

The Joint Committee on Taxation of
The Canadian Bar Association
and

Chartered Professional Accountants of Canada

The Canadian Bar Association, 66 Slater St., Suite 1200, Ottawa, ON, Canada K1P 5H1
Chartered Professional Accountants of Canada, 145 King St. West, Suite 500, Toronto, ON Canada M5H 1J8

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Department of Finance Canada
Tax Policy Branch
Tax Legislation Division
90 Elgin Street, Ottawa, ON K1A 0G5

Email: consultation-legislation@fin.gc.ca

Subject: Submission on Hybrid Mismatch Arrangements — Technical Comments and Recommendations

This submission sets out comments of the Joint Committee on Taxation of the Canadian Bar Association and Chartered Professional Accountants of Canada (“Joint Committee”) regarding the Hybrid mismatch arrangements, as proposed in the draft legislative proposals released on January 29, 2026.

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

- Ian Bradley – PwC
- David Bunn – Deloitte
- Harry Chana – BDO Canada
- Nik Diksic – EY
- Richele Frank – KPMG
- Kaitlin Gray – Osler
- Hetal Kotecha – BDO Canada
- Daryl Maduke – BDO Canada
- Ryan Minor – CPA Canada
- Ken Saddington – Goodmans
- Jeffrey Shafer – Blakes
- Simon Townsend – RSM
- Sabrina Wong – KPMG

We would be pleased to discuss this submission with you in further detail at your convenience.

Yours truly,



Janette Pantry
Chair, Taxation Committee
Chartered Professional Accountants of Canada



Anu Nijhawan
Chair, Taxation Section
Canadian Bar Association

CC: Trevor McGowan, Associate Assistant Deputy Minister, Tax Policy Branch

Joint Committee on Taxation of The Canadian Bar Association and CPA Canada
Submission to the Department of Finance
Submission on Draft Legislative Proposals Released January 29, 2026
Hybrid Mismatch Arrangements — Technical Comments and Recommendations

The Joint Committee on Taxation of The Canadian Bar Association and CPA Canada (the “Joint Committee”) appreciates the opportunity to provide further comments to the Department of Finance Canada (“Finance”) on the draft legislative proposals released on January 29, 2026 (the “Proposals”). In discussions between Finance and the Joint Committee, Finance suggested that further submissions on certain specific issues would be helpful. These comments are intended to address those issues.

Dual Inclusion Income and Effects of Tax Relief

In our previous submission, we recommended that clarification be provided on whether certain forms of tax relief would prevent amounts from being considered “ordinary income” (and thus prevent such amounts from being included in “dual inclusion income” and “investor dual inclusion income”). Among other things, we recommended that the “ordinary income” definition (or the related Explanatory Notes) be modified to clarify that:

- Double taxation relief, such as a foreign tax credit or similar foreign tax relief, does not prevent an amount from being treated as ordinary income; and
- An amount of trust income is not excluded from ordinary income merely because the trust receives a deduction under subsection 104(6) in respect of the distribution of that income to its beneficiaries.

Based on subsequent discussions, we understand that Finance has a different interpretation of how the “ordinary income” definition would apply in these circumstances. Under this interpretation, an amount will not be included in ordinary income, to the extent that a foreign tax credit (or similar foreign tax relief) is provided for taxes paid on that amount in another country. However, because such foreign tax relief generally applies to net income (rather than gross revenue), revenue amounts that benefit from such tax relief will be excluded from ordinary income only to the extent that they exceed deductible expenses. In other words, if an investor in a hybrid entity receives a foreign tax credit for taxes paid on the entity’s net income, an amount of the entity’s revenue equal to that net income will be excluded from ordinary income (rather than excluding the entire amount of gross revenue). We understand that Finance takes a similar approach with respect to subsection 104(6) deductions – i.e., if a trust distributes its net income and receives a subsection 104(6) deduction, this tax relief would exclude only a portion of the trust’s revenue from ordinary income, corresponding to the amount of net income.

We have concerns about this approach to the ordinary income test, particularly with respect to foreign tax relief. As a general matter, we believe that departing from the approach recommended in the Action 2 Report creates a risk of conflicts with other countries’ tax laws, and potential double taxation. While we acknowledge that Canada may choose to depart from the Action 2 approach where appropriate, we believe that such departures should be made only when driven by compelling policy objectives. In this case, it is not clear to us that this more restrictive approach to the “ordinary income” definition (as outlined above) is needed to prevent hybrid mismatch outcomes.

