Explanatory Notes to Legislative Proposals Relating to the Income Tax Act and Regulations

Published by
The Honourable François-Philippe Champagne, P.C., M.P.
Minister of Finance and National Revenue

July 2026

Department of Finance Canada Ministère des Finances Canada

Preface

These explanatory notes describe proposed amendments to the *Income Tax Act* and *Income Tax Regulations*. These explanatory notes describe these proposed amendments, clause by clause, for the assistance of Members of Parliament, taxpayers and their professional advisors.

The Honourable François-Philippe Champagne, P.C., M.P.
Minister of Finance and National Revenue

These notes are intended for information purposes only and should not be construed as an official interpretation of the provisions they describe.

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Income Tax Act and Income Tax Regulations

Amendments to the *Income Tax Act* (the "Act" or "ITA") and the *Income Tax Regulations* (the "Regulations" or "ITR")

Disability Tax Credit

Clause 1

ITA
118.3(1)(a.2)(ii)

Subsection 118.3(1) provides the disability tax credit, which is a 14% non-refundable tax credit that recognizes the impact of non-itemizable disability-related costs on an individual's ability to pay tax.

To be eligible for the disability tax credit, an individual must have a severe and prolonged impairment in physical or mental functions. The effects of the impairment must be such that, even with appropriate therapy, the individual is:

- markedly restricted in their ability to perform a basic activity of daily living, due to the effects of one or more severe and prolonged impairments in mental or physical functions;
- significantly restricted in their ability to perform more than one basic activity of daily living if the cumulative effect of the restrictions is equivalent to having a single marked restriction in the ability to perform a basic activity of daily living; or
- would be markedly restricted were it not for extensive life sustaining therapy occurring at least two times a week for an average of at least 14 hours per week in total.

The basic activities of daily living are defined as walking; feeding or dressing oneself; mental functions necessary for everyday life; speaking; hearing; and eliminating bodily waste.

Paragraph 118.3(1)(a.1) provides certain conditions related to disability tax credit eligibility. Paragraph 118.3(1)(a.2) sets out the types of medical practitioners that are eligible to certify the effects of various impairments for the purposes of paragraph 118.3(1)(a.1).

Subparagraph 118.3(1)(a.2)(ii) provides that for an individual with a speech impairment, a speech-language pathologist is able to provide the required certification regarding the effects of the impairment. Subparagraph 118.3(1)(a.2)(ii) is amended to provide that a speech-language pathologist may also provide the required certification regarding an impairment with respect to an individual's ability in feeding themselves.

This amendment applies to the 2027 and subsequent taxation years in respect of certificates that are issued after 2026.

ITA
118.3(1)(a.2)(iii)

Subparagraph 118.3(1)(a.2)(iii) provides that for an individual with a hearing impairment to be eligible for the disability tax credit, an audiologist is able to provide the required certification regarding the effects of the impairment. Subparagraph 118.3(1)(a.2)(iii) is amended to provide that a speech-language pathologist may also provide the required certification regarding a hearing impairment.

This amendment applies to the 2027 and subsequent taxation years in respect of certificates that are issued after 2026.

ITA
118.3(1)(a.2)(iv)

Subparagraph 118.3(1)(a.2)(iv) provides that for an individual to be eligible for the disability tax credit with respect to an impairment to their ability in feeding or dressing themself, an occupational therapist is able to provide the required certification regarding the effects of the impairment. Subparagraph 118.3(1)(a.2)(iv) is amended to provide that a physiotherapist may also provide the required certification regarding an impairment with respect to an individual’s ability in feeding or dressing themself.

This amendment applies to the 2027 and subsequent taxation years in respect of certificates that are issued after 2026.

ITA
118.3(1)(a.2)(v)

Subparagraph 118.3(1)(a.2)(v) provides that for an individual to be eligible for the disability tax credit with respect to an impairment to their ability in walking, an occupational therapist or a physiotherapist is able to provide the required certification regarding the effects of the impairment. Subparagraph 118.3(1)(a.2)(v) is amended to provide that a podiatrist may also provide the required certification regarding an impairment with respect to an individual’s ability in walking.

This amendment applies to the 2027 and subsequent taxation years in respect of certificates that are issued after 2026.

ITA
118.3(1)(a.2)(vii)

New subparagraph 118.3(1)(a.2)(vii) provides that for an individual to be eligible for the disability tax credit with respect to an impairment to eliminating (bowel or bladder functions), an occupational therapist, an occupational therapist is able to provide the required certification regarding the effects of the impairment.

This amendment applies to the 2027 and subsequent taxation years in respect of certificates that are issued after 2026.

ITA
118.3(1)(a.3)

Paragraph 118.3(1)(a.3) applies with respect to the certification of eligibility for the disability tax credit as a result of the cumulative effects of multiple restrictions (i.e., severe and prolonged impairments in mental or physical functions the effects of which are significant (but not marked) restrictions in more than one basic activity of daily living, if the cumulative effect of the restrictions is equivalent to having a single marked restriction in one basic activity of daily living). A medical doctor or a nurse practitioner must make such certifications, unless the multiple restrictions pertain only to walking, feeding, or dressing, in which case certification may also be made by an occupational therapist.

Paragraph 118.3(1)(a.3) is amended to provide for additional practitioners who may provide the required certifications regarding the cumulative effects of an impairment.

- A physiotherapist may also provide the required certification regarding the cumulative effects of an impairment with respect to the individual's ability in feeding or dressing themself, or in walking.

- An occupational therapist may also provide the required certification regarding the cumulative effects of an impairment with respect to the individual's ability in elimination.

- A speech-language pathologist may also provide the required certification regarding the cumulative effects of an impairment with respect to the individual's ability in speaking, hearing, and feeding.

This amendment applies to the 2027 and subsequent taxation years in respect of certificates that are issued after 2026.

ITA
118.3(1)(a.4)

Public guardians and trustees (or public curators, in the case of Quebec) can be authorised to act as substitute decision-makers of last resort with respect to property matters for individuals who lack the mental capacity to make certain decisions, where no suitable family member or private guardian is available.

New subparagraph 118.3(1)(a.4)(i) would allow provincial or territorial public guardians, trustees, and curators to certify, on the disability tax credit application form, for an adult under their care for property matters (including the filing of income tax returns), that the individual has a valid certificate of incapacity (or equivalent document) issued by a healthcare professional in accordance with applicable provincial or territorial laws for determining decision-making capacity. Where such a certification is provided, a qualified medical practitioner would no longer be required to certify the individual's impairment for their disability tax credit application.

New subparagraph 118.3(1)(a.4)(ii) would allow the Minister of Indigenous Services Canada and the Minister of Crown-Indigenous Relations and Northern Affairs Canada to provide similar certification for adult dependants in their care for property matters under the *Indian Act*.

This amendment applies to disability tax credit certifications issued for the 2026 and subsequent taxation years.

ITA
118.3(1)(a.5)

New paragraph 118.3(1)(a.5) provides for a streamlined disability tax credit certification regarding certain long-lasting medical conditions.

New paragraph 118.3(1)(a.5) provides that, for individuals who have at least one of the listed medical conditions, a qualified medical practitioner would only need to certify that the individual has the medical condition. The practitioner would no longer be required to certify that the individual's impairment is severe and prolonged and that its effects meet the legislated thresholds regarding daily living impacts.

New paragraph 118.3(1)(a.5) would apply if a medical doctor, a nurse practitioner or other medical practitioner as described in paragraph (a.2) or (a.3), has certified in prescribed form that an individual who has one or more impairments in physical or mental functions has one or more of the following conditions: Alzheimer’s disease, amyotrophic lateral sclerosis / Lou Gehrig’s disease, Angelman syndrome, autism spectrum disorder level 3, bilateral blindness (legally blind), bilateral hearing loss (severe or profound), cardiac functional class of 4/ IV or an ejection fraction of 20% or less, cerebral palsy (severe), chronic obstructive pulmonary disease, stage III or higher, colostomy (permanent), cystic fibrosis, dementia, Down Syndrome/Trisomy 21, Duchenne muscular dystrophy (advanced or severe), Edwards syndrome/Trisomy 18, hemipelvectomy, hemophilia A (severe), hip disarticulation, Huntington disease, ileostomy (permanent), intellectual disability (severe, profound or IQ of 70 or below), lower limb amputation (leg or foot), microcephaly, paraplegia, Parkinson’s disease (advanced or severe), Patau syndrome/Trisomy 13, phenylketonuria, Prader-Willi syndrome, profound hearing loss in one ear and severe hearing loss in the other ear, progeria, quadriplegia or tetraplegia, relies only on lip-reading and/or use sign language to understand conversations or communicate, renal (kidney) failure requiring lifelong hemodialysis or peritoneal dialysis, requires lifelong continuous supplemental oxygen (O2), schizophrenia, sickle cell disease (severe) requiring transfusions, sign language is primary means of communicating due to profound hearing loss or expressive aphasia, spinal muscular atrophy of type 1 and 2, stroke (severe) no functional recovery, Tay-Sachs disease (infantile/juvenile), total mutism, traumatic brain injury (severe) and upper limb amputations (transcarpal or higher).

This amendment applies to disability tax credit certifications issued for the 2026 and subsequent taxation years.

ITA
118.3(1)(b)

Existing paragraphs 118.3(1)(a.1) to (a.3) provide various conditions that must be met to be eligible for the disability tax credit. Paragraph 118.1(3)(b) requires the individual to file with the Canada Revenue Agency the certificate described in paragraph 118.3(1)(a.2) or (a.3).

Consequential to the addition of new paragraphs 118.3(1)(a.4) and (a.5), paragraph 118.3(1)(b) is amended to add references to the certificate described in paragraph 118.3(1)(a.2), (a.3), (a.4) or (a.5).

This amendment applies to disability tax credit certifications issued for the 2026 and subsequent taxation years.

ITA
118.3(4)(b)

Paragraph 118.3(4)(a) provides a requirement for certain persons to provide, upon request of the Minister of National Revenue, additional information with respect to an individual's impairment. If this information is provided by a person referred to in paragraph 118.3(1)(a.2) or (a.3), paragraph 118.3(4)(b) provides that the information is considered to be in the form of a certificate required for the purpose of claiming the disability tax credit.

Consequential to the introduction of new paragraphs 118.1(3)(a.4) and (a.5), paragraph 118.3(4)(b) is amended to add references to persons described in new paragraphs 118.3(1)(a.4) and (a.5).

This amendment applies to disability tax credit certifications issued for the 2026 and subsequent taxation years.

ITA
118.4(2)

Subsection 118.4(2) contains interpretive rules relating to references to certain medical practitioners in section 63 (relating to childcare expenses), section 118.2 (referring to medical expenses) section 118.3 (relating to the disability tax credit) and section 118.6 (which provides various education-related definitions for a number of purposes).

Subsection 118.4(2) is amended, consequential on the amendment to subparagraph 118.3(1)(a.2)(v), which authorizes podiatrists to certify eligibility for the disability tax credit.

This amendment applies to the 2027 and subsequent taxation years.

Red Seal Completion Bonus

Clause 1

Apprentice mechanics' tool costs

ITA
8(1)(r)

Paragraph 8(1)(r) allows an eligible apprentice mechanic to deduct the cost of certain extraordinary expenditures incurred by the apprentice in respect of the cost of eligible tools. The formula for the maximum amount deductible includes, among other income factors, a reference to amounts required by paragraph 56(1)(n.1) to be included in computing the mechanic's income in respect of the Apprenticeship Incentive Grant.

Consequential on the introduction of the Red Seal Completion Bonus, paragraph 8(1)(r) is amended to add a reference to amounts included in income under new paragraph 56(1)(n.2).

This amendment is deemed to have come into force on April 28, 2026.

Deduction – tradesperson's tools

ITA
8(1)(s)

Paragraph 8(1)(s) provides a deduction of up to $1,000 in respect of the cost of eligible tools acquired in a taxation year by an employed tradesperson. The formula for determining the deductible amount for a taxation year includes a reference to amounts required by paragraph 56(1)(n.1) to be included in the tradesperson's income for the year in respect of the Apprenticeship Incentive Grant.

Consequential on the introduction of the Red Seal Completion Bonus, paragraph 8(1)(s) is amended to add a reference to amounts included in income under new paragraph 56(1)(n.2).

This amendment is deemed to have come into force April 28, 2026.

Clause 2

Other sources of income

ITA
56

Section 56 provides a list of certain types of income that are required to be included in computing the income of a taxpayer from sources that are not an office or employment, a business or a property.

Consequential on the introduction of the Red Seal Completion Bonus program administered by the Department of Employment and Social Development, new paragraph 56(1)(n.2) requires amounts received under the Apprenticeship Completion Bonus program to be included in the recipient’s income in the year received.

This amendment is deemed to have come into force on April 28, 2026.

Clause 3

Repayment of apprenticeship amounts

ITA
60(p)

Paragraph 60(p) provides that a taxpayer may deduct a repayment of amounts received under the apprenticeship incentive grant program or the apprenticeship completion grant program. Paragraph 60(p) in amended to include a reference to the Red Seal Completion Bonus Program that is included in income under new paragraph 56(1)(n.2).

This amendment is deemed to have come into force on April 28, 2026.

Clause 4

Definitions

ITA
63(3)

Subsection 63(3) contains the definition “earned income” for the purpose of the child care expense deduction. Paragraph (b) of the definition is amended, consequential on the introduction of the new Red Seal Completion Bonus, to include in a taxpayer's earned income amounts included in the taxpayer's income under new paragraph 56(1)(n.2) in respect of the Red Seal Completion Bonus.

This amendment is deemed to have come into force on April 28, 2026.

Clause 5

Withholding

ITA
153(1)

Subsection 153(1) requires the withholding of tax from certain payments described in paragraphs (a) to (v). The person making such a payment is required to remit the amount withheld to the Receiver General on behalf of the payee.

Subsection 153(1) is amended to add new paragraph (d.3) which requires withholding of tax on the payment of amounts described in new paragraph 56(1)(n.2).

This amendment is deemed to have come into force on April 28, 2026.

Clause 6

Interpretation

ITR
100(1)

Part I of the Regulations provides rules for deductions at source that must be withheld on specified amounts of “remuneration”.

Consequential on the introduction of the Red Seal Completion Bonus program, new paragraph (s) is added to the definition “remuneration” in subsection 100(1) of the Regulations.

This addition ensures that the tax withholding rules in the Regulations apply as intended to payments of the Red Seal Completion Bonus which is included in the recipient’s income under paragraph 56(1)(n.2) of the Act.

For more information, see the commentary on paragraphs 56(1)(n.2) and 153(1)(d.3) of the Act. This amendment is deemed to have come into force on April 28, 2026.

Clause 7

Lump sup payment

ITR
103(6)

Subsection 103(6) defines a “lump sum payment” for the purposes of subsection 103(4), which sets out the amount of tax that is required to be withheld from such payments.

Subsection 103(6) is amended to add new paragraph (j), which applies to amounts required to be withheld under new paragraph 153(1)(d.3) of the Act in respect of payments under the Red Seal Completion Bonus program.

This amendment is deemed to have come into force on April 28, 2026.

Accelerated Capital Cost Allowances for Low-Carbon Liquified Natural Gas Facilities

Clause 1

Class 1

ITR
1100(1)(a.3)

Paragraph 1100(1)(a.3) provides an additional 6% capital cost allowance (CCA) for eligible buildings acquired before 2025 that are used as part of an eligible liquefaction facility, for a total effective CCA rate of 10%.

This additional deduction can only be claimed against income of the taxpayer from eligible liquefaction activities in respect of the facility, taking into consideration any deduction under paragraph 1100(1)(yb) in respect of eligible liquefaction equipment.

Consequential to the implementation of accelerated CCA rates for "certified liquefaction buildings" and "certified liquefaction equipment", subparagraph 1100(1)(a.3)(i) is amended so that any deductions under new paragraphs 1100(1)(a.31) and (yc) are also taken into account in determining the taxpayer's income from eligible liquefaction activities.

This amendment applies to property acquired on or after November 4, 2025.

ITR
1100(1)(a.31)

Paragraph 1100(1)(a.31) is added to implement a new accelerated CCA for "certified liquefaction buildings" (defined in subsection 1104(2)) included in a separate class under new subsection 1101(5b.3). To qualify, the building must be used primarily to support the functioning of a "certified liquefaction facility" (also defined in subsection 1104(2)). For more information, see the commentary on subsection 1101(5b.3) and the "certified liquefaction building" and "certified liquefaction facility" definitions.

Similar to the existing rule under paragraph 1100(1)(a.3), this additional deduction can only be claimed against income of the taxpayer from eligible liquefaction activities (described in subsection 1104(18)) in respect of the certified liquefaction facility that the building supports, taking into consideration any deduction under paragraphs 1100(1)(a.3), (yb) and (yc) in respect of other property supporting the facility that may be eligible for an accelerated CCA deduction.

This paragraph provides for an additional 6% allowance (on top of the regular 4% rate for Class 1 property) to bring the effective CCA rate up to 10% for certified liquefaction buildings.

This amendment applies to property acquired on or after November 4, 2025.

Additional Allowance — Class 47

ITR
1100(1)(yb)

Paragraph 1100(1)(yb) provides for an additional 22% CCA for eligible equipment acquired before 2025 that is used as part of an eligible liquefaction facility, for a total effective CCA rate of 30%.

This additional deduction can only be claimed against income of the taxpayer from eligible liquefaction activities in respect of the facility, taking into consideration any deduction under paragraph 1100(1)(a.3) in respect of eligible liquefaction buildings.

Consequential to the implementation of accelerated CCA rates for “certified liquefaction buildings” and “certified liquefaction equipment”, subparagraph 1100(1)(yb)(i) is amended so that any deductions under new paragraphs 1100(1)(a.31) and (yc) are also taken into account in determining the taxpayer’s income from eligible liquefaction activities.

This amendment applies to property acquired on or after November 4, 2025.

ITR
1100(1)(yc)

Paragraph 1100(1)(yc) is added to implement a new accelerated CCA for “certified liquefaction equipment” (defined in subsection 1104(2)) included in a separate class under new subsection 1101(4j). To qualify, the equipment must be used primarily to support the functioning of a “certified liquefaction facility” (also defined in subsection 1104(2)). For more information, see the commentary on subsection 1101(4j) and the “certified liquefaction equipment” and “certified liquefaction facility” definitions.

Similar to the existing rule under paragraph (yb), this additional deduction can only be claimed against income of the taxpayer from eligible liquefaction activities (described in subsection 1104(18)) in respect of the certified liquefaction facility that this equipment supports, taking into consideration any deduction under paragraphs 1100(1)(a.3), (a.31) and (yb) in respect of other property supporting the facility that may be eligible for an accelerated CCA deduction.

This paragraph provides for an additional 42% allowance (on top of the regular 8% rate under Class 47) to bring the effective CCA rate up to 50% for certified liquefaction equipment.

This amendment applies to property acquired on or after November 4, 2025.

Clause 2

Certified Liquefaction Equipment

ITR
1101(4j)

New subsection 1101(4j) provides for a separate class for certified liquefaction equipment to be used primarily to support the functioning of a certified liquefaction facility.

Property included in this separate class would be eligible for an accelerated CCA deduction of up to 50%, limited to the taxpayer's income from eligible liquefaction activities in respect of the certified liquefaction facility. For more information, see the commentary on paragraph 1100(1)(yc) and the "certified liquefaction equipment" and "certified liquefaction facility" definitions.

This subsection applies to property acquired on or after November 4, 2025.

Eligible Non-Residential or Manufacturing Buildings

ITR
1101(5b.1)

Subsection 1101(5b.1) provides that taxpayers may elect to include a building in a separate prescribed class if the building is an eligible non-residential building (or an "eligible manufacturing building"), other than an eligible liquefaction building. Where a building qualifies, it may be eligible for an additional CCA under paragraphs 1100(1)(a.1) or (a.2) in respect of the building if a separate class election has been filed with the Minister of National Revenue in the taxation year in which the building is acquired.

Subsection 1101(5b.1) is amended to exclude "certified liquefaction buildings" (defined in subsection 1104(2)) from its scope. A certified liquefaction building may be included in a separate prescribed class under new subsection 1101(5b.3).

This amendment applies to property acquired on or after November 4, 2025.

Certified Liquefaction Buildings

ITR

1101(5b.3)

New subsection 1101(5b.3) provides for a separate class for certified liquefaction buildings to be used primarily to support the functioning of a certified liquefaction facility.

Property included in this separate class would be eligible for an accelerated CCA deduction of up to 10%, limited by the taxpayer's income from eligible liquefaction activities in respect of the certified liquefaction facility. For more information, see the commentary on paragraph 1100(1)(a.31) and the "certified liquefaction building" and "certified liquefaction facility" definitions.

