspects of the EIFEL rules and the hybrid mismatch rules that are interrelated, and therefore require specific coordination. In particular, we believe that if a taxpayer has an income inclusion under proposed subsection 12.7(3) in respect of a particular payment (including a deemed payment with respect to a notional interest expense covered by proposed subsection 18.4(9)), such amount should be included in the taxpayer's "interest and financing revenues" as defined in proposed subsection 18.2(1). While such payments do not have the legal character of interest income, they are effectively treated as interest income for Canadian tax purposes by virtue of proposed subsections 12.7(3) and 18.4(9), and for that reason it would be appropriate, in our view, to include these amounts in "interest and financing revenues" for purposes of the EIFEL rules.

- **Thin Capitalization Rules**: For purposes of the hybrid mismatch rules, the determination of whether an amount is deductible in the first instance (and therefore within the scope of the rules) is determined without regard to the application of the thin capitalization rules in subsection 18(4). As such, the hybrid mismatch rules take priority to the thin capitalization rules. As noted in the Explanatory Notes, if only a portion of an amount in respect of an interest payment is subject to the hybrid mismatch rules, the remaining

portion may nevertheless be restricted under thin capitalization rules. Under the definition of “outstanding debts to specified non-residents” in subsection 18(5), a debt is only treated as an outstanding debt to a specified non-resident, and therefore included in the debt-to-equity ratio for purposes of the thin capitalization rules, if, *inter alia*, any amount in respect of interest paid or payable on the debt is or would be, but for subsection 18(4), deductible in computing income for the year. As such, we understand that a debt whose interest is fully restricted under the hybrid mismatch rules (i.e., not deductible by virtue of subsection 18.4) would not be treated as an outstanding debt to a specified non-resident. However, if a portion, but not all, of the interest is restricted under the hybrid mismatch rules, then, as currently drafted, the entire debt would be treated as an outstanding debt to a specified non-resident. In such cases, it may be appropriate to instead prorate the debt such that only a portion of the debt is treated as an outstanding debt to a specified non-resident. Also, given that a debt whose interest is restricted under the hybrid mismatch rules is restricted because the debt is treated as equity from the holder’s perspective, it may be appropriate to treat such debts as equity for purposes of thin capitalization rules (i.e., by introducing a new category within the “equity amount” definition in subsection 18(5)).

- **Foreign Tax Credit Generator Rules**: The foreign tax credit generator rules were first introduced in the 2010 Federal Budget. These rules deny the deduction of foreign tax credits and amounts for foreign accrual tax (FAT) and underlying foreign tax (UFT) in certain circumstances. The reason for introduction of the foreign tax credit generator rules was included in the Explanatory Notes that accompanied their introduction:

  > *…[the foreign tax credit generator rules] are intended to address tax schemes established by taxpayers with the intent of creating foreign tax credits and similar deductions for foreign tax the burden of which is not, in fact, borne by the taxpayer. The main thrust of all of these schemes is to exploit asymmetry as between the tax laws of Canada and those of a relevant foreign jurisdiction in the characterization of equity and debt instruments.*

  The foreign tax credit generator rules were introduced in Canada before the OECD’s BEPS initiative commenced in 2013. The BEPS initiative ultimately led to a number of recommendations, including the Action 2 Report which is the basis for Canada’s proposed hybrid mismatch rules. As discussed in the Explanatory Notes, the hybrid mismatch rules “…are intended to implement the recommendations in, and be generally consistent with, . . . [the Action 2 Report] . . . [which] recommends a number of specific rules for countries to implement in their domestic laws, which are intended to neutralize mismatches in tax resulting from ‘hybrid mismatch arrangements’.” Given the overlap between the hybrid mismatch rules and the foreign tax credit generator rules (i.e., both are intended to address asymmetry between the tax laws of Canada and those of a relevant foreign jurisdiction in the characterization of equity and debt instruments, in

certain circumstances), it would make sense in our view to consider whether the foreign tax credit rules could be repealed or, at least, considerably simplified (recognizing that simplification is an important aspect of any tax system). At minimum, we think it is important to ensure that the hybrid mismatch rules and the foreign tax credit generator rules interact with each other appropriately, and do not result in any unintended outcomes. We would be pleased to work with the Department on this.