Text of the “Ordinary Income” Definition

As a preliminary matter, we do not believe the text of the “ordinary income” definition in the draft legislation is sufficient to achieve the intended result with respect to foreign tax credits and subsection 104(6) deductions. The proposed definition refers to tax relief that applies specifically in respect of all or a portion of the particular amount, and not in computing income or profits in general. A foreign tax credit is typically provided on net income from a foreign source. Similarly, the subsection 104(6) deduction is generally based on the amount of a trust’s net income that becomes payable to its beneficiaries. In each case, the tax relief is generally computed based on net income, without distinguishing between the different revenue amounts that are included in computing net income. Accordingly, foreign tax credits and subsection 104(6) deductions appear to be general forms of tax relief, rather than relief that applies specifically in respect of particular amounts of revenue. In the case of foreign tax credits, this conclusion is reinforced by the comments in the Action 2 Report indicating that this kind of foreign tax relief should generally not prevent amounts from being included in dual inclusion income (combined with subsection 18.4(2), which indicates that the rules in section 18.4 are to be interpreted consistently with the Action 2 Report, unless the context otherwise requires). Therefore, although there is some uncertainty, we believe that the most reasonable interpretation of the proposed “ordinary income” definition would include amounts that benefit from foreign tax credits or subsection 104(6) deductions.

Furthermore, if the “ordinary income” definition were interpreted so as to exclude amounts that benefit from foreign tax credits or subsection 104(6) deductions, it could be difficult to limit this exclusion to the net income amount. Since all revenue amounts are generally included in computing net income, if foreign tax credits and similar tax relief based on net income were considered a form of tax relief that applies specifically to particular revenue amounts, arguably this tax relief would apply to all revenue amounts that are included in the computation of net income. It could be difficult to distinguish between revenue amounts that are sheltered by expenses, and other revenue amounts (representing the net income) that are sheltered by foreign tax credits (or subsection 104(6) deductions).

Therefore, if the “ordinary income” definition is intended to exclude amounts representing net income that are sheltered by foreign tax credits or subsection 104(6) deductions, we believe the draft legislation should be modified to achieve that result. The revised “ordinary income” definition should specify the basis under which those forms of tax relief will exclude amounts from ordinary income. In particular, the definition should specify how such tax relief is allocated between the various amounts that are included in computing net income.

Computational Difficulties

Because foreign tax credits and subsection 104(6) deductions apply to amounts of net income, it would be difficult to determine which specific revenue amounts are sheltered by this tax relief (and thus excluded from ordinary income). This challenge would be exacerbated by complex foreign tax credit rules in other countries (e.g., detailed rules for allocating credits to particular sources of income, which may differ from Canadian sourcing principles), as well as differences in the computation of taxable income in Canada and foreign countries. This could cause interpretive difficulties and anomalous results, as illustrated by the following examples.

In the first example, a corporation resident in a foreign country (“Foreignco”) owns the shares of a Canadian-resident ULC (“ULC”). ULC also has a minority ownership interest in a Canadian-resident corporation (“Canco”). ULC is disregarded under the tax laws of Foreignco’s country, but Canco is not disregarded. The Canadian tax rate is 25% and the foreign tax rate is 20%.

- ULC has \$300 revenue in a taxation year, consisting of a \$100 dividend from Canco and \$200 revenue from other sources; it also makes \$100 expense payments to third parties.
- In computing its Canadian taxable income, ULC receives a \$100 deduction for the Canco dividend, under subsection 112(1). ULC therefore has \$100 taxable income and pays \$25 Canadian tax.
- The foreign tax regime does not provide a deduction for the Canco (due to ULC’s partial ownership of Canco). Foreignco therefore has \$200 foreign taxable income.¹ The foreign tax liability would be \$40, but is reduced to \$15 by a foreign tax credit, reflecting the Canadian tax paid by ULC.

In this example, it is not clear how the foreign tax relief should be allocated to ULC’s revenue amounts, for purposes of the ordinary income test.

- First, it is unclear what quantum of revenue is sheltered by the foreign tax credit, given the difference in tax rates. Under one interpretation, \$100 of revenue is sheltered by the foreign tax credit, because the credit reflects the Canadian tax paid on \$100 of net income (i.e., the Canadian tax rate determines the sheltered amount). Under another interpretation, \$125 of revenue is sheltered by the foreign tax credit, because the \$25 Canadian tax is sufficient to eliminate foreign tax on \$125 of Foreignco’s income (i.e., the foreign tax rate determines the sheltered amount).
- Second, it is unclear which specific revenue amounts are sheltered by the foreign tax credit, since the foreign tax system does not distinguish between the \$100 dividend and the \$200 other revenue. Under one interpretation, the \$100 dividend would be sheltered by the subsection 112(1) deduction and the \$200 other revenue would be sheltered by the foreign tax credit, such that ULC has no dual inclusion income.² This result seems inconsistent with the goal of applying foreign tax credits only to the extent of net income; it would also produce circular calculations (since subsection 18.4(15.6) would deny the deduction of the \$100 expenses). If only \$100 of other revenue were sheltered by the foreign tax credit (reflecting ULC’s net income), ULC would have \$100 dual inclusion income. This would be sufficient to offset the \$100 double deduction mismatch from the expense payment, but would leave no dual inclusion income available to offset expenses arising in future years. While this is more reasonable than the result under the first interpretation, it still seems inappropriate to have no dual inclusion income available for carryforward, since there is positive net income for both Canadian and foreign tax (and \$40 tax is paid on this income).