This subsection applies to property acquired on or after November 4, 2025.

Clause 3

Definitions

ITR
1104(2)

Subsection 1104(2) sets out definitions that apply for the purposes of Part XI and Schedule II of the Regulations.

Various definitions are added to this subsection to implement accelerated capital cost allowance (CCA) deductions in respect of certain liquefied natural gas (LNG) equipment and related buildings supporting low-carbon LNG facilities. These definitions apply to property acquired on or after November 4, 2025.

"carbon dioxide equivalent"

"Carbon dioxide equivalent" means the carbon dioxide emissions that would be required to produce a warming effect equivalent to the emissions of any specified greenhouse gas, as determined in a manner acceptable to the Minister of Natural Resources.

This definition is relevant to determining the expected emissions intensity of an eligible liquefaction facility. In general terms, a facility's expected emissions intensity represents the amount in tonnes of carbon dioxide equivalent emitted by the facility per tonne of LNG produced by the facility.

For more information, see the commentary on the "expected emissions intensity" and "specified greenhouse gas" definitions.

"certified liquefaction building"

The definition “certified liquefaction building” sets out the eligibility requirements for the accelerated CCA deduction under paragraph 1100(1)(a.31) in respect of buildings used to support the functioning of a “certified liquefaction facility” (also defined in this subsection).

A “certified liquefaction building” means a taxpayer’s property that:

- is acquired by the taxpayer after November 3, 2025 and before 2035;
- is included in Class 1 because of paragraph (q) of that Class;
- has not been used or acquired for use for any purpose before it was acquired by the taxpayer;
- is not a residential building; and
- is primarily used to support the functioning of a certified liquefaction facility.

For more information, see the commentary on paragraph 1100(1)(a.31), subsection 1101(5b.3) and the “certified liquefaction facility” definition in this subsection.

“certified liquefaction equipment”

The definition “certified liquefaction equipment” sets out the eligibility requirements for the accelerated CCA deduction under paragraph 1100(1)(yc) in respect of equipment used to support the functioning of a “certified liquefaction facility” (also defined in this subsection).

“Certified liquefaction equipment” means a taxpayer’s property that:

- is acquired by the taxpayer after November 3, 2025 and before 2035;
- is included in Class 47 because of paragraph (b) of that Class;
- has not been used or acquired for use for any purpose before it was acquired by the taxpayer;
- is not “excluded equipment” (also defined in this subsection); and
- is primarily used to support the functioning of a certified liquefaction facility.

The scope of eligible equipment is generally similar to that equipment described in the “eligible liquefaction equipment” definition, the key differences being the acquisition dates and the requirement for the facility to be a “certified liquefaction facility”.

For more information, see the commentary on paragraph 1100(1)(yc), subsection 1101(4j) and the “certified liquefaction facility” definition in this subsection.

“certified liquefaction facility”

A “certified liquefaction facility” is an “eligible liquefaction facility” (as defined in this subsection) that the Minister of Natural Resources has determined meets an expected emissions intensity that is less than or equal to 0.20, based on and subject to conformity with the facility’s liquefaction facility plan.

For buildings and equipment used in LNG production to be eligible for the accelerated CCA deductions under paragraphs 1100(1)(a.31) and (yc), they must be primarily used to support the functioning of a certified liquefaction facility.

The rules contemplate that an eligible liquefaction facility may become a certified liquefaction facility based on a calculation of the facility's expected emissions intensity contained in the associated "liquefaction facility plan". This plan, in turn, is required to set out the facility's "specified operating configuration". As a result, if a facility is ultimately operated in a manner that does not conform with the specified operating configuration included in the plan (e.g., if the actual configuration of the facility is substantially different from the configuration found in the plan) then the facility would no longer qualify as a certified liquefaction facility.

For more information, see the commentary on the "expected emissions intensity", "liquefaction facility plan" and "specified operating configuration" definitions in this subsection.

"expected emissions intensity"

The definition "expected emission intensity" is relevant for the definition "certified liquefaction facility", which is a key eligibility requirement for the accelerated CCA deductions under paragraphs 1100(1)(a.31) and (yc) for buildings and equipment used in LNG production.

In general terms, "expected emissions intensity" in this context means the tonnes of carbon dioxide equivalent emitted by the facility for each tonne of LNG produced by the facility, as determined by the formula (A – B) ÷ C.

Variable A represents the quantity of carbon dioxide equivalent, in tonnes, expected to be emitted from:

- the combustion of fuel, including fuel used to generate any integrated power or electricity (e.g., emissions from generators that are directly connected to the facility);
- the combustion (including thermal oxidation, flaring and incineration) or venting of gas, including acid gas; and
- fugitive losses of methane.

Both mechanical power and electrical energy may be used in the production of LNG, so emissions from the generation of both are required to be taken into account.

Variable B represents the quantity of carbon dioxide, in tonnes, expected to be captured and stored in an "eligible use" (as defined in subsection 127.44(1) of the Act).

Variable C represents the quantity of LNG, in tonnes, expected to be produced by the facility.

All quantities must be determined based on expectations for the facility's first operating year and in a manner that is acceptable to the Minister of Natural Resources. For more information, see the commentary on the "first operating year" definition in this subsection.

"first operating year"

The "first operating year" in respect of an eligible liquefaction facility means the first cumulative 365-day period during which the facility is expected to operate in accordance with its "specified operating configuration" (also defined in this subsection), disregarding any day during which the facility is not producing LNG in any amount.

This definition sets the timing parameters for the determination of the facility's "expected emissions intensity". The quantities of carbon dioxide equivalent emissions, carbon dioxide captured and stored, and LNG produced by a particular facility are all to be determined based on expected activities during the first operating year.

For more information, see the commentary on the "specified operating configuration" definition in this subsection.

"liquefaction facility plan"

A "liquefaction facility plan" is a plan that must be filed in order for a liquefaction facility to become certified by the Minister of Natural Resources as a "certified liquefaction facility". This is a necessary step for buildings and equipment used in LNG production to be eligible for the accelerated CCA deductions under paragraphs 1100(1)(a.31) and (yc).

In general terms, a "liquefaction facility plan" means a plan for an eligible liquefaction facility of a taxpayer that:

- is prepared by a qualified engineering firm;
- includes a front-end engineering design study (or an equivalent study as determined by the Minister of Natural Resources) for the facility;
- sets out the facility's expected emissions intensity (determined by the qualified engineering firm based on the facility's specified operating configuration);
- includes any information required by the Minister of Natural Resources; and
- is filed with the Minister of Natural Resources, in the form and manner determined by the Minister.

While the plan must be prepared by a qualified engineering firm, the actual front-end engineering study (or equivalent) may be provided to the firm by the taxpayer for inclusion in the plan. However, the expected emissions intensity must be determined by the qualified engineering firm.

This definition is relevant for the purposes of the definitions "certified liquefaction facility", "expected emissions intensity", "qualified engineering firm" and "specified operating configuration" in this subsection. For more information, see the commentary under those definitions.

"qualified engineering firm"

A "qualified engineering firm" means an engineer or engineering firm that meets the requirements in paragraphs (a) to (d). These generally include requirements to be registered and in good standing with a professional association that regulates the profession of engineering in the jurisdiction where the facility is located, to have appropriate insurance coverage, to be independent of, and deal at arm's length with, the taxpayer, and to meet the requirements described in any technical guideline published by the Minister of Natural Resources.

A qualified engineering firm is responsible for preparing the "liquefaction facility plan" for the facility, particularly the determination of the facility's "expected emissions intensity" (both defined in this subsection). For more information, see the commentary under those definitions.

"specified greenhouse gas"

"Specified greenhouse gas" means carbon dioxide, methane, nitrous oxide and any other greenhouse gas described in any guidance published by the Minister of Natural Resources.

This definition sets out the greenhouse gases that may be relevant in determining the expected emissions intensity of an eligible liquefaction facility. For more information, see the commentary on the "carbon dioxide equivalent" and "expected emissions intensity" definitions in this subsection.

"specified operating configuration"

"Specified operating configuration" refers to the design configuration of an eligible liquefaction facility, as described in the design information set out in the facility's liquefaction facility plan, that reflects how the facility is expected to operate once it has completed commissioning and ramp-up and is operating at a sustained production level consistent with its design capacity.

The specified operating configuration is required to take into consideration all property that will form part of the facility when it commences commercial operations at design capacity (including property already in use and property to be acquired), as well as the sources of energy, fuel and utilities that will be available at that time.

This definition provides the basis for determining the expected emissions intensity of an eligible liquefaction facility, as well as the start of the facility's first operating year.

Classes 1 and 47 — Liquefaction Property

ITR
1104(18)

Subsection 1104(18) provides rules for the determination of a taxpayer's income for a taxation year from eligible liquefaction activities in respect of an eligible liquefaction facility, for the purposes of the accelerated CCA deductions under paragraphs 1100(1)(a.3) and (yb).

This subsection is amended to add references to the new accelerated CCA deductions under paragraphs 1100(1)(a.31) and (yc) in respect of buildings and equipment primarily used to support the functioning of a certified liquefaction facility.

This amendment applies in respect of property acquired on or after November 4, 2025.

Authority of the Minister of Natural Resources

ITR
1104(19)

Subsection 1104(19) is added to give the Department of Natural Resources the authority to publish guidance that will apply conclusively with respect to engineering and scientific matters for the purpose of determining the expected emissions intensity of an eligible liquefaction facility.

This subsection applies in respect of property acquired on or after November 4, 2025.

Investment Tax Credit for Carbon Capture, Utilization, and Storage

Clause 1

ITA
127.44

Section 127.44 provides an investment tax credit for certain expenditures incurred in respect of carbon capture, utilization, and storage (CCUS) projects. Section 127.44 is amended to extend the tax credit to projects that permanently store captured carbon in the course of enhanced oil recovery operations. These amendments generally come into force in respect of expenditures made on or after April 28, 2026. Recovery of the investment tax credit under Part XII.7 of the ITA will potentially apply to taxation years ending after that day, as the calculation of recovery tax for any prior year claims may be affected if captured carbon that was projected to be stored in dedicated geological storage is instead stored in dedicated EOR storage.

Definitions

ITA
127.44(1)

"dedicated EOR storage"

The new definition “dedicated EOR storage” generally means a geological formation that is capable of permanently storing captured carbon and is located in a “designated EOR jurisdiction”. The formation must also be authorized and regulated under the laws of the designated EOR jurisdiction, and be used for enhanced oil recovery. For more information, refer to the commentary for the “designated EOR jurisdiction” definition.

“designated EOR jurisdiction”

The new definition “designated EOR jurisdiction” means any jurisdiction within Canada (including its exclusive economic zone) or the United States that the Minister of the Environment designates under new subsection 127.44(13.1).

This definition applies for the purpose of the definition “dedicated EOR storage”, in that dedicated EOR storage must be capable of storing captured carbon in a designated EOR jurisdiction. For more information, see the commentary for the “dedicated EOR storage” definition and for subsection 127.44(13.1).

“eligible EOR use”

An “eligible EOR use” in the context of CCUS means the storage of captured carbon in dedicated EOR storage as part of an enhanced oil recovery operation. For more information, see the commentary for the definition “dedicated EOR storage”.

“ineligible use”

An “ineligible use” in the context of CCUS means the emission of captured carbon dioxide into the atmosphere (other than emissions for the purposes of system integrity or safety or a *de minimis* tolerance for incidental emissions made in the ordinary course of operations), the use of captured carbon dioxide for enhanced oil recovery (EOR), or for any other purpose that is not an “eligible use”.

The definition is amended to replace the prohibition of EOR with a prohibition of storage or use of carbon that is not an “eligible EOR use”.

“projected eligible use percentage”

“Projected eligible use percentage” provides a calculation of the proportion of an expenditure for carbon capture or transportation equipment that will be a “qualified carbon capture expenditure” or “qualified transportation expenditure” eligible for the CCUS investment tax credit. The percentage is determined for a specific length of time – usually for each project period, which is generally five calendar years each (with four such periods spanning approximately 20 years). Projected eligible use percentage is determined from the project plan as the quotient obtained from the division of projected eligible use during the relevant period with, in general terms, projected total use (i.e., ineligible use + eligible use) during the same period, expressed as a percentage.

This quotient is amended concurrently with the extension of the CCUS investment tax credit to expenditures in respect of captured carbon that is permanently stored as part of an enhanced oil recovery (EOR) operation. The numerator of the quotient now includes, in addition to the projected eligible use, one-half of the projected "eligible EOR use" for the relevant period. The one-half rate results in half the normal rate of investment tax credit applying in respect of these expenditures, to the extent that carbon storage is an eligible EOR use. For more information, see the commentary to the new definition "eligible EOR use".

Part XII.7 of the Act provides a companion definition "actual eligible use percentage" which is important for the calculation of the recovery tax. For more information, see the commentary for the definition in that Part.

"project plan"

A "project plan" is a plan for a CCUS project that reflects a front-end engineering design study (or an equivalent study as determined by the Minister of Natural Resources) for the project and describes the quantity of captured carbon that the CCUS project is expected to support for storage, in each calendar year over the life of the project, in eligible use and ineligible use. The plan must also contain any information required in guidelines published by the Minister of Natural Resources and be filed with the Minister of Natural Resources, in the form and manner determined by the Minister of Natural Resources.

This definition is amended to add new paragraph (b.1) which provides that, where a project is expected to support the storage of captured carbon in an eligible EOR use, the associated project plan must include the quantity of captured carbon that the project is expected to support in such storage, including a method of capturing and reinjecting the carbon that is mixed with the oil in the process of enhanced oil recovery.

"qualified CCUS expenditure"

A "qualified CCUS expenditure" is any expenditure that is a qualified carbon capture expenditure, qualified carbon transportation expenditure, qualified carbon storage expenditure or qualified carbon use expenditure. The definition is amended to add a "qualified EOR storage expenditure". For more information, see the commentary for that new definition.

"qualified CCUS project"

A "qualified CCUS project" is a CCUS project of a taxpayer that meets certain conditions, among them being that an initial project evaluation has been issued by the Minister of Natural Resources, in the form and manner determined by that Minister, in respect of the project.
This definition is amended to add new paragraph (c.1) concurrently with the extension of the CCUS investment tax credit to expenditures in respect of the permanent storage of captured carbon as part of an enhanced oil recovery (EOR) operation. In addition to the existing conditions new paragraph (c.1) provides that, if a project plan of a taxpayer includes plans for

“eligible EOR use”, a minimum of 95 per cent of captured carbon intended for storage, in dedicated EOR storage over the total CCUS project review period (generally 20 years), must be expected to be permanently stored.

“qualified EOR storage expenditure”

The new definition “qualified EOR storage expenditure” is relevant to determining the amount of the taxpayer's CCUS development tax credit under subsection (4) and CCUS refurbishment tax credit under subsection (5). In general terms, it represents one-half of the portion of the taxpayer's capital expenditures related to property used for the storage of captured carbon in a geological formation as part of an enhanced oil recovery (EOR) operation. More specifically, the property must be described in paragraphs (a) to (e) of Class 58 in Schedule II to the *Income Tax Regulations* and must be expected to support storage of captured carbon in “dedicated EOR storage”. As with the other categories of qualified expenditures, expenditures must be verified by the Minister of Natural Resources as being in respect of property described in those paragraphs. The property must also be situated in Canada, and may not be used all or substantially all in the handling or processing of oil.

Unlike with qualified expenditures for capture and transportation, there is no proration of the expenditure to the extent that it relates in part to an eligible EOR use and in part to another use. For more information, see the commentary for the new definitions “dedicated EOR storage” and “eligible EOR use”.

“specified percentage”

The definition “specified percentage” is the tax credit rate used to determine the amount of a taxpayer’s CCUS investment tax credit. The definition is amended consequential to the extension of the CCUS investment tax credit to enhanced oil recovery (EOR) operations.

The specified percentage is different depending on the type of qualified CCUS expenditure. For example, for qualified carbon transportation expenditures, qualified carbon storage expenditures and qualified carbon use expenditures, the rate is 37 ½% (for expenditures incurred after 2021 and before 2036) or 18 ¾% (for expenditures incurred after 2035 and before 2041). For all expenditures made after 2040 the rate is zero.

These rates will also apply to a new class of “qualified EOR storage expenditures”, which in general represents one-half of the portion of a taxpayer's capital expenditures related to property used for the storage of captured carbon in a geological formation as part of an EOR operation.

For more information, see the commentary for the new definition “qualified EOR storage expenditure”.

Special rules — adjustments

ITA

127.44(9)

New paragraph 127.44(9)(k) is added consequential to the extension of the CCUS investment tax credit to enhanced oil recovery operations. It provides that once captured carbon dioxide has been stored in "dedicated EOR storage" (as defined in subsection 127.44(1)), if the carbon dioxide is released into the atmosphere for *bona fide* reasons outside the control of the taxpayer, this is not considered to be an ineligible use of the captured carbon dioxide as it is deemed to be stored in an "eligible EOR use" at the time of the release and all subsequent times. An example might be the release of carbon dioxide from a geological formation as the result of an earthquake, where regulatory requirements were followed and such a release could not reasonably have been avoided by means of preventative measures.

Designation of EOR jurisdiction

ITA
127.44(13.1)

In order for captured carbon to be stored in accordance with the requirements of the CCUS rules in respect of enhanced oil recovery, it must be stored in "dedicated EOR storage" as defined in subsection 127.44(1). Among other things, dedicated EOR storage must be in a "designated EOR jurisdiction", which is also defined in subsection 127.44(1). A designated EOR jurisdiction means any jurisdiction in Canada (including its exclusive economic zone) or the United States for which a designation by the Minister of the Environment is in effect.

New subsection 127.44(13.1) provides the authority and mechanism for the Minister of the Environment to designate a jurisdiction for this purpose. Similar to subsection (13), which applies to the "designated jurisdiction" definition in the context of dedicated geological storage, the Minister of the Environment may designate a "designated EOR jurisdiction" if the Minister determines that the jurisdiction has sufficient environmental laws and enforcement governing the permanent storage of captured carbon. The designation must specify its effective time (which may be retroactive) and be published on a website maintained by the Government of Canada.

Revocation of designation

ITA
127.44(14)

Subsection 127.44(14) provides the Minister of the Environment with the authority to revoke a designation of a jurisdiction made under subsection (13), in circumstances where the regulatory regime or the enforcement of that regime has ceased to be adequate to ensure permanent storage of captured carbon.

Subsection (14) is amended to add references to new subsection (13.1), which would allow the Minister of the Environment to revoke a designation of a jurisdiction made under subsection (13.1) in respect of a "designated EOR jurisdiction".

Jurisdiction not designated

ITA
127.44(14.1)

Subsection 127.44(14.1) addresses certain situations where a geological formation either begins to be "dedicated geological storage" (e.g., because its jurisdiction is newly designated under subsection 127.44(13)) or ceases to be "dedicated geological storage" because it does not meet the conditions of that definition at the time of an expenditure that might otherwise qualify for a CCUS investment tax credit (i.e., the geological formation is either located in a jurisdiction that is not, at that time, a "designated jurisdiction" or it is not authorized or regulated under the laws of a designated jurisdiction).

Very generally paragraph (a) provides grandfathering, in that the "dedicated geological storage" conditions are deemed to be met at the time of an expenditure if they were met at the time of an earlier qualified CCUS expenditure in respect of the same CCUS project. Paragraph (b) provides that where grandfathering does not apply under paragraph (a) and the "dedicated geological storage" conditions are not met at the time of the expenditure, the calculation of the CCUS tax credit and the recovery tax under Part XII.7 of the Act will, effectively, ignore that expenditure. Lastly, paragraph (c) provides that, where grandfathering under paragraph (a) applies in respect of a geological formation, the description of A in the definition "actual eligible use percentage" in subsection 211.92(1) includes any quantity of carbon stored in the geological formation.

Subsection (14.1) is amended to make these rules apply to geological formations that are used for enhanced oil recovery (i.e., dedicated EOR storage). Specifically, references to "designated EOR jurisdiction" are added to paragraph (a), new subparagraphs (b)(iii) and (iv) are added (to apply in the same way as existing subparagraphs (b)(i) and (ii) in respect of dedicated geological storage), and a reference to new variable A.1 of the "actual eligible use percentage" definition is added to paragraph (c), to apply in the same way as variable A of that definition.

Clause 2

Definitions

ITA
127.48(1)

"clean hydrogen project plan"

To qualify for the clean hydrogen tax credit, a "clean hydrogen project plan" must be filed with the Minister of Natural Resources for confirmation, in the form and manner determined by the Minister of Natural Resources.

