

BUDGET 2021: GOVERNMENT TARGETS HYBRID MISMATCH ARRANGEMENTS

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On April 19, 2021, the Federal Minister of Finance, Chrystia Freeland, presented the Liberal government's first Budget in over two years.

One of the over-arching tax themes of Budget 2021 was the continuing pursuit of the recommendations made by the Organisation for Economic Co-operation and Development (the "OECD") in connection with its "Base Erosion and Profit Shifting" Project (the "BEPS Project").

In 2015, as part of the BEPS Project, 15 separate action items were released by the OECD that were aimed at encouraging the coordinated reform of international tax rules. Since 2015, the Canadian government has sought to implement several of the proposed action items.

In Budget 2021, the government proposes to introduce measures to address perceived tax inequities that flow from certain "hybrid mismatch arrangements" identified as part of the BEPS Project. The government has expressed concern that multinational enterprises may take advantage of foreign and domestic "mismatches" in the income tax treatment of commercial entities or financial instruments to secure improper tax advantages.

BEPS Project - Hybrid Mismatch Recommendations

The Action 2 Report released by the OECD at the conclusion of the BEPS Project (the "Hybrid Report") proposed detailed measures to counteract the tax benefits that could arise from "hybrid mismatch arrangements".^[1] The Hybrid Report primarily focused on two main types of hybrid mismatches:

- (a) **Deduction/Non-Inclusion Mismatches ("D/NI Mismatches").** D/NI Mismatches arise where a deduction may be claimed in respect of a cross-border payment by the payor in one country, while the foreign recipient of the payment is not required to include the payment in the computation of its "ordinary income" within a reasonable period of time.^[2]
- (b) **Double Deduction Mismatches.** Double deduction mismatches arise where a tax deduction may be claimed in two or more countries in respect of a single expense.

The Hybrid Report further recommended that countries take steps to address certain other types of hybrid mismatches, including “imported mismatches” and “branch mismatch arrangements”.

The BEPS Project acknowledged that cross-border mismatches may not be able to be addressed on a unilateral basis without raising the spectre of double taxation. Accordingly, the Hybrid Report asserted that coordinated international action is required to address perceived mismatches on an efficient basis and recommended a common framework for legislative change.

Hybrid Mismatch Arrangement Proposals

While the government believes that existing anti-avoidance rules could address what it perceives to be improper tax advantages attributable to cross-border hybrid arrangements, the government has suggested that specific statutory measures would provide greater certainty and that advantages may be realized by adhering to a common international approach to addressing hybrid mismatch arrangements.

In Budget 2021, the government proposes to introduce amendments to the *Income Tax Act* (Canada) (the “**Tax Act**”) to counteract hybrid mismatch arrangements in a manner consistent with the recommendations made in the Hybrid Report.

The Hybrid Report recommended adherence to a general ordering framework to address hybrid mismatch arrangements. Specifically, the report recommended that the jurisdiction in which a payor is situated should deny deductions in respect of payments made under a hybrid mismatch arrangement to the extent they give rise to a D/NI Mismatch. To the extent the payor jurisdiction does not “neutralise” the mismatch, the report recommended that the payee jurisdiction require the subject payments to be included in the ordinary income of the payee to the extent the payment gives rise to a D/NI Mismatch.

The Hybrid Report suggested that differences in the timing of the recognition of payments should not be treated as giving rise to a D/NI Mismatch, provided the taxpayer can establish to the satisfaction of the relevant tax authority that the payment will be included in the computation of ordinary income within a reasonable period of time.

Consistent with the Hybrid Report, Budget 2021 proposes that payments made by Canadian residents under hybrid mismatch arrangements will not be deductible to the extent they (i) give rise to further deductions in another country, or (ii) are not included in the computation of the ordinary income of the foreign recipient of the payment.

Similarly, to the extent a Canadian resident receives a payment under a hybrid mismatch arrangement from a non-resident, the Canadian resident will not be permitted to claim a deduction in respect of the payment if the non-resident is entitled to deduct the amount of the payment for foreign tax purposes. Instead, the amount of

the payment will be required to be included in the income of the Canadian resident. To the extent the payment represents a dividend for Canadian tax purposes, it will generally not be eligible to be deducted when computing the Canadian resident's income under the Canadian foreign affiliate rules.

Budget 2021 further indicates that rules addressing other hybrid mismatch scenarios raised in the Hybrid Report, including branch mismatch arrangements, imported mismatch arrangements and reverse hybrids, may be introduced at a future date.

Key Interpretive Considerations

Budget 2021 indicates that the new statutory provisions to address hybrid mismatch arrangements will be "mechanical in nature" and will not be subject to a purpose test.

In most circumstances, the proposed rules will only apply in respect of payments between related persons and payments between unrelated persons that are designed to produce a mismatch.

Implementation Timing

Budget 2021 proposes that the rules to address hybrid mismatch arrangements be implemented in two separate legislative tranches.

The first tranche will focus on measures to neutralize D/NI Mismatches arising from payments made under financial instruments. The legislative proposals in the first tranche are anticipated to be released for stakeholder comment in the latter part of 2021, with a proposed application date as of July 1, 2022.

The second tranche of legislative proposals will address other types of hybrid mismatch arrangements raised in the Hybrid Report and will be released for stakeholder comment after 2021. Such later provisions, if enacted, will apply no earlier than 2023.

Practical Considerations

The government expects that the proposed hybrid mismatch arrangement rules generate an additional \$775 million of tax revenue over the next five years.

The hybrid mismatch arrangement proposals contained in Budget 2021 underscore the government's desire to challenge hybrid structures, including certain tower and repo arrangements. Multinational enterprises should canvass their internal cross-border commercial arrangements to identify circumstances where payments giving rise to a deductible expense in one jurisdiction are not correspondingly required to be included in the computation of the income of the recipient in another jurisdiction. The absence of a purpose test to constrain the proposed hybrid mismatch rules will require taxpayers to perform an objective assessment and

mechanically examine the net tax effect of cross-border arrangements.

Budget 2021 did not include any specific legislative text relating to the hybrid mismatch proposals. Given the need to reconcile domestic legislative action with foreign taxation rules to avoid instances of double taxation, it will be interesting to see how the ultimate legislative provisions are drafted in a manner that ensures that the Canadian and foreign tax treatment of any arrangement are effectively harmonized, particularly where there is uncertainty as to the proper application of foreign tax provisions.

[1][ps2id id='1' target=''] The Hybrid Report can be accessed at oecd.org/ctp/neutralising-the-effects-of-hybrid-mismatch-arrangements-action-2-2015-final-report-9789264241138-en.htm.

[2][ps2id id='2' target=''] The Hybrid Report generally conceives of “ordinary income” as income that is subject to tax at the recipient’s full tax rate and that does not benefit from any exemption, exclusion, deduction, credit or comparable tax relief.

By [Michael Friedman](#)

A Cautionary Note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.

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