¹ For simplicity, the examples in this discussion assume that no foreign hybrid payer mismatch applies to an investor in a hybrid entity.

² Based on our discussions, we understand that subsection 112(1) deductions may be considered a form of specific tax relief, which excludes such dividend amounts from ordinary income. We do not believe this is the best approach for dealing with subsection 112(1) deductions, considering the guidance in the Action 2 Report. However, for the purposes of this example, we assume that subsection 112(1) deductions will exclude dividends from ordinary income.

The second example also involves a foreign-resident Foreignco that owns a Canadian-resident ULC (which is disregarded for foreign tax purposes).

- ULC has \$200 revenue in a taxation year, and makes \$200 expense payments to third parties. The expenses are fully deductible for foreign tax, but are only 50% deductible for Canadian tax.³
- ULC has \$100 Canadian taxable income and pays \$25 Canadian tax.
- Foreignco has nil foreign taxable income and pays no foreign tax. Foreignco therefore claims no foreign tax credit for the Canadian tax.

In this example, the \$200 revenue amount is not sheltered by any foreign tax credit; it is instead sheltered by the \$200 expense deduction. This is a deduction that applies generally in computing Foreignco's income, rather than a form of tax relief that is specific to the revenue amount. ULC therefore has \$200 dual inclusion income; \$100 of this dual inclusion income offsets the double deduction mismatch, and the other \$100 is available for use in future years. We believe this is an appropriate result, since ULC pays tax on \$100 of income. However, the overall treatment of the two examples seems arbitrary; more dual inclusion income is produced in the second example, even though more tax is paid in the first example. It seems odd that foreign tax credits can prevent the recognition of dual inclusion income, while differences in the computation of taxable income do not produce the same result.

Timing Differences and Circular Calculations

The proposed rules are designed to address timing differences between the recognition of double deduction mismatches and dual inclusion income (through the carryforward of unused dual inclusion income, and the deductions provided under paragraphs 20(1)(zz) and (aaa) where dual inclusion income arises in a future year). However, these mechanisms to resolve timing differences may not operate as intended if net income for a particular year is excluded from dual inclusion income, on the basis that a foreign tax credit or subsection 104(6) deduction is available in respect of that net income.

Circularity problems can also arise in some scenarios involving timing differences. This is because the determination of dual inclusion income is affected by tax relief that is provided on net income (e.g., foreign tax credits and subsection 104(6) deductions); the amount of dual inclusion income can therefore depend on the amount of net income. However, the amount of net income is determined in part by the application of the hybrid mismatch rules, and thus by the amount of dual inclusion income.

These problems can be illustrated by the following example. As in the previous examples, a foreign-resident Foreignco owns a Canadian-resident ULC, which is disregarded under the foreign tax laws. For simplicity, the Canadian and foreign tax rates are both 25% in this example.

- In 2027, ULC has no revenue and \$100 expense payments. For foreign tax, Foreignco has a \$100 loss for 2027. For Canadian tax, ULC has a \$100 double deduction mismatch and no dual inclusion income, so subsection 18.4(15.6) applies to deny the \$100 deduction.

³ The results would be similar if the expense payment were fully deductible for Canadian tax, but the foreign tax regime provided a super-deduction that exceeded the actual amount of the payment.

- In 2028, ULC has \$200 revenue and no expenses. The revenue amount is included in computing ULC's income for Canadian tax, and in computing Foreignco's income for foreign tax. Foreignco receives a foreign tax credit for any Canadian tax paid on this income.⁴

If ULC has dual inclusion income in 2028, it may claim a deduction under paragraph 20(1)(zz). However, the amount of ULC's dual inclusion income is unclear. To determine if the \$200 revenue amount is ordinary income, we must first determine whether this amount is effectively sheltered from tax. However, the method for determining the amount that is sheltered by a foreign tax credit is not clear.

One interpretive approach would first compute dual inclusion income on the basis that no amounts are sheltered by foreign tax credits (or other forms of tax relief on net income). ULC's hypothetical net income would be computed on this basis, and the amount of foreign tax credits would be determined based on that hypothetical net income. Dual inclusion income would then be re-computed, based on that foreign tax credit amount. Applying that approach, ULC would start with \$200 dual inclusion income in 2028. ULC would therefore claim a \$100 deduction under paragraph 20(1)(zz), and would have \$100 hypothetical net income. ULC would pay \$25 Canadian tax on this hypothetical net income, producing a foreign tax credit that shelters \$100 of Foreignco's income. Dual inclusion income would therefore be re-computed as \$100 (on the basis that \$100 of revenue is sheltered by the foreign tax credit). This would still leave sufficient dual inclusion income to claim a \$100 deduction under paragraph 20(1)(zz), so ULC's net income would still be \$100. Accordingly, while there is an element of circularity in this approach, the calculations appear to eventually produce an appropriate result.