Concurrent with the extension of the Carbon Capture, Utilization, and Storage (CCUS) investment tax credit to CCUS projects that contemplate storing captured carbon through enhanced oil recovery (EOR), clean hydrogen projects that produce and capture carbon may also store that carbon through EOR.

New paragraph (d.1) is added to this definition to require clean hydrogen projects that expect to store captured carbon in an “eligible EOR use” (as defined in subsection 127.44(1)) to include in their clean hydrogen project plan a method of capturing and injecting the captured carbon that is mixed with the oil in the process of enhanced oil recovery.

This amendment is deemed to come into force on April 28, 2026.

Calculation of carbon intensity

ITA
127.48(6)

Subsection 127.48(6) provides rules for calculating carbon intensity of hydrogen production, for the purpose of the Clean Hydrogen investment tax credit. Subparagraph (6)(d)(ii) provides that, if hydrogen is produced from eligible hydrocarbons, any captured carbon that is subject to an “eligible use” (as defined in subsection 127.44(1)) is deemed to be permanently stored.

New subparagraph (6)(d)(ii.1) is added, concurrently with the extension of the CCUS investment tax credit to certain qualifying expenditures incurred as part of enhanced oil recovery (EOR) operations, to deem captured carbon subject to an “eligible EOR use” (as defined in subsection 127.44(1)) to be permanently stored, other than captured carbon that ends up being emitted into the atmosphere in connection with the EOR process.

This amendment is deemed to come into force on April 28, 2026.

Clause 3

Definitions

ITA
127.491(1)

“dedicated EOR storage”

The definition “dedicated EOR storage” is relevant for calculating the emission intensity of a natural gas energy system and has the same meaning as in subsection 127.44(1).

This definition is added concurrently with the extension of the CCUS tax credit to certain qualifying expenditures incurred as part of enhanced oil recovery operations and the corresponding amendment to the “emission intensity” definition to exclude from its calculation the quantity of carbon dioxide emitted that is captured by the natural gas energy system and stored in “dedicated EOR storage”.

This definition is deemed to come into force on April 28, 2026.

“emission intensity”

The definition “emission intensity” applies for the purposes of the Clean Electricity investment tax credit. A taxpayer’s emission intensity, as set out in its system plan for a natural gas energy system, must be below 65 tonnes of carbon dioxide emitted per gigawatt hour of electrical energy produced. The calculation is also relevant to the taxpayer’s “actual emission intensity” and “average actual emission intensity” (as defined in subsection 127.491(1)) and subsection 127.491(18), which provides for a recovery amount payable in respect of a “specified natural gas energy system” (as defined in subsection 127.491(1)).

The calculation of emission intensity excludes the quantity of carbon dioxide emitted that is captured by the natural gas energy system and stored in “dedicated geological storage”, which is defined in subsection 127.491(1) by reference to the definition in subsection 127.44(1) that applies for the purpose of the Carbon Capture, Utilization and Storage (CCUS) investment tax credit.

The definition “emission intensity” is amended concurrently with the extension of the CCUS tax credit to certain qualifying expenditures incurred as part of enhanced oil recovery (EOR) operations, to also exclude from its calculation the quantity of carbon dioxide emitted that is captured by the natural gas energy system and stored in “dedicated EOR storage”. In this regard, “dedicated EOR storage” is defined in subsection 127.44(1).

This amendment is deemed to come into force on April 28, 2026.

Clause 4

Definitions

ITA
211.92(1)

Subsection 211.92(1) provides definitions relevant for the recovery of CCUS investment tax credits claimed in prior taxation years.

The definition “actual eligible use percentage” is amended and the new definition “actual EOR use” is introduced concurrently with the extension of the CCUS investment tax credit in section 127.44 of the Act to qualifying expenditures in respect of the capture, transportation and permanent storage of carbon dioxide as part of an enhanced oil recovery (EOR) operation.

These amendments apply to taxation years ending after April 28, 2026.

"actual eligible EOR use"

The new definition "actual eligible EOR use" applies for the purpose of the calculation of a taxpayer's "actual eligible use percentage" for a period. Actual eligible EOR use is, generally, the quantity of captured carbon that a CCUS project supported for storage or use in eligible EOR use during the period. This amount excludes captured carbon that was released (and not recovered) during the period from EOR operations; however, a taxpayer is afforded an allowance for the release of up to 5 per cent of the total carbon captured for EOR storage or use. For more information, see the commentary to the new definition "eligible EOR use" in subsection 127.44(1).

"actual eligible use percentage"

The definition "actual eligible use percentage" is the companion to the definition "projected eligible use percentage" in subsection 127.44(1). In general terms, to qualify for tax credit support, the proponents of a carbon capture, utilization and storage (CCUS) project must (among other things) project their eligible use percentage in their project plan before commencing operations. The recovery tax calculations in subsections 211.92(4) and (5), which apply for the purpose of determining qualifying carbon capture and transportation expenditures, compare projected eligible use percentage to actual eligible use percentage at the end of each of four "project periods".

Both projected and actual eligible use percentages are determined as the quotient obtained from the division of "eligible use" of captured carbon during the relevant period with, in general terms, projected total use (i.e., ineligible use + eligible use) during a period, expressed as a percentage. If the actual eligible use percentage is more than five percentage points lower than projected eligible use percentage in a given period, then a recovery tax is payable to recoup the excess tax credits claimed based on what has turned out to be an over-projection of eligible use. The amended numerator of the quotient now includes, in addition to the projected eligible use, one-half of the newly defined "actual eligible EOR use" for the relevant period. The one-half rate results in half the normal rate of investment tax credit applying in respect of these expenditures, to the extent that carbon storage is an eligible EOR use. The denominator now also includes the quantity of carbon stored or used in an eligible EOR use.

Example

A taxpayer's projected eligible use percentage (defined in subsection 127.44(1)) for 100 tonnes of captured carbon for a period was 75%, based on 50 tonnes expected to be stored in dedicated geological storage and 50 tonnes in dedicated EOR storage (i.e., $[50 + (50\% \times 50)] \div 100 = 75\%$).

However, the actual storage was 30 tonnes directed to dedicated geological storage and 60 tonnes to dedicated EOR storage. Ten tonnes were released into the atmosphere before arriving at storage. Further, of the 60 tonnes, 17 tonnes were released in the course of EOR operations, of which only 10 tonnes were recovered and reinjected into EOR storage.

The actual eligible use percentage is calculated as:

Carbon dioxide stored in dedicated geological storage:		30 tonnes
Carbon dioxide actually stored in dedicated EOR storage:		
The final amount stored (variable A of “actual eligible EOR use”):		60 tonnes
Less: the portion emitted and not recovered during EOR operations (variable C of “actual eligible EOR use”)	7 tonnes	
Less: 5% of the final amount stored (5% of 60 tonnes)	3 tonnes	
Net (variable B of “actual eligible EOR use”):		4 tonnes
“Actual eligible EOR use” (60 tonnes – 3 tonnes):		56 tonnes
Variable A.1 of “actual eligible use percentage”:	50% × 56 tonnes = 28 tonnes	
“Actual eligible use percentage”:	(30 tonnes + 28 tonnes) ÷ 100 tonnes = 58%	

Because the actual eligible use percentage (58%) is more than five percentage points lower than the projected eligible use percentage (75%) for the period, a recovery tax will be payable in respect of excess credits claimed based on the over-projection of eligible use.

For more information, see the commentary to the new definitions “eligible EOR use” in subsection 127.44(1) and “actual eligible EOR use” in subsection 211.92(1).

“reporting-due day”

The definition “reporting-due day” establishes the reporting-due day for annual climate risk disclosure, the construction and completion knowledge sharing report, and the annual operations knowledge sharing report. The definition is amended to extend the deadline for these reports and disclosures to the later of December 31, 2026, and each otherwise specified deadline.

This amendment applies as of January 1, 2022.

Investment Income Derived from Assets Supporting Canadian Insurance Risks

Clause 1

ITA
95(2)(a.2)

Paragraph 95(2)(a.2) is a rule designed to prevent erosion of the Canadian tax base that might otherwise result from the use of foreign affiliates by Canadian taxpayers to earn income from the insurance of Canadian risks or from the ceding of such risks that, if earned directly by the Canadian taxpayers, would be taxable in Canada.

Subparagraphs 95(2)(a.2)(i) and (ii) include in the income from a business other than an active business (and thus the foreign accrual property income "FAPI") of a foreign affiliate of a taxpayer resident in Canada the income of the affiliate from the insurance of any risk (including income from the reinsurance of the risk) where the risk insured is a "specified Canadian risk". "Specified Canadian risk" is defined in paragraph (a.23) as a risk in respect of

- a person resident in Canada,
- a property situated in Canada, or
- a business carried on in Canada.

The definition also encompasses risks insured by a foreign affiliate that do not meet the conditions described above but are deemed to be specified Canadian risks under paragraph (a.21) or (a.24).

Income of a foreign affiliate from the insurance of specified Canadian risks includes income derived from property held by the foreign affiliate for the purpose of backing the liabilities that result from those risks.

Subparagraph 95(2)(a.2)(i) is amended to clarify that the insurance of specified Canadian risks includes the holding of property by a foreign affiliate to back specified Canadian risks of another entity, for instance, a Canadian-resident insurance corporation that owns the affiliate. This amendment addresses tax avoidance concerns that arise in situations where only the assets backing the risk, and not the risk itself, are held by a foreign affiliate. The amendment ensures that income from the holding of such assets is included in the affiliate's FAPI, irrespective of whether the corresponding insurance contracts have been entered into by the affiliate itself.

Specifically, subparagraph 95(2)(a.2)(i) is amended to clarify that the insurance of specified Canadian risks by a foreign affiliate (the income in respect of which is deemed to be FAPI) includes the holding of any property by the affiliate in connection with the insurance or reinsurance of specified Canadian risks (i.e., in connection with such insurance or reinsurance activities by any person or partnership). This amendment is similar to the language in existing provisions that describe a connection with insurance contracts, or liabilities arising under those contracts. The amended rule applies to property held for reserves or surplus that backs specified Canadian risks (e.g., property that is indicated as backing specified Canadian risks under internal actuarial and asset allocation practices such as asset-liability matching). However, it does not include property held by a foreign affiliate of a Canadian insurer that is not backing specified Canadian risks, for instance property that is held to back foreign insurance risks in the course of a foreign insurance business or property held in the surplus account that is not indicated as backing specified Canadian risks.

The amendment to subparagraph 95(2)(a.2)(i) also clarifies that the rule only applies in circumstances where the foreign affiliate that holds the property does not deal at arm's length with an insurer resident in Canada (in other words, this amendment does not apply to foreign affiliates that exclusively deal at arm's length with Canadian resident insurers). This exception is provided for greater certainty, excluding from the rule situations where property of an affiliate would unlikely be held in connection with specified Canadian risks given the minimal direct or indirect control of that property by a Canadian resident insurer, which would generally limit an insurer's ability to liquidate (or otherwise deal with) the property.

Subparagraph 95(2)(a.2)(i) is also amended so that its 90% gross revenue safe harbor takes into account all revenue of the affiliate (as opposed to just premium revenue). This amendment recognizes that the gross premium revenue test is not appropriate in the context where the foreign affiliate solely or mainly earns income from the holding of assets that back specified Canadian risks but does not hold the risks themselves and, therefore, does not receive premiums.

These amendments apply to taxation years of a foreign affiliate of a taxpayer that begin after November 4, 2025.

Transfer Pricing

Clause 1

ITR
Part XCVIII

New Part XCVIII and its sections 9800 to 9805 of the Regulations set out the prescribed conditions that must be met for a taxpayer or partnership to prepare simplified transfer pricing contemporaneous documentation as set out in subsection 247(4.1) of the Act.

Even if the relevant requirements in sections 9801 to 9805 are met, taxpayers and partnerships are still required to make reasonable efforts to determine transfer pricing amounts that are based on arm's length conditions in respect of the transaction or series, and to use those amounts for the purposes of the Act. Failure to do so could lead to a penalty under subsection 247(3) of the Act.

These amendments apply to taxation years and fiscal periods that begin on or after January 1, 2026.

Definitions

ITR
9800

Section 9800 provides that the definitions in subsection 247(1) of the Act apply in Part XCVIII of the Regulations.

Small taxpayers and partnerships

ITR
9801(1)

Subsection 9801(1) provides that for the purpose of paragraph 247(4.1)(a) of the Act, a taxpayer or partnership is deemed to satisfy the prescribed conditions for a particular taxation year or fiscal period in respect of any transaction or series of transactions between the taxpayer or the partnership and a non-resident person with whom the taxpayer or partnership, or a member of the partnership, does not deal at arm's length (or a partnership of which the non-resident person is a member), if the taxpayer or partnership meets all of the enumerated requirements set out in paragraphs 9801(1)(a), (b), (c) and (d).

Paragraph (a) requires that the total of the gross revenue of the taxpayer or partnership and of the gross revenue of all other members of the multinational enterprise group resident in Canada (other than a member of the partnership) during the immediately preceding taxation year or fiscal period does not exceed $25,000,000.

Paragraph (b) requires that the taxpayer or partnership did not transfer to a non-resident person with whom the taxpayer or partnership, or a member of the partnership, does not deal at arm's length, an intangible property or incorporeal property during the taxation year or fiscal period.
Paragraph (c) requires that the taxpayer or partnership did not pay or credit to, or receive from, a non-resident person with whom the taxpayer or partnership, or a member of the partnership, does not deal at arm's length, a royalty payment during the taxation year or fiscal period.

Paragraph (d) requires that the taxpayer or partnership elect in prescribed form and manner, on or before the taxpayer's or partnership's documentation-due date for the taxation year or fiscal period, to have subsection 247(4.1) of the Act apply for the taxation year or fiscal period.

ITR
9801(2)

Subsection 9801(2) provides that if a taxpayer or partnership meets the conditions under subsection 9801(1) for a particular taxation year or fiscal period, the taxpayer or partnership is deemed to satisfy the conditions of paragraph 247(4.1)(b) of the Act in respect of a transaction or series of transactions if the taxpayer or partnership also meets all of the enumerated requirements set out in paragraphs 9801(2)(a), (b) and (c).

Subparagraph (a)(i) requires that the taxpayer or partnership makes or obtains, on or before the taxpayer's or partnership's documentation-due date for the taxation year or fiscal period in which the transaction or series is entered into, records or documents that provide an accurate description of the calculation of the taxpayer's or partnership's gross revenue and the gross revenue of all other members of the multinational enterprise group resident in Canada (other than a member of the partnership), in order to demonstrate that the total does not exceed the $25,000,000 gross revenue limit.

Subparagraph (a)(ii) requires that the taxpayer or partnership makes or obtains, on or before its documentation-due date for the taxation year or fiscal period in which the transaction or series is entered into, records or documents that provide an accurate description of the terms and conditions of the transaction or series, including the identity of the participants in the transaction or series, the property or services to which the transaction or series relate, and the amounts paid or payable (or received or receivable).

Subparagraph (a)(iii) requires that the taxpayer or partnership makes or obtains, on or before its documentation-due date for the taxation year or fiscal period in which the transaction or series is entered into, records or documents that provide an accurate description of the analysis performed to determine that the amounts are based on arm's length conditions. This analysis generally includes a description of the transfer pricing results, the transfer pricing method used, and the identity of the tested party.

Paragraph (b) requires that for each subsequent taxation year or fiscal period, if any, in which the transaction or series continues, the taxpayer or partnership makes or obtains, on or before the taxpayer's or partnership's documentation-due date for the year or period, records or documents that provide an accurate description of each material change in the year or period to the matters referred to in any of subparagraphs (a)(i) to (iii) in respect of the transaction or series.

Paragraph (c) stipulates that the taxpayer or partnership provides the records or documents described in paragraphs (a) and (b) to the Minister within 30 days after service of a written request therefor.

Tangible property – sales or purchases

ITR
9802(1)

Subsection 9802(1) provides that for the purpose of paragraph 247(4.1)(a) of the Act, a taxpayer or partnership is deemed to satisfy the prescribed conditions for a particular taxation year or fiscal period in respect of a transaction or series of transactions that is a sale or purchase of tangible property (or corporeal property) between the taxpayer or the partnership and a non-resident person with whom the taxpayer or partnership, or a member of the partnership, does not deal at arm's length (or a partnership of which the non-resident person is a member) if the taxpayer or partnership meets all of the enumerated requirements set out in paragraphs 9802(1)(a) and (b).

Paragraph (a) requires that the gross amount paid or payable, (or received or receivable) for the tangible property (or corporeal property) by the taxpayer or partnership in respect of the transaction or series during the taxation year or fiscal period does not exceed $5,000,000.

Paragraph (b) requires that the taxpayer or partnership elect in prescribed form and manner, on or before the taxpayer's or partnership's documentation-due date for the taxation year or fiscal period, to have subsection 247(4.1) of the Act apply in respect of the transaction or series.

ITR
9802(2)

Subsection 9802(2) provides that if a taxpayer or partnership meets the conditions under subsection 9802(1) for a particular taxation year or fiscal period, the taxpayer or partnership is deemed to satisfy the conditions in paragraph 247(4.1)(b) of the Act in respect of the transaction or series of transactions if the taxpayer or partnership also meets all of the enumerated requirements set out in paragraphs 9802(2)(a), (b) and (c).

Subparagraph (a)(i) requires that the taxpayer or partnership makes or obtains, on or before its documentation-due date for the taxation year or fiscal period in which the transaction or series is entered into, records or documents that provide an accurate description of the terms and conditions of the transaction or series, including the identity of the participants in the transaction or series, the tangible property (or corporeal property) to which the transaction or series relates, and the amounts paid or payable (or received or receivable).

Subparagraph (a)(ii) requires that the taxpayer or partnership makes or obtains, on or before its documentation-due date for the taxation year or fiscal period in which the transaction or series is entered into, records or documents that provide an accurate description of the analysis performed to determine that the amounts are based on arm's length conditions. This analysis generally includes a description of the transfer pricing results, the transfer pricing method used, and the identity of the tested party.

Paragraph (b) requires that for each subsequent taxation year or fiscal period, if any, in which the transaction or series continues, the taxpayer or partnership makes or obtains on or before the taxpayer’s or partnership’s documentation-due date for the year or period, records or documents that provide an accurate description of each material change in the year or period to the matters referred to in any of subparagraphs (i) to (ii) in respect of the transaction or series.

Paragraph (c) stipulates that the taxpayer or partnership provides the records or documents described in paragraph (a) and (b) to the Minister within 30 days after service of a written request therefor.

Intra-group services

ITR
9803(1)

Subsection 9803(1) provides that for the purpose of paragraph 247(4.1)(a) of the Act, a taxpayer or partnership is deemed to satisfy the prescribed conditions for a particular taxation year or fiscal period in respect of a transaction or series of transactions that is a provision or receipt of services between the taxpayer or the partnership and a non-resident person with whom the taxpayer or partnership, or a member of the partnership, does not deal at arm’s length (or a partnership of which the non-resident person is a member) if the taxpayer or partnership meets all of the enumerated requirements set out in paragraph 9803(1)(a) and (b).

Paragraph (a) requires that the gross amount paid or payable (or received or receivable) by the taxpayer or partnership for the services in respect of the transaction or series during the taxation year or fiscal period does not exceed $2,000,000.

Paragraph (b) requires that the taxpayer or partnership elect in prescribed form and manner, on or before the taxpayer's or partnership's documentation-due date for the taxation year or fiscal period, to have subsection 247(4.1) of the Act apply in respect of the transaction or series.

ITR
9803(2)

Subsection 9803(2) provides that if a taxpayer or partnership meets the conditions under subsection 9803(1) for a particular taxation year or fiscal period, the taxpayer or partnership is deemed to satisfy the conditions of paragraph 247(4.1)(b) of the Act in respect of the transaction or series if the taxpayer or partnership also meets all of the enumerated requirements set out in paragraphs 9803(2)(a), (b) and (c).

Subparagraph (a)(i) requires that the taxpayer or partnership makes or obtains on or before its documentation-due date for the taxation year or fiscal period in which the transaction or series is entered into, records or documents that provide an accurate description of the terms and conditions of the transaction or series, including the identity of the participants in the transaction or series, the services to which the transaction or series relates, and the amounts paid or payable (or received or receivable).

Subparagraph (a)(ii) requires that the taxpayer or partnership makes or obtains on or before its documentation-due-date for the taxation year or fiscal period in which the transaction or series is entered into, records or documents that provide an accurate description of the analysis performed to determine that the amounts are based on arm's length conditions. This analysis generally includes a description of the transfer pricing results, the transfer pricing method used, and the identity of the tested party.