Another interpretive approach would first compute dual inclusion income based on the hypothetical foreign tax credit that would be available in the absence of the hybrid mismatch rules (including paragraph 20(1)(zz)). The hybrid mismatch rules would then be applied based on that amount of dual inclusion income. If the application of those rules changed the amount of the foreign tax credit, dual inclusion income would be re-computed accordingly. Under this approach, ULC would have \$200 net income in 2028 (before applying the hybrid mismatch rules), and would pay \$50 Canadian tax. Foreignco would receive a foreign tax credit for that \$50 tax, which would shelter all of its taxable income. The entire \$200 revenue amount would be effectively sheltered from tax, so there would be no dual inclusion income. Accordingly, no paragraph 20(1)(zz) deduction would be available. ULC would have \$200 actual net income, and would pay \$50 Canadian tax. The actual foreign tax credit would be \$50, so no re-computation of dual inclusion income would be necessary. This seems like an inappropriate result, since ULC would pay \$50 tax, even though its combined net income for 2027 and 2028 is only \$100.

Summary

The above discussion probably does not represent a comprehensive review of the challenges that could arise from this approach to the "ordinary income" definition. Given the complexity of foreign tax systems, there are likely other anomalous results and potential conflicts, in addition to those noted here. In some cases, taxpayers may be able to take interpretive positions that produce appropriate results, as illustrated in some of the above examples. However, confirming those positions would require significant additional tax analysis, and the rules would still produce significant uncertainty for structures that do not raise hybrid mismatch concerns. We therefore believe that this approach to the

⁴ Under the foreign tax rules, Foreignco is either not permitted to carry-forward the 2027 loss to offset 2028 income, or must use any available foreign tax credits in 2028 before applying carried-forward losses from prior years.

“ordinary income” definition could significantly increase the tax complexity of many common arrangements for investing into Canada. We believe it would be better to avoid these problems by applying the “ordinary income” and “dual inclusion income” concepts in a manner that is more consistent with the Action 2 Report.

Recommendations:

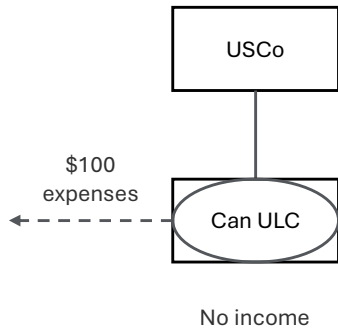
- **The “ordinary income” definition should not exclude amounts that are subject to double taxation relief, particularly relief that is applied on net income (such as foreign tax credits or similar foreign tax relief granted by a country in respect of taxes paid on an amount of income in another country, or subsection 104(6) deductions in respect of trust distributions).**
- **If such amounts are to be excluded from ordinary income, the definition of “ordinary income” in subsection 18.4(1) should be redrafted to reflect this approach. The definition or the Explanatory Notes should specify that where a revenue amount is excluded from ordinary income due to foreign tax credits or subsection 104(6) deductions (or similar tax relief that applies to amounts of net income), only an amount equal to the net income is so excluded. They should also provide guidance for allocating the tax relief between different revenue amounts. Guidance should also be provided to address the application of this test in scenarios such as those discussed above (e.g., involving different rules for computing Canadian and foreign taxable income, timing differences, and circular calculations). Careful consideration should be taken to avoid inappropriate results and overly complex tax computations. We would be happy to discuss these considerations further.**

Interaction with the U.S. Dual Consolidated Loss Rules

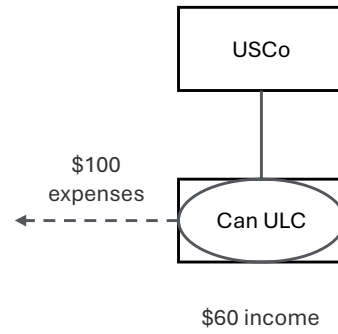
Further submissions were also requested on the interaction between the Proposals and the U.S. dual consolidated loss (“DCL”) rules. These interactions are discussed in the charts below. The following scenarios are considered:

- Scenario 1 – USCo owns a disregarded Can ULC that makes a deductible payment of \$100, with Can ULC having no dual inclusion income.
- Scenario 2 – USCo owns a disregarded Can ULC that makes a deductible payment of \$100, with Can ULC having dual inclusion income of \$60.
- Scenario 3 – Canco owns a US LP that elects to be treated as corporation for US tax purposes. US LP makes a deductible payment of \$100 and has no dual inclusion income.
- Scenario 4 – Canco owns a US LP that elects to be treated as corporation for US tax purposes. US LP makes a deductible payment of \$100 and has dual inclusion income of \$60.

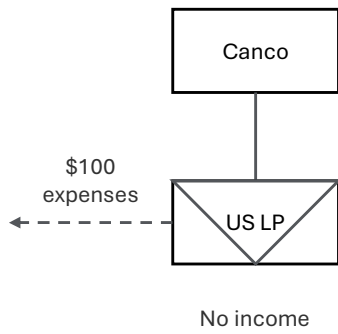
Scenario 1



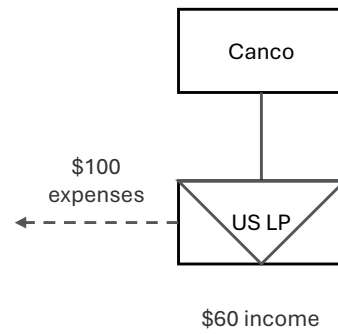
Scenario 2



Scenario 3



Scenario 4



Scenario 1 – USCo owns a disregarded Can ULC that makes a deductible payment of \$100, with Can ULC having no dual inclusion income.

	<i>Alternative 1a – The US DCL rules are <u>not</u> considered “substantially similar” and thus <u>not</u> a foreign hybrid payer mismatch rule</i>	<i>Alternative 1b – The US DCL rules are considered “substantially similar” and thus a foreign hybrid payer mismatch rule</i>
DD Mismatch	<ul style="list-style-type: none"> • Whether a DD mismatch arises depends on whether an amount would be deductible in respect of the payment for US tax purposes, after applying the US DCL rules 	<ul style="list-style-type: none"> • There is always a DD mismatch, as foreign deductibility is applied without reference to the US DCL rules
Assuming a domestic use election is <u>not</u> made for US tax purposes	<ul style="list-style-type: none"> • There is no DD mismatch • Since there is no DD mismatch, the Canadian hybrid payer arrangement rule does not apply • Outcome: \$100 deduction in Canada; no deduction in US 	<ul style="list-style-type: none"> • There is a DD mismatch • Since a foreign hybrid payer mismatch rule applies, the Canadian hybrid payer arrangement does not apply • Outcome: \$100 deduction in Canada; no deduction in US
Assuming a domestic use election is made for US tax purposes	<ul style="list-style-type: none"> • There is a DD mismatch • Since no foreign hybrid payer mismatch rule applies, the Canadian hybrid payer arrangement rule applies • The US mirror legislation rule is not expected to apply, as Canadian tax law is only denying the deduction because of the domestic use election in the US • Outcome: \$100 deduction in the US; no deduction in Canada 	<ul style="list-style-type: none"> • There is a DD mismatch • Since no foreign hybrid payer mismatch rule applies, the Canadian hybrid payer arrangement rule applies • The US mirror legislation rule is not expected to apply, as Canadian tax law is only denying the deduction because of the domestic use election in the US • Outcome: \$100 deduction in the US; no deduction in Canada
Overall outcome	<ul style="list-style-type: none"> • There is optionality as to whether to take the deduction in Canada or the US, but not both 	<ul style="list-style-type: none"> • There is optionality as to whether to take the deduction in Canada or the US, but not both

Scenario 2 – USCo owns a disregarded Can ULC that makes a deductible payment of \$100, with Can ULC having dual inclusion income of \$60.

	<i>Alternative 2a – The US DCL rules are <u>not</u> considered “substantially similar” and thus <u>not</u> a foreign hybrid payer mismatch rule</i>	<i>Alternative 2b – The US DCL rules are considered “substantially similar” and thus a foreign hybrid payer mismatch rule</i>
DD Mismatch	<ul style="list-style-type: none"> • There is always a DD mismatch, as only a portion of the payment is denied by the US DCL rules 	<ul style="list-style-type: none"> • There is always a DD mismatch, as foreign deductibility is applied without reference to the US DCL rules
Assuming a domestic use election is <u>not</u> made for US tax purposes	<ul style="list-style-type: none"> • There is a DD mismatch • Since no foreign hybrid payer mismatch rule applies, the Canadian hybrid payer arrangement rule applies • The amount denied in Canada is equal to the DD mismatch amount of \$100 less dual inclusion income of \$60 • Outcome: Deduction in both Canada and the US is limited to the dual inclusion income of \$60; remaining \$40 is denied in both countries 	<ul style="list-style-type: none"> • There is a DD mismatch • Since a foreign hybrid payer mismatch rule applies, the Canadian hybrid payer arrangement does not apply • Outcome: \$100 deduction in Canada; \$60 deduction in US (i.e., limited to the amount of dual inclusion income)
Assuming a domestic use election is made for US tax purposes	<ul style="list-style-type: none"> • There is a DD mismatch • Since no foreign hybrid payer mismatch rule applies, the Canadian hybrid payer arrangement rule applies • The amount denied in Canada is equal to the DD mismatch amount of \$100 less dual inclusion income of \$60 • The US mirror legislation rule may apply, in which case only \$60 of the payment is deductible for US tax purposes (i.e., limited to the amount of dual inclusion income) • Outcome: Deduction in both Canada and the US is limited to the dual inclusion income of \$60; remaining \$40 is denied in both countries 	<ul style="list-style-type: none"> • There is a DD mismatch • Since no foreign hybrid payer mismatch rule applies, the Canadian hybrid payer arrangement rule applies • The US mirror legislation rule is not expected to apply, as Canadian tax law is only denying the deduction because of the domestic use election in the US • Outcome: \$100 deduction in the US; \$60 deduction in Canada (i.e., limited to the amount of dual inclusion income)
Overall outcome	<ul style="list-style-type: none"> • Regardless of whether a domestic use election is made in the US, it appears that both the Canadian hybrid payer arrangement rule and the US DCL rules could apply, effectively resulting in a <u>double non-deduction outcome</u> for the portion of the payment that exceeds dual inclusion income⁵ 	<ul style="list-style-type: none"> • There is optionality as to whether to take the deduction in excess of dual inclusion income in Canada or the US, but not both