Paragraph (b) requires that for each subsequent taxation year or fiscal period, if any, in which the transaction or series continues, the taxpayer or partnership makes or obtains on or before the taxpayer's or partnership's documentation-due date for the year or period, records or documents that provide an accurate description of each material change in the year or period to the matters referred to in any of subparagraphs (a)(i) to (ii) in respect of the transaction or series.

Paragraph (c) stipulates that the taxpayer or partnership provides the records or documents described in paragraph (a) and (b) to the Minister within 30 days after service of a written request therefor.

Loans

ITR
9804(1)

Subsection 9804(1) provides that for the purpose of paragraph 247(4.1)(a) of the Act, a taxpayer or partnership is deemed to satisfy the prescribed conditions for particular taxation year or fiscal period in respect of a transaction or series of transactions that is a lending or borrowing of money between the taxpayer or the partnership and a non-resident person with whom the taxpayer or partnership, or a member of the partnership, does not deal at arm's length (or a partnership of which the non-resident person is a member) if the taxpayer or partnership meets all of the enumerated requirements set out in paragraphs 9804(1)(a) and (b).
Paragraph (a) requires that the gross amount of interest paid or payable (or received or receivable) on the loan in the taxation year or fiscal period does not exceed $1,000,000.

Paragraph (b) requires that the taxpayer or partnership elect in prescribed form and manner, on or before the taxpayer's or partnership's documentation-due date for the taxation year or fiscal period, to have subsection 247(4.1) of the Act apply in respect of the transaction or series.

ITR
9804(2)

Subsection 9804(2) provides that if a taxpayer or partnership meets the conditions under subsection 9804(1) for a particular taxation year or fiscal period in respect of a transaction or series of transactions, the taxpayer or partnership is deemed to satisfy the conditions of paragraph 247(4.1)(b) of the Act if the taxpayer or partnership also meets all of the enumerated requirements set out in paragraphs 9804(2)(a), (b) and (c).

Subparagraph (a)(i) requires that the taxpayer or partnership makes or obtains on or before its documentation-due date for the taxation year or fiscal period in which the transaction or series is entered into, records or documents that provide an accurate description of the terms and conditions in respect of the loan, including the identity of the participants in the transaction or series, the principal amount, term, issuance date, maturity, credit rating of the borrower, interest rate, currency and payment terms of the loan, and the amounts paid or payable (or received or receivable).

Subparagraph (a)(ii) requires that the taxpayer or partnership makes or obtains on or before its documentation-due date for the taxation year or fiscal period in which the transaction or series is entered into, records or documents that provide an accurate description of the purpose of the loan.

Subparagraph (a)(iii) requires that the taxpayer or partnership makes or obtains, on or before its documentation-due date for the taxation year or fiscal period in which the transaction or series is entered into, records or documents that provide an accurate description of the analysis performed to determine that the amounts are based on arm's length conditions. This analysis generally includes a description of the transfer pricing results, the transfer pricing method used, and the identity of the tested party.

Paragraph (b) requires that for each subsequent taxation year or fiscal period, if any, in which the transaction or series continues, the taxpayer or partnership makes or obtains on or before the taxpayer's or partnership's documentation-due date for the year or period, records or documents that provide an accurate description of each material change in the year or period to the matters referred to in any of subparagraphs (i) to (iii) in respect of the transaction or series.
Paragraph (c) stipulates that the taxpayer or partnership provides the records or documents described in paragraph (a) and (b) to the Minister within 30 days after service of a written request therefor.

Anti-avoidance

ITR
9805

Section 9805 provides an anti-avoidance rule to protect the integrity of the simplified contemporaneous documentation rules for transfer pricing permitted under subsection 247(4.1) of the Act and Part XCVIII of the Regulations.

The provision applies where it is reasonable to conclude that one of the purposes of a transaction or series of transactions is to benefit from subsection 247(4.1) of the Act. In such case, then notwithstanding sections 9801 to 9804, a taxpayer or partnership is deemed not to have met the prescribed conditions in subsection 247(4.1) of the Act for a taxation year or fiscal period in respect of the transaction or series of transactions, or in any subsequent taxation year or fiscal period in which the transaction or series continues. Consequently, the taxpayer or partnership will be subject to the contemporaneous documentation requirements under subsection 247(4) of the Act in respect of the transaction or series.

Section 9805 will apply, for example, where a taxpayer (that would not otherwise satisfy the conditions of section 9801 because of royalty payments made in the year to a non-resident person with whom the taxpayer does not deal at arm's length) creates a new entity and assigns to it contracts (entered into with non-residents with whom the taxpayer does not deal at arm's length) so that the new entity can satisfy the conditions of section 9801 and benefit from subsection 247(4.1) of the Act for that taxation year.

Section 9805 will also apply where a taxpayer staggers or fragments transactions to stay under certain thresholds; for example, a taxpayer that splits a purchase or sale of tangible property into multiple transactions for no reason other than for each transaction to remain under the $5,000,000 threshold of paragraph 9802(1)(a). In addition, where transactions are typically bundled together and a taxpayer or partnership unbundles them to meet any of the conditions listed under sections 9801 to 9804, then section 9805 will apply to deem the taxpayer or partnership not to have met the prescribed conditions under subsection 247(4.1) of the Act in respect of the unbundled transactions.

Hybrid Mismatch Arrangements

Clause 1

Secondary rule — consequences

ITA
12.7(3)

Subsection 12.7(3) is amended as a consequence of amendments to subsections 18.4(3), (4), (11), (13) and (15) and the definition “hybrid mismatch amount” in subsection 18.4(1), to ensure that the hybrid mismatch rules apply to a hybrid mismatch amount attributable to a taxation year. (For more information, see the commentary on the definition “hybrid mismatch amount” in subsection 18.4(1) and subsections 18.4(6) and (11).) In particular, a reference to the hybrid mismatch amount being “for a taxation year” is added and the rule in paragraph 12.7(3)(b) for determining the timing of a taxpayer’s income inclusion is eliminated, as this timing now flows from the determination of the hybrid mismatch amount for a taxation year. For more information, see the commentary on subsections 18.4(11), (13), (15) and (15.4).

These amendments apply in respect of payments arising on or after July 1, 2026.

Investor hybrid payer mismatch amount

ITA
12.7(4)

New subsection 12.7(4) provides a specific operative rule applicable to an investor hybrid payer mismatch amount in respect of a payment, which arises under a hybrid payer arrangement. The mismatch is neutralized under this subsection by means of an income inclusion to the taxpayer equal to the investor hybrid payer mismatch amount. Paragraph (b) then deems this income inclusion to be from the same source as the income or loss, of the hybrid payer under the hybrid payer arrangement, that is computed taking into account a deduction in respect of the payment. For more information, see the commentary on subsections 18.4(15.5) to (15.7).

Subsection 12.7(4) applies in respect of payments arising on or after July 1, 2026.

Clause 2

Limitation on deduction of interest

ITA
18(4)

Subsection 18(4) forms part of the thin capitalization rules that limit deductions, by corporations and trusts, in respect of interest on debt owing to certain specified non-residents. If the amount of debt owing to specified non-residents exceeds a debt-to-equity ratio of 1.5-to-1, subsection 18(4) limits the deductibility of interest on that debt to the extent that the interest would otherwise be deductible (i.e., in the absence of subsection 18(4)).

Under the existing subsection 18(4), the thin capitalization limitation applies only in respect of interest that would, in the absence of section 18.2 (the excessive interest and financing expenses limitation) and subsection 18(4), be deductible in computing income from a business or property. In other words, the thin capitalization rules apply in priority to the interest restriction under section 18.2.

Subsection 18(4) is amended to include a reference to section 18.4 (the primary operative rule of the hybrid mismatch rules) in the list of provisions that are disregarded in determining, for the purposes of applying the thin capitalization rules, if an amount in respect of interest would otherwise be deductible in computing income from a business or property. As a result, the thin capitalization rules also apply in priority to section 18.4.

This amendment ensures that the rule in subsection 214(16) – which deems an amount of interest expense for which a deduction is denied under the thin capitalization rules to be a dividend for the purposes of Part XIII (withholding tax) of the Act – can apply in respect of an amount for which a deduction would otherwise be denied under the hybrid mismatch rules. This is relevant especially in the case of interest payments arising under reverse hybrid arrangements, disregarded payment arrangements, hybrid payer arrangements and imported hybrid arrangements, since the parallel rule in subsection 214(18) does not apply where a deduction in respect of an interest payment is denied under the hybrid mismatch rules in respect of those arrangements.

This amendment applies in respect of payments arising on or after Announcement Date.

Clause 3

ITA
18.4

The existing hybrid mismatch rules (the “first package of rules”) in sections 12.7 and 18.4, together with subsection 113(5), primarily implemented the recommendations in Chapters 1 and 2 of the report under Action 2 of the Group of 20 and Organisation for Economic Co-operation and Development’s Base Erosion and Profit Shifting Project (the “BEPS Action 2 Report”), titled *Final Report on Neutralising the Effects of Hybrid Mismatch Arrangements*, with appropriate adaptations to the Canadian income tax context. The legislative amendments introduced at this time (the “second package of rules”) to the hybrid mismatch rules implement most of the various other recommendations in the BEPS Action 2 Report. Specifically, these new rules implement the recommendations in Chapters 3, 4 and 6 to 8 of the BEPS Action 2 Report in order to address deduction/non-inclusion mismatches arising from payments under “reverse hybrid arrangements", "disregarded payment arrangements" and "imported hybrid arrangements", as well as double deduction mismatches arising from payments under "hybrid payer arrangements".

Key changes under the second package of rules

The legislative amendments introduced at this time include the following key provisions:

- *Amendments to key definitions:* Various amendments are made to the definitions "hybrid mismatch amount", "hybrid mismatch arrangement" and "structured arrangement" (each contained in subsection 18.4(1)) in order to incorporate the additional hybrid mismatch arrangements targeted under the second package of rules.

- *Reverse hybrid arrangement:* Subsection 18.4(15.1) determines if a payment arises under a reverse hybrid arrangement, consistent with the recommendations in Chapter 4 of the BEPS Action 2 Report. Subsection 18.4(15.2) determines the amount of the reverse hybrid mismatch and ensures that subsection 18.4(4) applies only to the extent that the deduction/non-inclusion mismatch amount arising from the actual payment exceeds the aggregate of the deduction/non-inclusion mismatch amounts that would have arisen had there instead been hypothetical payments made to the owners of the reverse hybrid entity.

- *Disregarded payment arrangement:* Subsection 18.4(15.3) determines if a payment arises under a disregarded payment arrangement. Consistent with the recommendations in Chapter 3 of the BEPS Action 2 Report, this generally occurs if a payment made by a hybrid entity results in a deduction/non-inclusion mismatch by reason of the payment being disregarded under the income tax laws of the recipient country. Subsection 18.4(15.4) determines the amount of the disregarded payment mismatch and ensures that subsection 12.7(3) or 18.4(4) applies only to the extent that the portion of the deduction/non-inclusion mismatch amount satisfying the causal test exceeds the dual inclusion income of the hybrid entity.

- *Hybrid payer arrangement:* Subsection 18.4(15.5) determines if a payment arises under a hybrid payer arrangement. Consistent with the recommendations in Chapters 6 and 7 of the BEPS Action 2 Report, this generally occurs if a payer of a payment is a hybrid payer and the payment gives rise to a double deduction mismatch. In most cases, subsection 18.4(15.6) determines the amount of the hybrid payer mismatch and ensures that subsection 18.4(4) applies only to the extent the double deduction mismatch amount exceeds the hybrid payer's dual inclusion income. If, however, the hybrid entity is a partnership, subsection 18.4(15.7) determines the investor hybrid payer mismatch amount and ensures subsection 12.7(4) applies to cause an income inclusion for an investor in the partnership to the extent that the investor's share of the double deduction mismatch amount exceeds the investor's investor dual inclusion income.

- *Imported hybrid arrangement:* Subsections (15.8) through (15.94) contain rules for determining if there is an offshore hybrid mismatch (that is, a hybrid mismatch that is in respect of a payment of which neither the payer nor the recipient is a Canadian taxpayer but which is determined in a manner that is consistent with the Canadian hybrid mismatch rules) and whether the requisite link exists between a deductible payment made by a Canadian entity and the payment, made by the deducting entity, in respect of which the offshore hybrid mismatch arose (which link is necessary to establish that the mismatch has effectively been imported to Canada). These rules apply to identify such offshore hybrid mismatches (involving non-arm's length parties or a structured arrangement) that have not been neutralized through the application of hybrid mismatch rules in Canada or a foreign country and have been functionally imported to Canada through a deductible payment (or a chain of deductible payments between entities). The deduction in respect of the Canadian importing payment is then denied to the extent that there is any otherwise outstanding offshore hybrid mismatch amount to be neutralized. These rules address attempts to circumvent the hybrid mismatch rules through the use of hybrid mismatches between non-implementing jurisdictions.

- *Double deduction mismatch:* Subsection 18.4(7.1) determines if a payment gives rise to a double deduction mismatch. This generally occurs if there is an amount deductible in respect of the payment for Canadian income tax purposes and there is also an amount deductible in respect of the payment for foreign income tax purposes. This accords with Recommendations 6.1 and 7.1, and the recommendations in Chapter 12, of the BEPS Action 2 Report.

- *Dual inclusion income:* Dual inclusion income is a new definition added to subsection 18.4(1). Its main role is to determine the total of the amounts of income of a hybrid entity, dual resident or multinational entity that are subject to tax in both Canada and another country. This is relevant in determining the amount of a disregarded payment mismatch or hybrid payer mismatch under subsections 18.4(15.4) and (15.6), respectively. This accords with Recommendations 3.1, 6.1 and 7.1, and the recommendations in Chapter 12, of the BEPS Action 2 Report.

  Any dual inclusion income for a taxation year that is not fully used to shelter deduction/non-inclusion and double deduction mismatches for the year can be carried forward and applied to mismatches in a future taxation year, as set out in variable C of subsection 18.4(15.4) and variable E of subsection 18.4(15.6). New paragraph 20(1)(zz) also provides for a deduction for a particular taxation year where subsection 18.4(4) has restricted a deduction for a taxpayer for a prior year in respect of a payment and the taxpayer demonstrates that there is dual inclusion income in the particular taxation year that could be used to effectively reinstate the amount denied.

- *Investor dual inclusion income:* Investor dual inclusion income is a new definition added to subsection 18.4(1) and generally performs a similar function to the definition "dual inclusion income" except that it applies to an investor in a hybrid entity. It is relevant in determining the amount of a disregarded payment mismatch in subsection 18.4(15.4) or an investor hybrid payer mismatch amount in subsection 18.4(15.7), which can result in an income inclusion for an investor under subsection 12.7(3) or (4), respectively. New paragraph 20(1)(aaa) provides for a deduction for a taxation year where an amount is included in income for a preceding taxation year under subsection 12.7(4) in respect of an investor hybrid payer mismatch amount and the taxpayer has an offsetting amount of investor dual inclusion income for the taxation year.

- *Anti-avoidance rule:* The existing anti-avoidance rule is amended in order to reflect the additional hybrid mismatch arrangements targeted under the second package of rules.

- *Part XIII*: Amendments are made to the existing rule that treats an interest expense of a corporation resident in Canada that is not deductible because of the hybrid mismatch rules as a deemed dividend for the purposes of Part XIII of the Act, to expressly exclude from the application of this deeming rule the additional hybrid mismatch arrangements targeted under the second package of rules.

- *Other ancillary rules:* Various ancillary rules and definitions are being added to and amended in section 18.4 in order to facilitate the application of the hybrid mismatch rules to the additional hybrid mismatch arrangements targeted under the second package of rules.

Effective date

These amendments generally apply in respect of payments arising on or after July 1, 2026, including payments under arrangements entered into before that date.

Definitions

ITA
18.4(1)

Subsection 18.4(1) is amended consequential on the introduction of new paragraphs 20(1)(zz) and (aaa) and subsection 20(31). For more information, see the commentary on those provisions.

“*hybrid mismatch amount*”

The definition “hybrid mismatch amount” is used in the operative rules in subsections 12.7(3) and 18.4(4). Where the operative rules apply, the hybrid mismatch amount determines the amount of the deduction that will be denied (in the case of the primary rule in subsection 18.4(4)) and where applicable, the amount that will be included in income (in the case of the secondary rule in 12.7(3)) in respect of a payment.

This definition is amended to ensure that the operative rules also apply to reverse hybrid arrangements, disregarded payment arrangements and hybrid payer arrangements, which are set out in subsections 18.4(15.1) and (15.2), (15.3) and (15.4), and (15.5) and (15.6), respectively. For more information, see the commentary on those subsections. An investor hybrid mismatch amount, newly introduced in subsection 18(15.7), is not included in this definition and is subject to a standalone operative rule in new subsection 12.7(4).

To improve the operation of the existing rules and facilitate the addition of certain new hybrid mismatch arrangements, which in some cases require the determination of an entity's dual inclusion income for a taxation year, references to "taxation year" are added to this definition and to subsections 12.7(3), 18.4(3), (4), (11), (13) and (15), so that the hybrid mismatch rules apply to a hybrid mismatch amount attributable to a taxation year. In general, these amendments are clarifying in nature. For more information, see the commentary on subsections 18.4(6) and (11).

These amendments apply in respect of payments arising on or after July 1, 2026.

"*structured arrangement*"

The definition "structured arrangement" is amended consequential on the expansion of the hybrid mismatch rules to include additional forms of hybrid mismatch arrangements involving hybrid entities. The test in paragraph (a), which formerly required that there be a payment that gives rise to a deduction/non-inclusion mismatch, is amended to instead require that there would be a hybrid mismatch amount or investor hybrid payer mismatch amount in respect of the payment if the payment were assumed to meet the conditions set out in subparagraphs 18.4(10)(b)(ii), (12)(b)(ii), (14)(e)(ii), (15.1)(b)(ii) and (15.3)(b)(ii) and clause (15.5)(b)(i)(B). In other words, amended paragraph (a) poses the following hypothetical: assuming that the payment did arise under, or in connection with, a structured arrangement – such that the structured arrangement condition in each hybrid mismatch arrangement rule (e.g., subparagraph 18.4(10)(b)(ii)) were satisfied – would there be a hybrid mismatch amount or investor hybrid payer mismatch amount in respect of the payment? As a result of this amendment, the mere existence of a deduction/non-inclusion mismatch is not sufficient to satisfy the condition in paragraph (a). Rather, it is necessary to determine if the payment arises under a hybrid mismatch arrangement such that there is a hybrid mismatch amount (or investor hybrid payer mismatch amount). The expansion of the "hybrid mismatch amount" definition and the inclusion of a reference to "investor hybrid payer mismatch amount" in paragraph (a) together facilitate the application of the "structured arrangement" definition to the hybrid mismatch arrangements that are the subject of the second package of rules.

Paragraph (b) is consequentially amended to reference the "amount referred to in paragraph (a)" (i.e., the hybrid mismatch amount or investor hybrid payer mismatch amount). This change is especially important in the context of the second package of rules, where deduction/non-inclusion or double deduction mismatches may arise from the mere involvement of a hybrid entity or reverse hybrid entity in a transaction or series of transactions, even in situations where there is (or will be in a future year) sufficient dual inclusion income to offset the mismatch such that no permanent hybrid mismatch will arise. In these situations, the transaction or series may be viewed as reflecting the economic benefit of a deduction/non-inclusion or double deduction mismatch in its pricing or as being otherwise designed to give rise to such a mismatch, such that, absent the amendment to paragraph (b), the "structured arrangement" definition may be met in some cases where there is no significant prospect of a permanent hybrid mismatch arising. As a result of the amendment, it must be shown that a transaction or series reflects the economic benefit of a hybrid mismatch amount (or investor hybrid payer mismatch amount) in its pricing, or that the transaction or series was otherwise designed to give rise to that hybrid mismatch amount, in order for the condition in paragraph (b) to be met. Transactions or series that give rise to incidental, temporary hybrid mismatches are, therefore, not expected to meet this condition.

This definition applies in respect of payments arising on or after July 1, 2026.

"*foreign ordinary income*"

Consequential on the introduction of the new definition "income or profits tax" in this subsection, the parenthetical carve-out for income or profits that are subject to tax under certain types of taxation regimes is deleted because that parenthetical is redundant in light of that new definition.

This amendment applies in respect of payments arising on or after July 1, 2026.