⁵ This anomalous result would not arise if the deduction component of the double deduction mismatch was equal to the lesser of the amounts determined in (7.1)(a) and (7.1)(b).

Scenario 3 – Canco owns a US LP that elects to be treated as corporation for US tax purposes. US LP makes a deductible payment of \$100 and has no dual inclusion income.

	<i>Alternative 3a – The US DCL rules are <u>not</u> considered “substantially similar” and thus <u>not</u> a foreign hybrid payer mismatch rule</i>	<i>Alternative 3b – The US DCL rules are considered “substantially similar” and thus a foreign hybrid payer mismatch rule</i>
DD Mismatch	<ul style="list-style-type: none"> • Whether a DD mismatch arises depends on whether an amount would be deductible in respect of the payment for US tax purposes, after applying the US DCL rules 	<ul style="list-style-type: none"> • There is always a DD mismatch, as foreign deductibility is applied without reference to the US DCL rules
Assuming a domestic use election is <u>not</u> made for US tax purposes	<ul style="list-style-type: none"> • There is no DD mismatch • Since there is no DD mismatch, the Canadian hybrid payer arrangement rule does not apply • Outcome: \$100 deduction in Canada; no deduction in US 	<ul style="list-style-type: none"> • There is a DD mismatch • Since the payer is not a hybrid entity resident in Canada or a multinational entity, the Canadian hybrid payer arrangement rule is applied without reference to whether a foreign hybrid payer mismatch rule applies • As such, the Canadian hybrid payer arrangement rule applies • Outcome: No deduction in either country
Assuming a domestic use election is made for US tax purposes	<ul style="list-style-type: none"> • There is a DD mismatch • Since there is a DD mismatch and no foreign hybrid payer mismatch rule applies, the Canadian hybrid payer arrangement rule applies • The US mirror legislation rule does not apply to domestic reverse hybrids • Outcome: \$100 deduction in the US; no deduction in Canada 	<ul style="list-style-type: none"> • There is a DD mismatch • Since the payer is not a hybrid entity resident in Canada or a multinational entity, the Canadian hybrid payer arrangement rule is applied without reference to whether a foreign hybrid payer mismatch rule applies • As such, the Canadian hybrid payer arrangement rule applies • The US mirror legislation rule does not apply to domestic reverse hybrids • Outcome: \$100 deduction in the US; no deduction in Canada
Overall outcome	<ul style="list-style-type: none"> • There is optionality as to whether to take the deduction in Canada or the US, but not both 	<ul style="list-style-type: none"> • No optionality: a domestic use election is required in the US to avoid a double non-deduction outcome

Scenario 4 – Canco owns a US LP that elects to be treated as corporation for US tax purposes. US LP makes a deductible payment of \$100 and has dual inclusion income of \$60.