"*hybrid mismatch arrangement*"

The definition of "hybrid mismatch arrangement" comprises the various categories of arrangements to which the hybrid mismatch rules apply. This term is used in the conditions of application of the operative rules in subsections 12.7(3) and 18.4(4), as well as the new operative rule that applies to Canadian resident partners of a partnership that is a hybrid entity in certain cases under subsection 12.7(4). In order for the operative rules to apply to a payment, the payment must arise under at least one category of hybrid mismatch arrangement. There are separate provisions in section 18.4 setting out the conditions for each type of hybrid mismatch arrangement.

The definition now includes a reverse hybrid arrangement, a disregarded payment arrangement and a hybrid payer arrangement, as described in subsections 18(15.1), (15.3) and (15.5), respectively. For more information, see the commentary on those subsections.

These amendments apply in respect of payments arising on or after July 1, 2026.

"*specified minimum tax regime*"

The "specified minimum tax regime" definition is relevant in determining an entity's foreign ordinary income for a foreign taxation year. By virtue of the exceptions contained in the new definition "income or profits tax", amounts that are included in the entity's relevant foreign income or profits because of a specified minimum tax regime are not included in foreign ordinary income. For more information, see the commentary on those definitions in this subsection.

Paragraph (a) of this definition is amended in light of the replacement of the “global intangible low-taxed income” regime with the “net CFC tested income” regime applicable to American persons under the United States’ *Internal Revenue Code of 1986*.

These amendments apply in respect of foreign taxation years beginning after December 31, 2025.

“*dual inclusion income*”

Dual inclusion income is relevant mainly for the determination of the amount of a disregarded payment mismatch in respect of a payment arising under a disregarded payment arrangement, or the amount of a hybrid payer mismatch in respect of a payment arising under a hybrid payer arrangement.

Very generally, the dual inclusion income of an entity is the total of the entity’s income or profits that are subject to tax both in Canada and another relevant country (essentially, because of the entity being a hybrid entity, a dual resident or a multinational entity). More specifically, it takes the total of all amounts that are ordinary income in respect of both Canada and another relevant country (in determining the dual inclusion income of a hybrid entity, the ordinary income in respect of the other country would be ordinary income of an investor in the hybrid entity rather than ordinary income of the hybrid entity). For more information, see the commentary on the definition “ordinary income” in this subsection and the commentary on the ordinary income deeming rules in new subsections (16.1) to (16.4).

The relevance of dual inclusion income is that the mismatch in respect of a payment arising under a disregarded payment arrangement or a hybrid payer arrangement results in the denial of a deduction for a taxpayer under subsection 18.4(4) only to the extent that the amount of the mismatch exceeds the dual inclusion income of the hybrid payer. This accords with Recommendations 3.1, 6.1 and 7.1, and the recommendations in Chapter 12, of the BEPS Action 2 Report.

Paragraph (a) of the definition applies when the payer of a payment is a hybrid entity resident in Canada. Paragraph (b) of the definition applies when the payer of a payment is a dual resident entity or a multinational entity (both as defined in this subsection). In cases where the hybrid payer is a hybrid entity that is a partnership, the new definition “investor dual inclusion income” is applicable. For more information, see the commentary on that definition.

Because each of paragraphs (a) and (b) require the amount to be ordinary income in respect of both Canada and another country, dual inclusion income is effectively the lesser of the Canadian inclusion and the foreign inclusion. Further, ordinary income that is subject to foreign tax (or an amount that is deemed to be ordinary income of an entity in respect of a country other than Canada, under subsection (16.1) or (16.2)) is only factored into the determination of the dual inclusion income of an entity for a taxation year if the ordinary income is for a foreign taxation year that begins on or before the day that is 12 months after the end of the taxation year. If, due to a difference in the timing of when a foreign country taxes the income as compared to Canada, the ordinary income in respect of the foreign country arises after the required timeframe (or only a portion arises within the required timeframe because it is recognized in the foreign country over multiple foreign taxation years), new subsection 18.4(19.1) nonetheless includes the amount in dual inclusion income if, in the opinion of the Minister of National Revenue, the circumstances of the case are such that it would be just and equitable to do so. Where dual inclusion income arises in a taxation year after the taxation year for which subsection 18.4(4) has denied a deduction, paragraph 20(1)(zz) may provide relief. For more information, see the commentary on subsection 18.4(19.1) and paragraph 20(1)(zz).

Further, while dual inclusion income is determined for a particular taxation year, where the dual inclusion income for the particular taxation year is not fully used to shelter deduction/non-inclusion and double deduction mismatches for the particular taxation year, the unused portion can be carried forward and applied to mismatches of a future taxation year, as set out in variable C of subsection 18.4(15.4) and variable E of subsection 18.4(15.6). For more information, see the commentary on subsections 18.4(15.3) to (15.6).

The existing "no double counting" rule in subsection 18.4(8) has been expanded to provide additional rules that apply in computing an entity's dual inclusion income or investor dual inclusion income. For more information, see the commentary on subsection 18.4(8).

This definition applies in respect of payments arising on or after July 1, 2026.

"*dual resident*"

The "dual resident" definition is relevant for the hybrid mismatch rules concerning hybrid payers (in subsections 18.4(15.5) and (15.6)). A dual resident is any entity that is resident, for tax purposes, in at least two countries. Notably, subsection 18.4(19.2) provides an interpretive rule for the references, in the hybrid mismatch rules, to an entity being resident in a country.

If a dual resident is a payer of a payment, it will qualify as a "hybrid payer" (as defined in this subsection) and be potentially subject to the application of the hybrid payer rules. For more information, see the commentary on the definition "hybrid payer" and subsections 18.4(15.5) and (15.6).

This definition applies in respect of payments arising on or after July 1, 2026.

"*foreign hybrid payer mismatch rule*"

The "foreign hybrid payer mismatch rule" definition is a subset of the definition "foreign hybrid mismatch rule" and refers to a rule that is focused on counteracting mismatches that arise because a payer is a hybrid payer. It describes foreign tax laws that can reasonably be considered to have been intended to implement Chapter 6 or 7 of the BEPS Action 2 Report or to have an effect that is substantially similar to a provision of section 12.7 or 18.4 that is intended to implement one of those chapters. In the latter case, a foreign tax law may meet this condition (which is contained in paragraph (b) of the "foreign hybrid payer mismatch rule" definition) even if that law was enacted prior to the publication of the BEPS Action 2 Report, since the condition is focused only on the effect of the law and not its provenance. Further, a foreign tax law need only have an effect that is "substantially similar" to a provision of section 12.7 or 18.4 that is intended to implement Chapter 6 or 7 of the BEPS Action 2 Report – the effect need not be identical to such a provision. Accordingly, if the foreign tax law fulfils the same ultimate policy goal by a different means than the recommendations under those chapters of the BEPS Action 2 Report, that does not by itself prevent that law from being a foreign hybrid payer mismatch rule.

This definition is used in the determination of whether a payment gives rise to a double deduction mismatch under subsection 18.4(7.1). More specifically, the effect of any foreign hybrid payer mismatch rule is ignored in determining whether there is, in respect of a payment, an amount deductible for foreign tax purposes. In addition, this definition is used in determining whether a payment arises under a hybrid payer arrangement under subsection 18.4(15.5). In that context, the "foreign hybrid payer mismatch rule" definition works as part of an ordering rule to determine, in the case of a hybrid payer that is a hybrid entity resident in Canada or a multinational entity not resident in Canada (i.e., a multinational entity with a Canadian permanent establishment), whether the hybrid payer mismatch has been neutralized by the country of an investor in the hybrid entity or the country where the multinational entity is resident. For more information, see the commentary on subsections 18.4(7.1) and (15.5).

This definition applies in respect of payments arising on or after July 1, 2026.

"*foreign structured arrangement*"

The definition "foreign structured arrangement" is introduced as part of the imported hybrid mismatch rules and adapts the definition "structured arrangement" to apply in that context by reading out the existing paragraph (a) of the "structured arrangement" definition in favour of a new paragraph (a), which requires that the arrangement include a payment in respect of which there would be an amount of an imported hybrid mismatch if the payment (i.e., an importing payment), the corresponding mismatch payment and all other payments included in the series of payments interposed between the mismatch payment and the importing payment (such mismatch payment and series of payments being those referred to in subparagraph 18.4(15.92)(c)(ii)) were assumed to meet the condition set out in clause 18.4(15.92)(c)(ii)(B). This is a hypothetical test, requiring a determination of whether there would be an amount of an imported hybrid mismatch if it were assumed that all those payments arose under a foreign structured arrangement. If there would have been an amount of an imported hybrid mismatch in those circumstances, the condition in paragraph (a) is met.

Subsection 18.4(15.94) sets out the conditions for determining if there is an imported hybrid mismatch in respect of a payment (and the rules for determining the amount of the imported hybrid mismatch), and is likewise used, for the purposes of the hypothetical test described above, to determine if there would have been an amount of an imported hybrid mismatch.

The condition in paragraph (b) of the "structured arrangement" definition, which pertains to the pricing or design of the arrangement to secure the benefit of the amount referred to in paragraph

(a) of that definition, is retained but with the requirement that the amount in question be an amount of an imported hybrid mismatch (as opposed to a hybrid mismatch amount or investor hybrid payer mismatch amount).

This amendment applies in respect of payments arising on or after July 1, 2026.

"*hybrid entity*"

In line with the BEPS Action 2 Report, the term "hybrid entity" is defined in subsection 18.4(1) as an entity that is tax resident in one country and treated as fiscally transparent in a second country, such that some portion of its income, profits, expenses or losses are treated, under the laws of that second country, as those of a resident of that second country for the purposes of its income or profits tax.

A hybrid entity may, for example, be an entity that is viewed, for the purposes of the income or profits tax of the country where it is incorporated, as a corporation resident in that incorporation country, but is viewed, under the laws of the country where one of its investors is resident, as a branch of the investor with no separate existence for the purposes of the income or profits tax of the investor country. As "income or profits tax" is defined in this subsection as excluding from its scope, among other things, any tax under a controlled foreign company tax regime, an entity is not a hybrid entity merely because it is tax resident in a first country and a portion of its income is subject to a controlled foreign company tax regime in a second country (e.g., the country where its controlling shareholder is located). Since the foreign accrual property income ("FAPI") regime does not treat the income or losses of one entity as income or losses of another, but rather provides for an income inclusion to a Canadian taxpayer by reference to the FAPI of its controlled foreign affiliate, a FAPI inclusion likewise is not sufficient to cause the controlled foreign affiliate to be a hybrid entity.

This definition is primarily relevant in determining the existence of a disregarded payment arrangement or a hybrid payer arrangement, which are described in subsections 18.4(15.3) and (15.5), respectively. For more information, see the commentary on those subsections.

This definition applies in respect of payments arising on or after July 1, 2026.

"*hybrid payer*"

The definition "hybrid payer" is relevant for the purposes of the hybrid payer arrangement rules, primarily contained in subsections 18.4(15.5) to (15.7). A hybrid payer is any payer that is a dual resident, a hybrid entity or a multinational entity, each as separately defined in this subsection. For more information, see the commentary on those definitions.

This definition applies in respect of payments arising on or after July 1, 2026.

"*income or profits tax*"

A definition of the term “income or profits tax” is introduced for the purpose of excluding from the meaning of that term (to the extent that it would not already have been so excluded) Part XIII withholding tax and its foreign equivalents, as well as any tax levied under a controlled foreign company tax regime or a specified minimum tax regime, whenever the term “income or profits tax” is used in the hybrid mismatch rules. The term “income or profits tax” otherwise has the same meaning that it has in the Act in general.

This definition applies in respect of payments arising on or after July 1, 2026.

“*investor*”

A particular entity is an “investor” in a hybrid entity if:

- the particular entity holds a direct or indirect “equity interest” (defined in this subsection) in the hybrid entity; and
- a portion of the hybrid entity’s income, profits, expenses or losses are treated (or would be treated, if any such amount existed) as the particular entity’s own income, profits, expenses or losses for the purposes of an income or profits tax of the country in which the particular entity is resident.

Given that one condition for an entity to be a hybrid entity is that the entity must be resident in a country, such that the country treats the hybrid entity’s income as its own for the purposes of the income or profits tax of that country, it follows that an investor in a hybrid entity must be resident in a different country for the second condition of the “investor” definition to be met. An investor would include, for example, a Canadian partner in an entity that is a partnership from the perspective of Canadian tax law but is a hybrid entity because it is a tax resident in a country other than Canada.

This definition applies in respect of payments arising on or after July 1, 2026.

“*investor dual inclusion income*”

The new definition “investor dual inclusion income” is primarily relevant in determining the amount of a disregarded payment mismatch in subsection 18.4(15.4) or an investor hybrid payer mismatch amount in subsection 18.4(15.7), which can result in an income inclusion for an investor under subsection 12.7(3) or (4), respectively. For more information, see the commentary on those subsections.

This definition is structured similarly to the definition “dual inclusion income”. However, this definition is only applicable for an investor in a hybrid entity. It essentially aggregates each amount that is both the investor’s “ordinary income” (which is defined in this subsection) subject to tax in Canada and the hybrid entity’s ordinary income that is subject to tax in a foreign country. For more information, see the commentary on the definitions “dual inclusion income” and “ordinary income” in this subsection.

The existing “no double counting” rule in subsection 18.4(8) has been expanded to provide various rules that apply to the determination of dual inclusion income and investor dual inclusion income. For more information, see the commentary on subsection 18.4(8).

This definition applies in respect of payments arising on or after July 1, 2026.

“*multinational entity*”

The definition “multinational entity” is relevant for the hybrid payer arrangement rules, primarily contained in subsections 18.4(15.5) to (15.7). A multinational entity is an entity that is resident in one country and operates through a permanent establishment in another country, where the expression “permanent establishment” takes its meaning from either the tax treaty between those two countries (if there is such a tax treaty and it defines “permanent establishment”) or from section 8201 of the Regulations (if there is no such tax treaty that defines “permanent establishment”).

This definition applies in respect of payments arising on or after July 1, 2026.

“*ordinary income*”

The new definition “ordinary income” in subsection 18.4(1) is primarily relevant to the definitions “dual inclusion income” and “investor dual inclusion income” in this subsection, which are ultimately used to determine the amount of a disregarded payment mismatch or hybrid payer mismatch (or investor hybrid payer mismatch amount) when there is a payment arising under a disregarded payment arrangement (as described in subsections (15.3) and (15.4)) or hybrid payer arrangement (as described in subsections (15.5) to (15.7)), respectively.

This definition essentially describes a gross amount of income (i.e., revenue) that is included in the entity’s income or profits subject to an “income or profits tax” (as defined in this subsection) in a country and is not effectively sheltered from that tax in certain ways. For more information regarding the scope of the term “income or profits tax”, see the commentary on the definition “income or profits tax”.

Paragraph (a) provides that an amount is not ordinary income of an entity, in respect of a country, if the amount is included in computing the entity’s income or profits that are subject to tax but is subject to an offsetting relief (other than relief that applies to income in general). This exclusion only applies “to the extent that” that the amount included in computing the entity’s income or profits is “effectively sheltered from the income or profits tax” by the offsetting relief. Accordingly, if a form of tax relief applies after net income has been calculated (e.g., a tax credit), the gross amount included in calculating the entity’s income or profits can only be considered to have been effectively sheltered from tax to the extent of the net income that arises from that gross amount and benefits from the tax relief.

For example, assume a corporation is located in a country with a 20% corporate income tax rate and has two \$100 gross receipts and \$50 of business expense deductions for a year, such that its net income for the year is \$150. Assume also that the corporation has a \$10 tax credit that is granted specifically in respect of one of the \$100 gross receipts (e.g., because that receipt is a type of income that satisfies the conditions for the credit) but which is used against its overall income tax liability without distinction. The corporation has a \$30 pre-credit income tax liability, reduced to \$20 by the tax credit. Based on the country's 20% corporate income tax rate, \$50 of its net income is effectively sheltered from tax by the credit. Accordingly, \$50 of the \$100 gross receipt that gave rise to the credit is not ordinary income.

If the tax relief (e.g., a deduction) applies in calculating net income, the gross income will be considered to have been effectively sheltered from tax to the extent that net income is reduced by that tax relief and the relief applies in respect of a specific income amount. For example, if a corporation is permitted a \$50 deduction in respect of a \$100 gross receipt (e.g., a deduction for inter-corporate dividends received, which is intended to provide relief from double taxation), such that its net income is \$50 less than it would have otherwise been, \$50 of the gross receipt is not ordinary income.

Paragraph (b) provides for a reduction in computing ordinary income to the extent a refund is available for the tax for the year in which the amount is included in taxable income or profits. In the case of a partial refund of taxes paid for a year, it is intended that an amount of income or profits that would otherwise be included in ordinary income for the year will be reduced by the proportion of that amount that the income or profits tax repaid or repayable is of the total income or profits tax paid for the year.

For example, an amount of an entity's income is ordinary income of that entity in respect of Canada if that amount is included in computing the entity's income from a business or property (or its taxable income earned in Canada, if the entity is a non-resident) or is the taxable portion of any capital gain that is included in computing the entity's income, where there is no offsetting relief or tax refund in respect of the amount.

Under the rules in new subsections 18.4(16.1) and (16.2), an amount is deemed to be ordinary income, in respect of a country, of an entity that is an investor in a hybrid entity if the conditions in either of those subsections are met. Subsections 18.4(16.3) and (16.4) contain provisions to prevent double counting of ordinary income amounts in situations where subsection (16.2) deems an entity to have an amount of ordinary income. For more information, see the commentary on the ordinary income deeming rules in subsections (16.1) to (16.4).

This definition applies in respect of payments arising on or after July 1, 2026.

"*reverse hybrid entity*"

The definition "reverse hybrid entity" is relevant for the reverse hybrid arrangement rules, primarily contained in subsections 18.4(15.1) to (15.2).

An entity that is a recipient of a payment is a reverse hybrid entity in respect of the payment if the entity is treated as fiscally transparent in one country (paragraph (b) of this definition) and is treated as fiscally opaque in a country in which an equity interest holder is resident (paragraph (c) of this definition). Thus, when an entity is a reverse hybrid entity in respect of a payment, neither country treats the payment as income or profits of a resident of that country.

This definition applies in respect of payments arising on or after July 1, 2026.

Interpretation

ITA
18.4(2)

Subsection 18.4(2) provides an interpretive rule that applies for the purposes of sections 12.7 and 18.4 and subsection 113(5). These provisions implement the recommendations in, and are intended to be generally consistent with, the BEPS Action 2 Report. This is a key part of the context and purpose in light of which the text of the hybrid mismatch rules is to be interpreted.

This subsection is amended to add a reference to the additional report published by the OECD in 2017, titled *Neutralising the Effects of Branch Mismatch Arrangements, Action 2: Inclusive Framework on BEPS*.

These amendments apply in respect of payments arising on or after July 1, 2026.

Primary rule — conditions for application

ITA
18.4(3)

Subsection 18.4(3) is amended to remove the cross-reference to subsection 18(4). This amendment, along with the corresponding changes to subsections 18(4) and 18.4(6), (14) and (15), ensures that the thin capitalization rules in the Act apply in priority to the hybrid mismatch rules. For more information, see the commentary on subsection 18(4).

This subsection is also amended in line with the amendments to the definition “hybrid mismatch amount” in subsection 18.4(1). For more information, see the commentary on that definition.

These amendments apply in respect of payments arising on or after July 1, 2026, except that the amendment to remove the cross-reference to subsection 18(4) applies in respect of payments arising on or after Announcement Date.

Primary rule — consequences

ITA
18.4(4)

Subsection 18.4(4) is amended in line with the amendments to the definition “hybrid mismatch amount” in subsection 18.4(1). For more information, see the commentary on that definition.

These amendments apply in respect of payments arising on or after July 1, 2026.

Structured arrangements — exception

ITA
18.4(5)

Subsection 18.4(5) is amended consequential on the expansion of the hybrid mismatch rules, and in line with the amendments to the definitions of “structured arrangement” and “foreign structured arrangement”, to apply in respect of hybrid mismatch amounts, investor hybrid payer mismatch amounts and the amounts of imported hybrid mismatches (instead of deduction/non-inclusion mismatches). The test in paragraph (b) is not met if it is reasonable to expect that, at the relevant time, any of the listed entities were aware that there would be a hybrid mismatch amount, investor hybrid payer mismatch amount or amount of an imported hybrid mismatch, and there is no need for that entity to have been aware of the exact (or even approximate) quantum of the mismatch amount. For more information, see the commentary on the “structured arrangement” and “foreign structured arrangement” definitions.

These amendments apply in respect of payments arising on or after July 1, 2026.

Deduction/non-inclusion mismatch — conditions

ITA
18.4(6)

Subsection 18.4(6) sets out the conditions for determining if a payment gives rise to a deduction/non-inclusion mismatch. Very generally, a payment gives rise to a deduction/non-inclusion mismatch if the total of the amounts deductible in respect of the payment for Canadian income tax purposes exceeds the total of the amounts included in respect of the payment in taxable income for foreign income tax purposes (more specifically, the total amount of “foreign ordinary income” in respect of the payment), or if the total of the amounts deductible for foreign income tax purposes exceeds the total of the amounts included for Canadian income tax purposes (more specifically, the total amount of “Canadian ordinary income” in respect of the payment).

The amendments to this subsection, along with amendments to subsections 12.7(3), 18.4(3), (4), (11), (13) and (15) and the definition “hybrid mismatch amount” in subsection 18.4(1), reflect that the hybrid mismatch rules are intended to apply on a year-by-year basis. In general, these amendments are clarifying in nature.

Paragraph (a) is amended to clarify that a payment gives rise to a deduction/non-inclusion mismatch if the total of the amounts deductible, in respect of the payment, for Canadian income tax purposes for any taxation year exceeds the total of the inclusions, in respect of those deductible amounts for the taxation year, in the foreign ordinary income for foreign taxation years — or in the Canadian ordinary income for taxation years — that begin on or before the day that is 12 months after the end of the taxation year. For example, assume the total of the deductible amounts in respect of a payment is $100, with $70 being deductible for the first taxation year and $10 being deductible in each of years 2, 3 and 4. The amendments to paragraph (a) clarify that, in determining whether the payment gives rise to a deduction/non-inclusion mismatch, it is necessary to determine what amounts in respect of the $70 deductible for year 1 are included in foreign ordinary income for a foreign taxation year, or Canadian ordinary income for a taxation year, that begins on or before the day that is 12 months after the end of year 1. The same determination would be necessary for each of the $10 amounts deductible for years 2 to 4. If, for example, all $100 in respect of the payment were included in foreign ordinary income of a recipient of the payment in year 4 (i.e., where the foreign taxation years and the taxation years are the same 12-month periods, a foreign taxation year that begins more than 12 months after the end of years 1 and 2 but not more than 12 months after the end of year 3 or 4), the total amount of relevant inclusions would be $20. Thus, there would be a deduction/non-inclusion mismatch.

Similar clarifying amendments are made to paragraph (b).

In effect, where a payment is deductible over multiple years (each referred to as a “deduction year”), variables A and C will include deductible amounts for each deduction year. Each of variable B and D is then applied on an iterative basis, once for each deduction year, and includes only those Canadian ordinary income or foreign ordinary income amounts that are included (in respect of the deductible amount) for foreign taxation years or taxation years, respectively, that begin no more than 12 months after the end of the deduction year. For more information on this year-by-year determination, see the commentary on subsection 18.4(11).

In addition, the cross-reference to subsection 18(4) in variable A of the formula in paragraph (a) is removed. This amendment, along with the corresponding changes to subsections 18(4) and 18.4(3), (14) and (15), ensures that the thin capitalization rules in the Act apply in priority to the hybrid mismatch rules. For more information, see the commentary on subsection 18(4).

These amendments apply in respect of payments arising on or after July 1, 2026, except that the amendment to remove the cross-reference to subsection 18(4) applies in respect of payments arising on or after Announcement Date.

Special rule — purchase price of property

ITA
18.4(6.1)

New subsection 18.4(6.1) provides an exception for the purpose of determining whether a payment arises under a reverse hybrid arrangement or disregarded payment arrangement. In determining whether there is a deduction/non-inclusion mismatch under subsection 18.4(6) in respect of a payment that is for the purchase price of a property, variables A and C of the formula in subsection 18.4(6) exclude any amount deductible as an allowance in respect of depreciation, obsolescence or depletion. This accords with paragraph 121 of Chapter 3 and paragraph 145 of Chapter 4 of the BEPS Action 2 Report.

Subsection 18.4(6.1) applies in respect of payments arising on or after July 1, 2026.

Double deduction mismatch — condition

ITA
18.4(7.1)

New subsection 18.4(7.1) sets out the conditions for determining if a payment gives rise to a double deduction mismatch. A double deduction mismatch is a necessary condition for the existence of a hybrid payer arrangement under new subsection 18.4(15.5).

Essentially, a payment gives rise to a double deduction mismatch if an amount is deductible, in respect of the payment, for Canadian income tax purposes and an amount is deductible, in respect of the payment, for foreign income tax purposes. There is no requirement that:

- the amounts be deductible by the same entity;
- the deductible amounts be equal to each other, or within a certain range of each other; or
- a foreign deduction occur within a certain period of time from when a Canadian deduction occurs.

Where a hybrid payer that is a hybrid entity that is not resident in Canada claims a deduction in respect of a payment in the country where it is resident, the payment could give rise to a double deduction mismatch if the hybrid entity is viewed as a partnership for Canadian purposes. In that case, the same amount may be deductible by the hybrid entity in computing its income from a business or property under the Act, and the partnership income would then be allocated to a Canadian resident partner that is an "investor" (as defined in subsection 18.4(1)) in the hybrid entity.

In general, the test for a double deduction mismatch is based on amounts that are actually deductible. This means that if another domestic or foreign rule, such as an interest restriction rule or a hybrid mismatch rule, applies to restrict a deduction, that deduction is not taken into account in applying the condition in paragraph (a) or (b). There is, however, one exception to this general rule, which is that both the Canadian deductibility and the foreign deductibility are tested without regard to the application of any hybrid mismatch rules that neutralize mismatches arising from hybrid payer arrangements. In paragraph (a), the test is whether an amount would be deductible, in respect of the payment, in computing an entity's income from business or property under Part I of the Act, in the absence of paragraph (f) of the definition "hybrid mismatch arrangement" (which relates to hybrid payer arrangements). In paragraph (b), the test is whether an amount would be (or would reasonably be expected to be) deductible, in respect of the payment, in computing an entity's relevant foreign income or profits in the absence of any foreign hybrid payer mismatch rule (as newly defined in subsection 18.4(1)). This exception for where deductions are denied under rules applicable to hybrid payer arrangements is necessary both to avoid circularity and to preserve the appropriate rule ordering as set out in Chapters 6 and 7 of the BEPS Action 2 Report, particularly in the case of a hybrid payer that is a dual resident, where both residence countries are expected to deny the deduction in their respective countries.

Finally, in keeping with the broad application of this provision, there is no rule applicable, in the determination of double deduction mismatches, equivalent to new subsection 18.4(6.1), which excludes deductions in respect of depreciation, obsolescence or depletion in the determination of a deduction/non-inclusion mismatch for purposes of the rules relating to reverse hybrid arrangements and disregarded payment arrangements. Consequently, amounts deductible in respect of depreciation (e.g., capital cost allowance) could give rise to a double deduction mismatch under this subsection.

New subsection 18.4(7.1) applies in respect of payments arising on or after July 1, 2026.

Double deduction mismatch — application

ITA
18.4(7.2)

New subsection 18.4(7.2) is analogous to subsection 18.4(7), but applies in the context of a double deduction mismatch rather than a deduction/non-inclusion mismatch. It acts as a "bridge" to determine the amount of a double deduction mismatch and then connect that double deduction mismatch to the hybrid payer arrangement determined under new subsection 18.4(15.5) and to the operative rule in subsection 18.4(4).

First, subparagraph (a)(i) totals all the amounts determined under paragraph 18.4(7.1)(a) in respect of a payment (essentially, the Canadian deductions in respect of the payment), and then subparagraph (a)(ii) totals all the amounts determined under paragraph 18.4(7.1)(b) in respect of the payment (essentially, the foreign deductions in respect of the payment). Paragraph (a) labels the lesser of these two total amounts as the "deduction component" of the double deduction mismatch. Because paragraph (a) aggregates all the amounts determined under paragraph 18.4(7.1)(a), and separately all the amounts determined under (b), in respect of the payment, the deduction component of the double deduction mismatch may in some cases reflect deductions over multiple taxation years. This deduction component will, if the necessary conditions are met, be the deduction component of a hybrid payer mismatch by virtue of paragraph 18.4(15.6)(b), allowing the condition in paragraph 18.4(3)(b) to be met and for subsection 18.4(4) to restrict all or a portion of the deduction.

Paragraph (b) provides that the amount of the double deduction arising from the payment is equal to the deduction component determined under paragraph (a). This is the amount that is the starting point in determining the amount of a hybrid payer mismatch in respect of the payment under new subsection 18.4(15.6) or, in certain cases, the investor hybrid mismatch amount in respect of the payment under new subsection 18.4(15.7).

For more information, see the commentary on subsections 18.4(3) and (4) and (15.5) to (15.7).

Subsection 18.4(7.2) applies in respect of payments arising on or after July 1, 2026.

Double deduction mismatch — valuation differences

ITA
18.4(7.3)

New subsection 18.4(7.3) requires that certain valuation differences be disregarded in determining the deduction component of a double deduction mismatch (and, consequently, the amount of that double deduction mismatch) under subsection 18.4(7.2). More specifically, this subsection requires a determination of whether the aggregate foreign deductions amount in respect of a payment (i.e., the amount determined under subparagraph 18.4(7.2)(a)(ii)) is less than the aggregate Canadian deductions amount in respect of the payment (i.e., the amount determined under subparagraph 18.4(7.2)(a)(i)) and, if so, whether this is in whole or in part because of a difference in valuation (e.g., a difference in the way that the payment is measured under the laws of the respective countries that results in a lower aggregate amount of foreign deductions). If this is the case, the valuation used in determining the amount of the Canadian deductions is used in determining the amount under subparagraph 18.4(7.2)(a)(ii), in effect ensuring that a lower valuation in the foreign country does not result in a lower double deduction mismatch amount.

Subsection 18.4(7.3) applies in respect of payments arising on or after July 1, 2026.

No double counting

ITA
18.4(8)

Subsection 18.4(8) is a rule against double counting, which applies where an amount has already been included in computing foreign ordinary income or Canadian ordinary income of an entity in respect of a payment. This subsection is reorganized and amended to incorporate rules against double counting in computing an entity's dual inclusion income or investor dual inclusion income. The terms "dual inclusion income" and "investor dual inclusion income" are defined in subsection 18.4(1).

The existing rule against double counting of foreign ordinary income or Canadian ordinary income is now contained in paragraph (a).

New paragraph (b) ensures that an amount of ordinary income that has already been included in computing dual inclusion income or investor dual inclusion income of an entity cannot be included in computing dual inclusion income or investor dual inclusion income of any other entity. Put differently, this rule clarifies that the same amount cannot be taken into consideration in computing more than one entity's dual inclusion income or investor dual inclusion income.

New paragraph (c) provides that an amount of ordinary income that is included in computing the dual inclusion income of an entity, and has been used to reduce a hybrid mismatch amount or investor hybrid mismatch amount, or to enable a deduction under paragraph 20(1)(zz) or (aaa), cannot also be included in computing the investor dual inclusion income of that entity (and *vice versa*). This double counting could otherwise arise where, for example, an investor ("Canco") in a hybrid entity is itself a hybrid entity. In that case, the lower-tier hybrid entity's ordinary income would be included in Canco's investor dual inclusion income, in respect of the lower-tier hybrid entity, and also in Canco's dual inclusion income. If, for example, the lower-tier entity and Canco were both payers of payments arising under hybrid payer arrangements, Canco may have both a hybrid mismatch amount (i.e., the amount of the hybrid payer arrangement under which its payment arises) and an investor hybrid payer mismatch amount (in respect of the lower-tier hybrid entity's payment). In that case, paragraph (c) ensures that that amount of ordinary income may be used to reduce either – but not both – of those mismatch amounts, by being included either in Canco's dual inclusion income or in its investor dual inclusion income in respect of the lower-tier hybrid entity.

These amendments apply in respect of payments arising on or after July 1, 2026.

Hybrid financial instrument arrangement — amount

ITA
18.4(11)

Subsection 18.4(11) is relevant in determining the extent to which the operative hybrid mismatch rules restrict a deduction under subsection 18.4(4), or include an amount in income under 12.7(3), in respect of a payment arising under a hybrid financial instrument arrangement.

This subsection is amended in line with the amendments to the definition "hybrid mismatch amount" in subsection 18.4(1) and to subsections 12.7(3), 18.4(3), (4), (11), (13) and (15), to ensure that the hybrid mismatch rules apply, in a particular taxation year, to a hybrid mismatch amount for that year. In general, these amendments are clarifying in nature.

Specifically, paragraph (a) is amended to provide that the amount of the hybrid financial instrument mismatch for a taxation year, in respect of a payment, is the portion of the deduction/non-inclusion mismatch amount, in respect of a payment, that can reasonably be considered to be attributable to the taxation year (and that meets the condition in paragraph 18.4(10)(d)). In many cases, the Canadian tax deductions in respect of the payment (which are included under variable A of subsection 18.4(6)) will be for a single taxation year. However, these amendments are made in recognition that a payment may instead be deductible over multiple taxation years (e.g., over five years under paragraph 20(1)(e)) and, in such cases, require taxpayers to consider the relevant Canadian tax deductions in respect of the payment on a year-by-year basis and determine the portion of the Canadian tax deductions for each taxation year that do not give rise to corresponding inclusions within the period specified in subsection 18.4(6).

In the case of a deduction/non-inclusion mismatch resulting from amounts deductible in computing taxable income for foreign income tax purposes (i.e., where paragraph 18.4(6)(b) applies), new subparagraph (a)(ii) requires a determination of the portion of the mismatch that can reasonably be considered to be attributable to a taxation year of a taxpayer that is a recipient of the payment (and that satisfies the conditions in paragraph 18.4(10)(d)). The taxation year to which the mismatch is attributable would generally be the last taxation year of the taxpayer that begins at or before the end of the foreign taxation year in which an amount in respect of the payment is (or would reasonably be expected to be) deductible in computing relevant foreign income or profits.

These amendments apply in respect of payments arising on or after July 1, 2026.

Hybrid transfer arrangement — amount

ITA
18.4(13)

This definition is amended similarly to subsection 18.4(11), which is applicable for hybrid financial instrument arrangements. For more information, see the commentary on that subsection.

These amendments apply in respect of payments arising on or after July 1, 2026.

Substitute payment arrangement — conditions

ITA
18.4(14)

Subparagraph 18.4(14)(f)(ii) is amended to remove the cross-reference to subsection 18(4). This amendment ensures the thin capitalization rules in the Act apply in priority to the hybrid mismatch rules. For more information, see the commentary on subsection 18(4).

This amendment applies in respect of payments arising on or after Announcement Date.

Substitute payment arrangement — amount

ITA
18.4(15)

This definition is amended similarly to subsection 18.4(11), which is applicable for hybrid financial instrument arrangements. For more information, see the commentary on that subsection.

In addition, paragraph 18.4(15)(d) is amended to remove the cross-reference to subsection 18(4). This amendment ensures that the thin capitalization rules in the Act apply in priority to the hybrid mismatch rules. For more information, see the commentary on subsection 18(4).

These amendments apply in respect of payments arising on or after July 1, 2026, except that the amendment to remove the cross-reference to subsection 18(4) applies in respect of payments arising on or after Announcement Date.

Reverse hybrid arrangement — conditions

ITA
18.4(15.1)

New subsection 18.4(15.1) sets out the conditions to determine if a payment arises under a reverse hybrid arrangement. Along with subsection 18.4(15.2), this subsection is intended to implement the recommendations in Chapter 4 of the BEPS Action 2 Report.

A reverse hybrid arrangement is essentially one where differences in the income tax treatment, under the laws of different countries, of payments to a reverse hybrid entity (as defined in subsection 18.4(1)) give rise to a deduction/non-inclusion mismatch (as determined under subsection 18.4(6)) that would not have arisen in the hypothetical scenario where each entity that held a direct equity interest in the reverse hybrid entity at the time of the actual payment instead received a payment equal to the amount that can reasonably be considered to be the entity's share of the actual payment. However, there is also a reverse hybrid arrangement if a deduction/non-inclusion mismatch would have arisen in the hypothetical scenario and would have been the amount of a hybrid financial instrument mismatch, hybrid transfer mismatch or substitute payment mismatch, in respect of the hypothetical payment, for which a deduction would be denied under subsection 18.4(4). This ensures that the hybrid mismatch rules applicable to those types of arrangements cannot be circumvented by interposing a reverse hybrid entity.

Where all the conditions in subsection 18.4(15.1) are met, such that a payment is considered to arise under a reverse hybrid arrangement (and thus under a "hybrid mismatch arrangement", as defined in subsection 18.4(1)), the mismatch is neutralized under the primary operative hybrid mismatch rule. More specifically, if the payment is otherwise deductible for Canadian income tax purposes, subsection 18.4(4) restricts all or a portion of the deduction.

A payment is considered to arise under a reverse hybrid arrangement if four conditions are met.

The first condition, in paragraph 18.4(15.1)(a), requires that the payment is to a reverse hybrid entity. For more information, see the commentary on the definitions "payment" and "reverse hybrid entity" in subsection 18.4(1).

The second condition, in paragraph 18.4(15.1)(b), requires that the test in either subparagraph (b)(i) or (ii) be met. Subparagraph (b)(i) requires that the following entities not deal at arm's length with one another:

- the payer of the payment;
- the recipient reverse hybrid entity; and
- any entity that holds a direct or indirect equity interest in the reverse hybrid entity and is described in paragraph (c) of the "reverse hybrid entity" definition.

In other words, there must be an equity-holder in respect of the reverse hybrid entity that is resident in a country that views the reverse hybrid entity as fiscally opaque in respect of the payment, and that equity-holder must not deal at arm's length with either the reverse hybrid entity or the payer of the payment (and the reverse hybrid entity and the payer must likewise not deal at arm's length with each other). Alternatively, subparagraph (b)(ii) requires that the payment arises under a structured arrangement. The term "structured arrangement" is defined in subsection 18.4(1).

The third condition, in paragraph 18.4(15.1)(c), requires that the payment give rise to a deduction/non-inclusion mismatch. For more information, see the commentary on subsection 18.4(6), which sets out the conditions for such a mismatch.

The final condition, in paragraph 18.4(15.1)(d), tests whether the mismatch is due to "hybridity". Under this test, a mismatch is generally considered hybrid if the deduction/non-inclusion mismatch (as determined under subsection 18.4(6)) would not have arisen in the hypothetical scenario.

In line with the recommendations under Chapter 4 of the BEPS Action 2 Report, this final condition ensures that a reverse hybrid arrangement arises only where the interposition of the reverse hybrid entity brought about the mismatch in tax outcomes (i.e., the deduction/non-inclusion mismatch) or the reverse hybrid entity was being used to circumvent the operation of the hybrid financial instrument arrangement rule, the hybrid transfer arrangement rule or the substitute payment arrangement rule.

The "hybridity" condition for a reverse hybrid arrangement is met when the amount determined for variable A in the formula in paragraph (d) is greater than the amount determined for variable B, where:

- Variable A is equal to the deduction/non-inclusion mismatch (as determined under subsection 18.4(6)) arising from the payment; and
- Variable B is equal to the deduction/non-inclusion mismatch that would have arisen in the hypothetical scenario.

Subsection 18.4(15.1) applies in respect of payments arising on or after July 1, 2026.

Reverse hybrid arrangement — amount

ITA
18.4(15.2)

New subsection 18.4(15.2) is relevant in determining the extent to which the operative hybrid mismatch rules restrict a deduction in respect of a payment arising under a reverse hybrid arrangement.

Paragraph 18.4(15.2)(a) determines the amount by which a deduction is restricted under subsection 18.4(4) in the case of a payment arising under a reverse hybrid arrangement. It ensures that this result applies only to the extent that a deduction/non-inclusion mismatch would not have arisen in the hypothetical scenario (set out in variable B in the formula in paragraph 18.4(15.1)(d)) where each entity that held a direct equity interest in the reverse hybrid entity at the time of the actual payment received a payment equal to the amount that can reasonably be considered to be the entity's share of the actual payment (or such a mismatch would have arisen and would have been the amount of a hybrid financial instrument mismatch, hybrid transfer mismatch or substitute payment mismatch, in respect of the hypothetical payment, for which a deduction would be denied under subsection 18.4(4)).

The starting point is the amount of the deduction/non-inclusion mismatch that arises from the payment, as determined for variable A in the formula in paragraph 18.4(15.1)(d). Under paragraph 18.4(7)(c), this mismatch is essentially the amount by which the amounts deductible in respect of the payment for Canadian or foreign income tax purposes exceed the sum of the "Canadian ordinary income" and "foreign ordinary income" in respect of the payment (as defined in subsection 18.4(1)). For more information, see the commentary on subsection 18.4(7).