	<i>Alternative 4a – The US DCL rules are <u>not</u> considered “substantially similar” and thus <u>not</u> a foreign hybrid payer mismatch rule</i>	<i>Alternative 4b – The US DCL rules are considered “substantially similar” and thus a foreign hybrid payer mismatch rule</i>
DD Mismatch	<ul style="list-style-type: none"> • There is always a DD mismatch, as only a portion of the payment is denied by the US DCL rules 	<ul style="list-style-type: none"> • There is always a DD mismatch, as foreign deductibility is applied without reference to the US DCL rules
Assuming a domestic use election is <u>not</u> made for US tax purposes	<ul style="list-style-type: none"> • If no domestic use election is made in the US, \$60 is deductible for US tax purposes and the remaining \$40 is denied by the US DCL rules • Since there is a DD mismatch, the Canadian hybrid payer arrangement rule applies • The amount denied in Canada is equal to the DD mismatch amount of \$100 less dual inclusion income of \$60 • Outcome: Deduction in both Canada and the US is limited to the dual inclusion income of \$60; remaining \$40 is denied in both countries 	<ul style="list-style-type: none"> • If no domestic use election is made in the US, \$60 is deductible for US tax purposes and the remaining \$40 is denied by the US DCL rules • Since there is a DD mismatch, the Canadian hybrid payer arrangement rule applies • The amount denied in Canada is equal to the DD mismatch amount of \$100 less dual inclusion income of \$60 • Outcome: Deduction in both Canada and the US is limited to the dual inclusion income of \$60; remaining \$40 is denied in both countries
Assuming a domestic use election is made for US tax purposes	<ul style="list-style-type: none"> • If a domestic use election is made in the US, the full \$100 is deductible for US tax purposes • Since there is a DD mismatch, the Canadian hybrid payer arrangement rule applies • The amount denied in Canada is equal to the DD mismatch amount of \$100 less dual inclusion income of \$60 • The US mirror legislation rule does not apply to domestic reverse hybrids • Outcome: \$100 deduction in the US; \$60 deduction in Canada (i.e., limited to the amount of dual inclusion income) 	<ul style="list-style-type: none"> • If a domestic use election is made in the US, the full \$100 is deductible for US tax purposes • Since there is a DD mismatch, the Canadian hybrid payer arrangement rule applies • The amount denied in Canada is equal to the DD mismatch amount of \$100 less dual inclusion income of \$60 • The US mirror legislation rule does not apply to domestic reverse hybrids • Outcome: \$100 deduction in the US; \$60 deduction in Canada (i.e., limited to the amount of dual inclusion income)
Overall outcome	<ul style="list-style-type: none"> • No optionality: a domestic use election is required in the US to avoid a double non-deduction outcome 	<ul style="list-style-type: none"> • No optionality: a domestic use election is required in the US to avoid a double non-deduction outcome

Deduction Component of a Double Deduction Mismatch

In the course of preparing comments on the interaction with the U.S. DCL rules, we realized that a further submission would be helpful on the computation of the double deduction mismatch amount, in scenarios where a payment produces a partial deduction.

Under proposed subsection 18.4(7.1), a payment is considered to give rise to a deduction mismatch if

- (a) in the absence of paragraph (f) of the definition hybrid mismatch amount, an amount would be deductible, in respect of the payment, in computing the income of an entity from a business or property under this Part for a taxation year; and
- (b) in the absence of any foreign hybrid payer mismatch rule, an amount would be – or would reasonably be expected to be – deductible, in respect of the payment, in computing the relevant foreign income or profits of an entity for a foreign taxation year.

Under proposed subsection 18.4(7.2), if a payment gives rise to a double deduction mismatch,

- (a) the total of all amounts, each of which is an amount referred to in paragraph (7.1)(a) in respect of the payment, is the deduction component of the double deduction mismatch; and
- (b) the amount of the double deduction mismatch arising from the payment is equal to the deduction component of the double deduction mismatch.

Based on the language in proposed subsections 18.4(7.1) and (7.2), where any portion of a payment is deductible for both Canadian and foreign tax purposes, the deduction component is deemed to be equal to the amount that is deductible for Canadian tax purposes, even if the amount that is deductible for foreign tax purposes is less than this amount.

Paragraph 200 of the Action 2 Report makes it clear that the amount denied under a deductible hybrid payments rule “...should be no more than is necessary to neutralise the hybrid mismatch and should result in an outcome that is proportionate and that does not lead to double taxation”.

We are concerned that the Canadian hybrid payer arrangement rule, as currently drafted, could result in the denial of a deduction in excess of the amount necessary to neutralise the hybrid mismatch.

Consider, for example, the situation where a Canadian corporation (“Canco”) is the sole limited partner in a partnership (“P1”) that is treated as a corporation for local tax purposes in the country in which it was formed (“Country P”). P1 incurs \$100 of interest expense and earns \$20 of income. For Canadian tax purposes, Canco (as the sole limited partner) is allocated \$100 of interest expense and \$20 of income (i.e., a net deduction in Canada of \$80).⁶ For Country P tax purposes, only \$90 of interest expense is deductible because of a local interest restriction rule, with the full \$20 of income being recognized (i.e., a net deduction in Country P of \$70).

Under the Canadian proposals, as currently drafted, the deduction component of the double deduction mismatch would be equal to the Canadian deduction of \$100, notwithstanding that only \$90 is

⁶ For simplicity, we have assumed that Canco is allocated 100% of P1’s income or loss.

deductible for Country P tax purposes. After taking into account dual inclusion income (“DII”) of \$20, the amount denied under the proposed Canadian hybrid payer rule would be \$80 (i.e., \$100 less DII of \$20). As a result, Canco would have no net deduction (i.e., \$100 less \$80 less DII of \$20).