It is then necessary to determine the portion of the deduction/non-inclusion mismatch amount that would not have arisen in the hypothetical scenario described above. That portion of the mismatch amount is the difference between the amount determined for variable A in the formula in paragraph 18.4(15.1)(d) and the amount determined for variable B in that formula, with the latter amount being the deduction/non-inclusion mismatch that would have arisen in the hypothetical scenario. Once that portion of the mismatch amount is determined, it is necessary to then determine to what extent that portion can reasonably be considered to be attributable to the taxation year. In many cases, the Canadian tax deductions in respect of the payment (as determined under variable A of subsection 18.4(6)) will be for one single taxation year. However, in recognition that a payment may be deductible over multiple taxation years (e.g., over five years under paragraph 20(1)(e)), it is necessary to determine the extent to which the Canadian tax deductions for each taxation year are not matched with inclusions.

The portion of the amount of the deduction/non-inclusion mismatch that is described in paragraph 18.4(15.2)(a) is referred to as the "amount of the reverse hybrid mismatch" for the taxation year and, as a “hybrid mismatch amount” for the year (as defined in subsection 18.4(1)), it is the amount of the deduction that is restricted under 18.4(4) for the year.

If none of the deduction/non-inclusion mismatch would arise in the hypothetical scenario described above, or if any such mismatch that would arise in the hypothetical scenario would be the amount of a hybrid financial instrument mismatch, hybrid transfer mismatch or substitute payment mismatch for which a deduction would be denied under subsection 18.4(4), the entire amount of the deduction/non-inclusion mismatch that is attributable to the taxation year is the amount of the reverse hybrid mismatch.

Paragraph 18.4(15.2)(b) links subsection 18.4(15.1) with the operative rule in subsection 18.4(4), ensuring that the operative rule applies to restrict the amount deductible under Part I of the Act in respect of a payment arising under a reverse hybrid arrangement. This is achieved by labelling the amount that would otherwise be deductible under Part I in respect of the payment – which amount is referred to in paragraph 18.4(7)(a) as the “deduction component” of the deduction/non-inclusion mismatch – as the “deduction component of the reverse hybrid arrangement”. This allows the conditions for the application of subsection 18.4(4) to be satisfied, since that provision applies in respect of the deduction component of a “hybrid mismatch arrangement” (which is defined in subsection 18.4(1) to include a reverse hybrid arrangement).

Subsection 18.4(15.2) applies in respect of payments arising on or after July 1, 2026.

Disregarded payment arrangement — conditions

ITA
18.4(15.3)

New subsection 18.4(15.3) sets out the conditions for determining if a payment arises under a disregarded payment arrangement. Along with subsection 18.4(15.4), this subsection is intended to implement the recommendations in Chapter 3 of the BEPS Action 2 Report.

In general terms, a payment arises under a disregarded payment arrangement where the payer of the payment is a hybrid entity that does not deal at arm’s length with the recipient (or the payment is made as part of a structured arrangement) and the payment gives rise to a deduction/non-inclusion mismatch by virtue of being disregarded under the income tax laws of the recipient country. In other words, for there to be a disregarded payment arrangement, a “hybridity condition” must be met, which requires that the country where the hybrid entity is resident considers a deductible payment to have been made for income tax purposes, but the country where the recipient is resident does not consider the recipient to have received a payment, and this gives rise to the mismatch. The term “hybrid entity” is defined in subsection 18.4(1).

The hybridity condition incorporates a similar counterfactual test to that used in the context of the hybrid financial instrument arrangement rule, which in effect ensures that a payment is considered to have arisen under a disregarded payment arrangement if the payment being disregarded in the recipient country is sufficient to cause the deduction/non-inclusion mismatch. Thus, if the disregarding of the payment would be enough to cause the mismatch even if all other causes of the mismatch (e.g., the tax-exempt status of the recipient or an exemption applicable to a category of income) were absent, then the hybridity condition is met. This counterfactual test is set out in subparagraph (d)(ii).

The phrase "in whole or in part", used in subparagraph (d)(i), contemplates that, in some cases, one portion of the deduction/non-inclusion mismatch may satisfy the hybridity condition and another portion may not. The rules are intended to neutralize the mismatch only to the extent the mismatch satisfies the hybridity condition.

If all the conditions in subsection 18.4(15.3) are satisfied, the mismatch will be neutralized by either the denial of a deduction (under subsection 18.4(4)) or the inclusion of an amount in income (under subsection 12.7(3)), depending on which of the payer (i.e., the hybrid entity) or recipient is a Canadian resident. The maximum amount of the deduction that may be denied or the income that may be included to neutralize the mismatch is determined under paragraph 18.4(15.4)(a).

Subsection 18.4(15.3) applies in respect of payments arising on or after July 1, 2026.

Disregarded payment arrangement — amount

ITA
18.4(15.4)

New subsection 18.4(15.4) is relevant in determining the amount required to be included in income, or the amount of the deduction required to be denied, in respect of a payment arising under a disregarded payment arrangement.

Paragraph 18.4(15.4)(a) determines the amount included in income under subsection 12.7(3), or the maximum amount by which a deduction may be denied under subsection 18.4(4), for a taxation year in the case of a payment arising under a disregarded payment arrangement. In general terms, it ensures that these results apply only to the extent that the deduction/non-inclusion mismatch arising from the payment is "hybrid" in nature, attributable to the taxation year, not already neutralized under another of the hybrid mismatch rules and not offset by an amount of dual inclusion income or investor dual inclusion income.

The starting point is to determine the amount of the deduction/non-inclusion mismatch that arises from the payment (under paragraph 18.4(7)(c)). This mismatch is essentially the amount by which the amounts deductible in respect of the payment for Canadian or foreign income tax purposes exceed the sum of any "Canadian ordinary income" and "foreign ordinary income" in respect of the payment (as defined in subsection 18.4(1)).

Second, it is necessary to apply a causal test, by determining the extent to which the deduction/non-inclusion mismatch arises because the payment is disregarded under the laws of the recipient country (or would arise because the payment is disregarded if all other reasons for the mismatch were absent). The portion of the mismatch amount that both satisfies this causal test and can reasonably be considered to be attributable to a given taxation year is the amount determined for variable A for that year. For these purposes, a portion of the mismatch can reasonably be considered to be attributable to a given taxation year if the underlying deductions giving rise to the mismatch would otherwise have been taken in the year or, in the case of foreign deductions, the foreign taxation year most closely associated with the year.

Next, variable B is the portion of the amount determined for variable A that is also included in a hybrid mismatch amount determined under another of the hybrid mismatch rules (and neutralized, either by a deduction denial under subsection 18.4(4) or an income inclusion under subsection 12.7(3)). The purpose of variable B is to prevent a double neutralization of the same mismatch, by giving priority to another hybrid mismatch rule (e.g., the hybrid financial instrument mismatch rule) in situations where such a rule applies to a deduction/non-inclusion mismatch that is also subject to the disregarded payment arrangement rule.

Finally, subtracting the amount determined for variable C allows any available dual inclusion income or investor dual inclusion income, as applicable, to be offset against the mismatch amount that remains after the amount determined for variable A is reduced by the amount determined for variable B. Since dual inclusion income (and investor dual inclusion income) represents amounts included in taxable income in at least two countries, where a deduction is taken against such income in one country, it is assumed that the income is still subject to income tax in at least one other country, effectively negating the tax benefit the deduction/non-inclusion mismatch would otherwise achieve. Based on this assumption, there is no need to counteract the mismatch except to the extent that the mismatch amount exceeds the available dual inclusion income (or investor dual inclusion income).

If there is a deduction component in respect of the deduction/non-inclusion mismatch (i.e., if amounts are otherwise deductible in Canada in respect of the payment), it is dual inclusion income (defined in subsection 18.4(1)) that is relevant. Dual inclusion income generally comprises amounts that are ordinary income of the hybrid entity (i.e., the payer of the payment) in respect of Canada and ordinary income of an investor in the payer in respect of another country. The amount of dual inclusion income included under variable C is any dual inclusion income of the hybrid entity for the taxation year and any preceding taxation years that has not been used to offset a hybrid mismatch amount (i.e., the amount of a disregarded payment mismatch or hybrid payer mismatch) for a preceding year or the amount of another disregarded payment mismatch in the year, thus ensuring there is no double use of dual inclusion income to shelter mismatches. The effect of reducing available dual inclusion income by amounts already used in respect of other disregarded payment mismatch amounts in the taxation year is to create an implicit ordering rule, whereby the dual inclusion income is allocated between multiple disregarded payment mismatches arising in a given year (with the choice as to which particular mismatches the dual inclusion income is allocated to being at the taxpayer's discretion).

If there is a foreign deduction component in respect of the deduction/non-inclusion mismatch (i.e., if the deductions in respect of the payment are for foreign tax purposes), it is investor dual inclusion income (defined in subsection 18.4(1)) that is relevant. Investor dual inclusion income generally comprises amounts that are ordinary income of the hybrid entity (i.e., the payer) in respect of a foreign country and ordinary income of an investor in the payer in respect of Canada. The amount of available investor dual inclusion income is determined in much the same way as for dual inclusion income, with the main difference between dual inclusion income and investor dual inclusion income being that the latter does not reduce the amount of hybrid payer mismatches (but, instead, reduces investor hybrid payer mismatch amounts). Both dual inclusion income and investor dual inclusion income may reduce disregarded payment mismatches.

The amount, if any, determined under the formula in paragraph 18.4(15.4)(a) for a taxation year is a "hybrid mismatch amount" for the year (as defined in subsection 18.4(1)), which is the amount of the income inclusion under subsection 12.7(3), or the maximum deduction denial under subsection 18.4(4), for the year.

Paragraph 18.4(15.4)(b) links subsection 18.4(15.3) with the operative rule in subsection 18.4(4), ensuring that the operative rule will apply to restrict the amount deductible under Part I of the Act in respect of a payment arising under a disregarded payment arrangement. This is achieved by labelling the amount that would otherwise be deductible under Part I in respect of the payment – which amount is referred to in paragraph 18.4(7)(a) as the "deduction component" of the deduction/non-inclusion mismatch – as the "deduction component of the disregarded payment arrangement". This allows the conditions for the application of subsection 18.4(4) to be met, since that provision applies in respect of the deduction component of a "hybrid mismatch arrangement" (which is defined in subsection 18.4(1) to include a disregarded payment arrangement).

Paragraph 18.4(15.4)(c) similarly links subsection 18.4(15.3) with the operative rule in subsection 12.7(3).

Subsection 18.4(15.4) applies in respect of payments arising on or after July 1, 2026.

Hybrid payer arrangement — conditions

ITA
18.4(15.5)

New subsection 18.4(15.5) sets out the four conditions that must be met for a payment to arise under a hybrid payer arrangement.

The first and fourth conditions, in paragraphs (a) and (d), are similar to the conditions for other hybrid mismatch arrangements under this section: a payer of the payment must be a hybrid payer, and the payment must give rise to a double deduction mismatch. Beyond this, the determination of the existence of a hybrid payer arrangement differs from the determination of other hybrid mismatch arrangements in certain important ways, in addition to the obvious difference that a hybrid payer arrangement is the only hybrid mismatch arrangement concerned with double deduction mismatches, rather than deduction/non-inclusion mismatches.

First, paragraphs 18.4(15.5)(b) and (c) contain explicit ordering rules for determining when Canada's hybrid payer arrangement rules apply in priority to (or, in some cases, concurrently with) another country's equivalent provisions. These ordering rules reflect recommendations in Chapters 6 and 7 of the BEPS Action 2 Report and are referred to as "primary" and "defensive" rules in Chapter 6 of that report. The ordering rules are applicable to hybrid payer mismatches involving payments by hybrid entities or multinational entities and clarify that the "parent" or "residence" country should apply its hybrid mismatch rules first, with the "subsidiary" or "permanent establishment" country applying the defensive rule only if the first country fails to apply its primary rule.

For a hybrid payer arrangement involving a payment by a hybrid entity, this means that the country in which an investor in the hybrid entity is resident should neutralize the double deduction mismatch and, if that country fails to do so, the country in which the hybrid entity is resident should apply its defensive rule to neutralize the mismatch. For a hybrid payer arrangement involving a payment by a multinational entity, the country in which the entity is resident should neutralize the mismatch and, if that country fails to do so, the country in which the multinational entity carries on business through a permanent establishment should apply its defensive rule to neutralize the mismatch. Subparagraph (b)(ii) and paragraph (c) implement these ordering rules by conditioning the existence of a hybrid payer arrangement, in situations where Canada is the subsidiary or permanent establishment country, on the failure of the other country (or countries, where there are multiple investors) to fully neutralize the double deduction mismatch by applying a foreign hybrid payer mismatch rule (as defined in subsection 18.4(1)) in respect of the payment. Importantly, these ordering rules only apply to hybrid payers that are hybrid entities or multinational entities. For hybrid payers that are dual residents, the application of a foreign hybrid payer mismatch rule does not "turn off" the application of the Canadian rule, reflecting the recommendation in Chapter 7 of the BEPS Action 2 Report that in such cases, both affected countries should apply their respective hybrid payer mismatch rules.

Subparagraph (b)(i) further contains a relationship test, applicable only to hybrid payers that are hybrid entities resident in Canada (i.e., where the Canadian defensive rule applies). Similar to the rules for other hybrid mismatch arrangements, in this limited situation, the hybrid payer arrangement rule will only apply where the hybrid entity does not deal at arm's length with an investor in the hybrid entity or the payment arises under, or in connection with, a structured arrangement. For all other situations under the hybrid payer arrangement rule, no such relationship test is required to be met in order for a hybrid payer arrangement to exist.

Finally, unlike the other hybrid mismatch arrangements targeted under this section, the conditions for a hybrid payer arrangement do not include a causal test that looks at why the hybrid payer arrangement arises, or that limits the amount of the hybrid payer mismatch to the portion that can be considered to be caused by hybridity. The application of the hybrid mismatch rules to a hybrid payer arrangement is, however, limited by reducing the amount of the hybrid payer mismatch, or the investor hybrid payer amount, by any applicable dual inclusion income or investor dual inclusion income, as the case may be. For more information, see the commentary on new subsections 18.4(15.6) and (15.7), and to the definitions “dual inclusion income” and “investor dual inclusion income” in subsection 18.4(1).

Where all the conditions in subsection 18.4(15.5) are met, such that a payment is considered to arise under a hybrid payer arrangement (and thus under a “hybrid mismatch arrangement”, as defined in subsection 18.4(1)), the amount of the mismatch is neutralized under the operative hybrid mismatch rules by way of either a denial of a deduction under subsection 18.4(4) for the amount of the hybrid payer mismatch (determined under new subsection 18.4(15.6)), or an income inclusion under new subsection 12.7(4). Such an income inclusion occurs where the hybrid payer is a hybrid entity that is not resident in Canada and an investor in that entity is a taxpayer under the Act. In that case, the income inclusion is to the Canadian investor, in an amount equal to the investor hybrid payer mismatch amount (determined under new subsection 18.4(15.7)). For more information, see the commentary on subsections 18.4(15.6) and (15.7), and 12.7(4).

Subsection 18.4(15.5) applies in respect of payments arising on or after July 1, 2026.

Hybrid payer arrangement — amount

ITA
18.4(15.6)

New subsection 18.4(15.6) is relevant in determining the extent to which the operative hybrid mismatch rule in subsection 18.4(4) restricts a deduction for a taxation year in respect of a payment arising under a hybrid payer arrangement.

Analogously to the other hybrid mismatch arrangements described in this section, paragraph 18.4(15.6)(a) determines the amount of a hybrid payer mismatch for a taxation year, in respect of a payment arising under a hybrid payer arrangement. This is the amount by which a deduction may be restricted under subsection 18.4(4) in respect of the payment.

Unlike under the other hybrid mismatch arrangements addressed in this section, it is possible that a payment may arise under a hybrid payer arrangement under subsection 18.4(15.5) but no hybrid mismatch amount (as defined in subsection 18.4(1)) is determined in respect of the payment because an investor hybrid mismatch amount in respect of the payment is instead determined under new subsection 18.4(15.7). This possibility is reflected in subparagraph 18.4(15.6)(a)(i), which determines a nil amount for the hybrid payer mismatch in respect of the payment in that case, in order to cede the ground to the application of the investor hybrid payer mismatch amount.

Subparagraph 18.4(15.6)(a)(i) results in a nil determination for the amount of a hybrid payer mismatch in respect of a payment if the hybrid payer is a hybrid entity that is not resident in Canada, in which case the hybrid entity must be viewed in Canada as a fiscally transparent entity (i.e., a partnership) if it meets the definition “hybrid entity” in subsection 18.4(1). In that case, Canada, as the country in which an investor in the hybrid entity is resident (or is otherwise a taxpayer under the Act), has the primary right to neutralize the mismatch and will do so by means of an income inclusion to the investor in the amount determined under new subsection 18.4(15.7). This allows for a more targeted application of the primary rule that considers the investor's specific tax attributes – in particular, investor dual inclusion income – rather than denying the deduction at the partnership level (which could adversely affect investors that would otherwise have sufficient investor dual inclusion income to offset the double deduction).

In any other case – i.e., where the hybrid payer is a hybrid entity resident in Canada, a dual resident or a multinational entity – the formula in subparagraph 18.4(15.6)(a)(ii) determines the amount of the hybrid payer mismatch for a taxation year in respect of a payment arising under a hybrid payer arrangement. Unlike the other hybrid mismatch amounts determined under this section, this formula determines that mismatch amount by, in effect, aggregating all of the hybrid payer's deductions in respect of payments under hybrid payer arrangements for the year and applying the amount of any restriction proportionally to each deductible amount. This is the result of the formula, which allocates dual inclusion income proportionally among all of the deductible amounts under hybrid payer arrangements, instead of relying on an ordering rule to apply the dual inclusion income to all of those deductible amounts.

Variable A of the formula determines the portion of the amount of the double deduction mismatch arising from a particular payment that can reasonably be attributed to the year and to the hybrid payer. This refers to the amounts that would otherwise be deductible (or, in the case of a discretionary expense such as capital cost allowance, any portion of the expense that is actually claimed) by the hybrid payer in the year in respect of the particular payment, recognizing that the amount of a double deduction mismatch may comprise amounts that would otherwise be deductible over multiple years.

Variable B determines the amount of the hybrid payer's dual inclusion income that is available to offset the double deduction. This available dual inclusion income is the hybrid payer's dual inclusion income for the year minus any amount used to offset the amount of a disregarded payment mismatch for the year (variable D), plus any unused dual inclusion income from previous years (variable E). Since, consistent with the BEPS Action 2 Report, the disregarded payment rule applies in priority to the hybrid payer rule, dual inclusion income for both the taxation year and prior taxation years is reduced by the amounts of any disregarded payment mismatches for the taxation year and prior years in determining the amount of dual inclusion income available to be applied against the amount of a hybrid payer mismatch for the year. Prior year dual inclusion income will also be reduced by any hybrid mismatch amounts for prior years. Subsection 18.4(8) provides rules to prevent double counting in the determination of dual inclusion income and investor dual inclusion income.

Variable C simply aggregates any variable A amounts for the hybrid payer for the year, in respect of any payments that arise under hybrid payer arrangements.

Under the formula, the amount of the hybrid payer mismatch in respect of a payment for a taxation year is the amount by which the otherwise deductible amount in the year in respect of the payment that is reflected in the amount for variable A exceeds the hybrid payer's available dual inclusion income for the year (variable B) multiplied by the proportion that the variable A amount is of all the otherwise deductible amounts in the year in respect of payments arising under hybrid payer arrangements that are reflected in the amount for variable C. This effectively spreads the available dual inclusion income proportionally across all potentially affected otherwise deductible amounts. The restricted amount in respect of a particular payment is therefore the amount of the hybrid payer mismatch for the year in respect of the particular payment, which is included under paragraph (f) of the definition “hybrid mismatch amount” in subsection 18.4(1) and subject to restriction under subsection 18.4(4).

Paragraph 18.4(15.6)(b) links the hybrid payer arrangement with the operative rule in subsection 18.4(4), by labelling the deduction component of the double deduction mismatch as the deduction component of the hybrid payer mismatch in respect of the particular payment. This ensures that the conditions in subsection 18.4(3) are met in respect of the particular payment, such that subsection 18.4(4) will apply to restrict the amount deductible for the year in respect of the particular payment to the extent of the amount of the hybrid payer mismatch.

Subsection 18.4(15.6) applies in respect of payments arising on or after July 1, 2026.

Hybrid payer arrangement — investor amount

ITA
18.4(15.7)

New subsection 18.4(15.7) is relevant in determining the amount of any income inclusion to a taxpayer for a taxation year under the new operative hybrid mismatch rule in subsection 12.7(4) in respect of a payment arising under a hybrid payer arrangement.