We believe, from a policy standpoint, the deduction component of the double deduction mismatch should be limited to the lesser of the amounts in proposed paragraphs 18.4(7.1)(a) and (b) (i.e., the lesser of the Canadian deduction and the foreign deduction). In that case, the deduction component of the double deduction mismatch would be \$90. After taking into account dual inclusion income of \$20, the amount denied under the Canadian hybrid payer rule would be \$70 (i.e., \$90 less \$20). Canco would have a net deduction in that case of \$10 (i.e., \$100 less \$70 less DII of \$20).

Conceptually, this makes sense given that \$10 of the interest expense incurred by P1 is not deductible for Country P tax purposes and is therefore not contributing to the hybrid mismatch. In other words, if a payment by a hybrid payer gives rise to an \$80 net deduction (after DII) in Canada and a \$70 net deduction (after DII) in a foreign country, it would be inappropriate from a policy standpoint (and inconsistent with the Action 2 Report) for Canada to deny more than \$70, as any denial in excess of this amount is not simply neutralizing the hybrid mismatch, but is instead a disproportionate denial that effectively leads to double taxation.

Recommendation:

We recommend that the amount denied under the proposed hybrid payer arrangement rule be limited to the amount necessary to neutralize the hybrid mismatch resulting from a payment by a hybrid payer by limiting the amount of the deduction component of the double deduction mismatch to the lesser of the Canadian deduction and the foreign deduction. This could be achieved by amending the language in proposed subsection 18.4(7.2) as follows:

(7.2) For the purposes of this section and section 12.7, if a payment gives rise to a double deduction mismatch,

1. lesser of:

(i) the total of all amounts, each of which is an amount referred to in paragraph (7.1)(a) in respect of the payment, and

(ii) the total of all amounts, each of which is an amount referred to in paragraph (7.1)(b) in respect of the payment

is the deduction component of the double deduction mismatch; and

2. the amount of the double deduction mismatch arising from the payment is equal to the deduction component of the double deduction mismatch.

Withholding Tax

We understood from our discussions that a key element informing the proposed application of Part XIII tax to certain interest expenses that are denied under the anti-hybrid rules is the preservation of the integrity of the existing thin capitalization rules. Specifically, there was a concern that taxpayers might intentionally structure debt that would be off-side the thin capitalization rules, and thus give rise to Part XIII tax on interest pursuant to subsection 214(16), to fall within the scope of the anti-hybrid rules so as to avoid the application of Part XIII tax.

To the extent this is a primary concern, and without taking away from our prior submissions regarding subsection 214(18), this can be more easily and efficiently addressed with an ordering rule to ensure that the thin capitalization rules apply first. This approach has already been adopted for the EIFEL rules, as subsection 18(4) already refers to interest that would "... in the absence of this subsection and section 18.2, be deductible...". We note that this same approach would address the concern with respect to the existing anti-hybrid rules in the Act as well.

Recommendation:

- (i) Subsection 18(4) should be amended to clarify that the thin capitalization rule applies before the anti-hybrid rules, which can be done by replacing "...this subsection and section 18.2..." in subsection 18(4) with "...this subsection, section 18.2 and section 18.4...". Subsection 214(18) can then be repealed in its entirety.**
- (ii) In the alternative, we would revert to our original recommendations regarding withholding tax.**
- (iii) In the further alternative, we would revert to our original recommendations regarding withholding tax, coupled with the "ordering rule" amendment to subsection 18(4) described in (i) above.**

Timing

We understand that the Department of Finance will be releasing a further amended version of the proposed amendments to the anti-hybrid rules for further consultation. We commend this decision, as these rules are extremely complex. Any changes implemented as a result of comments received on the original proposals will benefit from additional review and careful consideration from the perspective of taxpayers that can consider how the rules may apply to real world situations.

However, with the release of further amended proposals, and allowing for time for review and comment, and for the Department of Finance to consider and react to such comments, it is unlikely that a "final" version of these proposals will be available for July 1, 2026. The application of these rules as of July 1, 2026 as originally proposed when taxpayers cannot know the final form of the proposed rules undermines the certainty, predictability and fairness of the tax system. The unfairness resulting from having to comply with unknown rules is particularly acute in the context of Part XIII tax, as taxpayers need to take an immediate position on whether to withhold or not to avoid the application of penalties and interest (it may also be very challenging from a practical perspective to fund Part XIII tax amounts after payments have been made).

Recommendation:

- (i) The effectiveness of the proposed changes to the anti-hybrid rules should be deferred until a reasonable time after the final form of the rules has been released to the public.**
- (ii) If a general deferral cannot be granted, at least the application of 214(18) (to the extent it continues to apply) to interest expenses that could be denied by the new proposed rules should be deferred until a reasonable time after the release of the final version of these proposals, so as to provide taxpayers with reasonable notice to allow compliance with withholding obligations.**