A payment arising under a hybrid payer arrangement may result in either an amount of a hybrid payer mismatch (under subsection 18.4(15.6)), or an investor hybrid payer mismatch amount (under subsection 18.4(15.7)). The latter amount results where Canada has the primary right (in accordance with the ordering rules set out in the BEPS Action 2 Report, as reflected in the hybrid mismatch rules in the Act) to neutralize the double deduction mismatch arising from a hybrid payer arrangement involving a hybrid payer that is a hybrid entity. In that case, Canada is necessarily the country in which an investor in that hybrid entity is resident (or is otherwise a taxpayer under the Act), and the hybrid entity is necessarily viewed as a partnership under the Act (given the definition of “hybrid entity”). To ensure that any neutralization of the mismatch occurs at the investor level (rather than at the partnership level) and on an investor-by-investor basis, the amount of the hybrid payer mismatch for the year is determined to be nil under subparagraph 18.4(15.6)(a)(i) and, instead, an investor hybrid payer mismatch amount is determined for the investor under paragraph 18.4(15.7)(a). This allows for a more targeted application of the primary rule, based on the investor’s specific tax attributes – in particular, investor dual inclusion income – rather than denying the deduction at the partnership level (which could adversely affect investors that would otherwise have sufficient investor dual inclusion income to offset the double deduction).

The determination of the investor hybrid payer mismatch amount follows the same general approach as the determination of the amount of the hybrid payer mismatch under subparagraph 18.4(15.6)(a)(ii). For more information, see the note to new subsection 18.4(15.6).

In general terms, variable A of the formula is the portion of the amount of the double deduction mismatch arising from a particular payment that is attributable to the investor. In most cases, this amount will be determined under paragraph (a) of variable A, as the portion that is both deductible (and claimed) by the hybrid payer and can reasonably be considered to be the investor's share of that amount (with the investor's share being determined consistently with the determination of the investor's share of the partnership income under subsection 96(1)). Where expenses incurred by a partnership are directly flowed through to partners, however, paragraph (b) applies to identify those amounts that are deductible (and claimed) by the investor. The reference to "is claimed" is intended to clarify that, in the case of a discretionary expense such as capital cost allowance, only the portion, if any, of the expense that is actually claimed by the relevant taxpayer in the year is picked up under variable A.

Variable B determines the amount of the investor's available investor dual inclusion income, in respect of the hybrid payer, for the year.

Variable C aggregates all of the variable A amounts of the investor for the year in respect of payments made by the hybrid payer under hybrid payer arrangements.

The formula then multiplies the investor dual inclusion income (variable B) by the proportion that the amount determined for variable A is of the amount determined for variable C, in effect spreading the available investor dual inclusion income proportionally across all the otherwise deductible amounts. The investor hybrid payer mismatch amount of the investor for the year, in respect of the particular payment, is then determined by subtracting the investor dual inclusion income that was allocated to the amount deductible in respect of the particular payment from that deductible amount.

One difference between subsection 18.4(15.7) and subsection 18.4(15.6) is that no deduction component is determined under the former subsection. This is because the investor hybrid payer mismatch amount is neutralized under a new operative rule in subsection 12.7(4) that does not require a deduction component.

Subsection 18.4(15.7) applies in respect of payments arising on or after July 1, 2026.

Offshore mismatch — conditions

ITA
18.4(15.8)

New subsection 18.4(15.8) sets out the conditions for determining if a payment gives rise to an offshore mismatch.

The determination of whether an offshore mismatch exists is the first step in ascertaining if a taxpayer has an imported hybrid mismatch. Subsequent steps involve testing the cause of the mismatch and whether there is sufficient linkage between the mismatch and an otherwise deductible cross-border payment by a Canadian taxpayer. Where an imported hybrid mismatch is determined to exist in respect of such a deductible cross-border payment, the rules neutralize that mismatch by denying a deduction in respect of the cross-border payment.

In general terms, an offshore mismatch is a mismatch that would be a deduction/non-inclusion mismatch or double deduction mismatch if those concepts applied to payments between non-Canadian entities. However, if the mismatch has been substantially neutralized under a foreign hybrid mismatch rule (by the denial of a deduction, or inclusion in income, in an amount that is substantially all of the amount that would have been denied or included under the Canadian hybrid mismatch rules if they had applied), it is not an offshore mismatch. This reflects that the imported hybrid mismatch rules are intended to apply only when a mismatch has not been neutralized under a country's hybrid mismatch rules.

Paragraph 18.4(15.8)(a) sets out a two-step test in respect of deduction/non-inclusion mismatches. First, subparagraph (a)(i) imports the test from subsection 18.4(6) for determining if a payment gives rise to a deduction/non-inclusion mismatch but reads out paragraph (a) of that subsection, such that only mismatches involving deductions under foreign tax laws are in view. Second, subparagraph (a)(ii) tests if an income inclusion has been made under subsection 12.7(3) (or the equivalent provision under foreign hybrid mismatch rules) to neutralize the mismatch. Since the determination of the deduction/non-inclusion mismatch in the first step takes account of any foreign hybrid mismatch rule that denies deductions, if the test in the second step is also met, then it can be concluded that no foreign country has applied its hybrid mismatch rules to neutralize the mismatch. If both tests in paragraph (a) are met, there is an offshore mismatch.

Paragraph 18.4(15.8)(b) imports the test from subsection 18.4(7.1) for determining if a payment gives rise to a double deduction mismatch, but adapts that test to the offshore context by providing a read-as rule that makes two main alterations to that subsection. First, paragraph 18.4(7.1)(a) is altered to refer to an amount that is deductible, in respect of the payment, in computing the relevant foreign income or profits of an entity in respect of a particular country (other than Canada). Paragraph 18.4(7.1)(b) is then altered to refer to an amount that is deductible, in respect of the same payment, in computing the relevant foreign income or profits of an entity in respect of a second country (other than Canada). Under this read-as rule, the effects of hybrid mismatch rules (both Canadian and foreign) – which are disregarded under subsection 18.4(7.1) in determining if there is a deduction of the kind referred to in that subsection – are taken into account. Thus, if one or both of the deductions otherwise comprising the mismatch is denied by a foreign hybrid mismatch rule, there is no offshore mismatch.

Subsection 18.4(15.8) applies in respect of payments arising on or after July 1, 2026.

Offshore mismatch — amount

ITA

18.4(15.9)

New subsection 18.4(15.9) determines the amount of an offshore mismatch arising from a payment.

In the case of an offshore mismatch that meets the conditions in paragraph (15.8)(a), the amount of the mismatch is determined under paragraph (15.9)(a) to be the amount by which the amount determined for variable C in paragraph 18.4(6)(b) (i.e., the aggregate of the foreign deductible amounts in respect of the payment) exceeds the amount determined for variable D in that paragraph (i.e., the aggregate of the Canadian ordinary income and foreign ordinary income in respect of such foreign deductible amounts).

In the case of an offshore mismatch that meets the condition in paragraph 18.4(15.8)(b), the amount of the mismatch is determined under paragraph 18.4(15.9)(b) and is the lesser of the total of the amounts described in paragraph 18.4(7.1)(a) in respect of the payment and the total of the amounts described in paragraph 18.4(7.1)(b) in respect of the payment (as those paragraphs are read applying the read-as rule in paragraph 18.4(15.8)(b)). In other words, the amount of the offshore mismatch is the lesser of the aggregate amount deductible in one country by an entity in respect of the payment, and the aggregate amount deductible in another country by an entity (which may be the same entity, for example in the case of a dual resident) in respect of the payment.

Subsection 18.4(15.9) applies in respect of payments arising on or after July 1, 2026.

Offshore hybrid mismatch amount — meaning

ITA
18.4(15.91)

New subsection 18.4(15.91) determines the offshore hybrid mismatch amount for a foreign taxation year in respect of a payment.

The determination of an offshore hybrid mismatch amount is the next step (after the determination that a payment gives rise to an offshore mismatch under subsection 18.4(15.8), and the amount of the offshore mismatch under subsection 18.4(15.9)) in the process of ascertaining if there is an imported hybrid mismatch. This involves a determination of whether the offshore mismatch is caused by "hybridity", as required in order for the mismatch to be in scope of the imported hybrid mismatch rules and potentially neutralized through the denial of a deduction in respect of a linked cross-border payment by a taxpayer.

Subsection 18.4(15.91) contains two sets of read-as rules for the purpose of determining if any of the hybridity conditions in the hybrid mismatch rules are satisfied in respect of an offshore mismatch falling within paragraph (15.8)(a) or (b), respectively. The first set of read-as rules, in paragraph 18.4(15.91)(a), essentially adapts the hybrid mismatch rules in subsections 18.4(10) to (15.4), which generally identify deduction/non-inclusion mismatches that are caused by different forms of hybridity, to apply to offshore mismatches described in paragraph 18.4(15.8)(a). This is achieved by reading out the references to “deduction/non-inclusion mismatch” in favour of “offshore mismatch” and undertaking various other alterations to the wording of subsections 18.4(10) to (15.4) and the supporting definitions “dual inclusion income” and “investor dual inclusion income” to adapt their application to the offshore context. Any amount that would be the amount of a hybrid financial instrument mismatch, hybrid transfer mismatch, substitute payment mismatch, reverse hybrid mismatch or disregarded payment mismatch, when applying these read-as rules, is an offshore hybrid mismatch amount.

The second set of rules, in paragraph 18.4(15.91)(b), essentially adapts the hybrid payer mismatch rule (as set out in subsections 18.4(15.5) and (15.6)), which generally applies to double deduction mismatches in respect of payments by hybrid payers, to apply to offshore mismatches described in paragraph 18.4(15.8)(b). Similarly to the first set of rules, this is achieved through the application of a series of alterations to those subsections. First, paragraphs 18.4(15.5)(b) and (c) are “read out” under subparagraph 18.4(15.91)(b)(i). This effectively disapplies certain rules that determine the order in which the hybrid payer mismatch rules of various countries apply in respect of hybrid entities and multinational entities, respectively. These ordering rules are not relevant in the context of imported hybrid mismatches since the imported hybrid mismatch rules only apply to the extent that a hybrid mismatch has not already been neutralized under any hybrid mismatch rule (whether primary or secondary) of any country.

Second, subparagraph 18.4(15.6)(a)(i) is “read out” under subparagraph 18.4(15.91)(b)(ii). Again, this is an ordering rule (this time governing which of the two hybrid payer mismatch rules in the Act applies) that applies in the case of a hybrid entity that is a partnership under Canadian tax law. This rule ensures that the more targeted investor-level rule in subsection 18.4(15.7) is applied in priority to the hybrid entity-level rule in subsection 18.4(15.5), such that each investor benefits from its own investor dual inclusion income. However, such an ordering rule is unnecessary in the context of the imported hybrid mismatch rules because the entity to which the deduction is denied under those rules is neither the payer of the payment that gave rise to the offshore hybrid mismatch amount, nor an investor in that payer.

Third, similar read-as rules to those in subparagraphs 18.4(15.91)(a)(i) and (ii) are included in subparagraphs 18.4(15.91)(b)(iii) and (iv). These read out the references to “double deduction mismatch” in favour of “offshore mismatch” and undertake various other alterations to the wording of subsections 18.4(15.5) and (15.6) and the supporting definition “dual inclusion income” to adapt their application to the offshore context.

Finally, subparagraph 18.4(15.91)(b)(v) removes the timing requirement for an ordinary income inclusion in subparagraphs (a)(ii) and (b)(ii) of the definition “dual inclusion income”. Without this alteration, in order for dual inclusion income to arise, it would have been necessary for an income amount to be included in the ordinary income of an investor in an entity (in the case of paragraph (a)) or the entity itself (in the case of paragraph (b)) in a foreign taxation year that begins on or before the day that is 12 months after the end of the foreign taxation year in which the ordinary income inclusion set out in subparagraph (a)(i) or (b)(i), respectively, is made. That timing requirement is intended to prevent the creation of dual inclusion income where there are substantial timing differences in realization of the income between countries or entities. The reason for removing this timing requirement in the offshore mismatch context is that, in that context, there are no equivalents of the discretion in subsection 18.4(19.1) or the deductibility provisions in paragraphs 20(1)(zz) and (aaa). In the offshore mismatch context, however, it is still required that the two ordinary income inclusions (described, respectively, in subparagraphs (a)(i) and (b)(i) or subparagraphs (a)(ii) and (b)(ii) of the definition "dual inclusion income") be in respect of the same income item.

Subsection 18.4(15.91) applies in respect of payments arising on or after July 1, 2026.

Imported hybrid arrangement — conditions

ITA
18.4(15.92)

New subsection 18.4(15.92) sets out the conditions for determining if a payment (referred to as the "importing payment") arises under an imported hybrid arrangement in respect of an offshore hybrid mismatch amount in respect of another payment (referred to as the "mismatch payment").

This determination is the second-last step in determining if there is an amount of an imported hybrid mismatch to be neutralized under the imported hybrid mismatch rules and entails linking an offshore hybrid mismatch amount to a deductible cross-border payment (i.e., the importing payment) of a taxpayer. Where the conditions in subsection 18.4(15.92) are met, the deduction otherwise available in respect of the importing payment may be denied to neutralize the indirect impact of the offshore hybrid mismatch amount on the Canadian tax base.

The first condition, in paragraph 18.4(15.92)(a), is that the importing payment would have been deductible under the Act in the absence of the imported hybrid mismatch rules. This condition effectively gives priority to the other rules in section 18.4 (as well as any other restrictions on deductibility in the Act) because, to the extent that any rule in the Act has already applied to deny a deduction in respect of the importing payment, the condition in paragraph 18.4(15.92)(a) will not be satisfied.

The second condition, in paragraph 18.4(15.92)(b), is that the recipient of the importing payment is non-resident. This condition ensures that, where there is a series of payments that includes payments between Canadian entities followed by a cross-border payment, only the cross-border payment will be an importing payment and therefore none of the deductions in respect of payments between Canadian entities are denied under the imported hybrid mismatch rules.

The third and final condition, in paragraph 18.4(15.92)(c), sets out the requisite link between the importing payment and the mismatch payment (i.e., the payment in respect of which the offshore hybrid mismatch amount arises). This condition is satisfied if:

- The payer of the mismatch payment is the recipient of the importing payment (i.e., a direct link), and either

  - the payer of the mismatch payment does not deal at arm's length with the payer of the importing payment, or
  - both payments arise under, or in connection with, the same foreign structured arrangement; or

- The payer of the mismatch payment is the recipient of a payment that is included in a series of payments interposed between the mismatch payment and the importing payment (i.e., an indirect link, involving a chain of payments, starting with the importing payment and ending with a payment made to the payer of the mismatch payment), and either
  - the payers of the mismatch payment, the importing payment and all those interposed payments do not deal at arm's length with each other, or
  - all those payments arise under, or in connection with, the same foreign structured arrangement.

For these purposes, the meaning of the term "series of payments" is modified by the interpretive rule in subsection 18.4(15.93).

If the three conditions described above are met, the payment will be considered to arise under an imported hybrid arrangement.

Subsection 18.4(15.92) applies in respect of payments arising on or after July 1, 2026.

Series of payments — interpretation

ITA
18.4(15.93)

New subsection 18.4(15.93) sets out an interpretive rule that narrows the scope of the term "series of payments" as it is used in subsections 18.4(15.92) and (15.94).

The rules in subsection 18.4(15.93) operate to exclude from a series of payments certain payments that would otherwise have been included in the series. As outlined in the note to subsection 18.4(15.92), the type of series contemplated by that subsection and subsection 18.4(15.94) is one in which there is a chain of payments between entities, starting with an importing payment and ending with a payment made to the payer of a mismatch payment. The payments in the chain need not follow in chronological order but must constitute an unbroken chain such that each payer in the chain (except the payer of the importing payment) is the recipient of another payment in the chain. Accordingly, if the rules in subsection 18.4(15.93) act to exclude from the series the only payment (otherwise within the series) between two entities in the chain, this breaks the series. If there are multiple payments between two entities that are within the series and not all of those payments are excluded under this subsection, however, then the series remains intact.

If either of the conditions in subsection 18.4(15.93) is met in respect of a particular payment, the payment is excluded from the series. The first condition, in paragraph (a), is that there is no amount that is deductible (or reasonably expected to be deductible) in respect of the payment in computing an entity's relevant foreign income or profits or, in the case of the importing payment, income from a business or property under Part I of the Act. For these purposes, the entity that is entitled to the deduction need not be the payer of the payment. For example, if the payer is resident in a country that has a consolidation or other similar tax regime that allows for the surrender of deductions between entities within a related group and a deduction in respect of the payment is surrendered to another group entity and deducted by that other entity, the condition in paragraph (a) is not met in respect of the payment. The second condition, in paragraph (b), is that there is an offshore hybrid mismatch amount in respect of the payment. Accordingly, any payment that is itself a mismatch payment will meet the condition in paragraph (b) and be excluded from the series.

Subsection 18.4(15.93) applies in respect of payments arising on or after July 1, 2026.

Imported hybrid mismatch — amount

ITA
18.4(15.94)

New subsection 18.4(15.94) determines the amount of an imported hybrid mismatch in respect of an importing payment.

In order for there to be an imported hybrid mismatch, there must be a payment (i.e., the importing payment) arising under an imported hybrid arrangement in respect of an offshore hybrid mismatch amount. Once this has been established, subsection 18.4(15.94) determines the amount of that imported hybrid mismatch.

The amount of an imported hybrid mismatch is the lesser of the two amounts set out in paragraphs 18.4(15.94)(a) and (b). The first amount, determined under paragraph (a), is essentially the portion of the offshore hybrid mismatch amount that has not previously been neutralized because of the application of subsection 18.4(15.95) to another importing payment or the application of an equivalent provision in the hybrid mismatch rules of another country to the equivalent of an importing payment under those foreign rules. Paragraph (a) ensures that the imported hybrid mismatch amount is no greater than the offshore hybrid mismatch amount that is linked to the importing payment. This prevents a denial of deductions in an amount beyond what is necessary to neutralize the offshore hybrid mismatch amount that is determined to have a sufficient linkage to a taxpayer's cross-border payment (i.e., the importing payment) to conclude that the deduction in respect of that importing payment effectively imports some or all of the offshore hybrid mismatch amount into Canada.

The second amount, determined under paragraph (b), depends on the type of link between the importing payment and the mismatch payment. If there is a direct link between the importing payment and the mismatch payment (i.e., the payer of the mismatch payment is a recipient of the importing payment), then the paragraph (b) amount is equal to the offshore hybrid mismatch amount. This reflects the fact that the tax benefit of the offshore hybrid mismatch amount can be considered to have been fully imported into Canada to the extent of the entire importing payment. As described above, paragraph (a) limits the amount of the imported hybrid mismatch to the portion of the offshore hybrid mismatch amount that has not already been neutralized through the application of a country's imported hybrid mismatch rules.

If there is an indirect link between the importing payment and the mismatch payment (i.e., the payer of the mismatch payment is the recipient of a payment included in a series of payments that satisfies the non-arm's length or foreign structured arrangement test in subparagraph 18.4(15.92)(c)(ii)), then the paragraph (b) amount is determined using the following four-step process:

- Step 1: For each series of payments that meets the condition in clause 18.4(15.92)(c)(ii)(A) or (B), identify all the entities that have deductible amounts in respect of payments (either the importing payment or an interposed payment) included in that series.

- Step 2: For each such entity in respect of a particular series, determine the total of the amounts deductible by the entity in respect of payments included in the particular series.

- Step 3: Determine which of those entities has the lowest such total.

- Step 4: Determine the total of all amounts, each of which is the amount determined under Step 3 in respect of a series of payments described in Step 1.

The total amount determined under Step 4 is the paragraph (b) amount. Paragraph (b) essentially performs a tracing function, determining the extent to which the importing payment has "funded" the mismatch payment. If at any point in the series an amount less than the amount of the importing payment is deductible by an entity in respect of the payments it makes as part of the series of payments, then this lower deductible amount acts as a "bottleneck", restricting the amount that can be said to have funded the mismatch payment and, correspondingly, the tax benefit of the offshore hybrid mismatch amount that can be said to have been imported to Canada.

For example, consider a situation where the non-arm's length recipient of a \$100 importing payment makes a \$30 deductible payment to each of three non-arm's length entities, and each of those three entities makes a \$20 deductible payment to the non-arm's length payer of the mismatch payment. The four-step process applies as follows:

- Step 1: All the referenced entities (except the payer of the mismatch payment) are identified as having deductible amounts in respect of payments included in at least one of the three series of payments that meet the condition in clause 18.4(15.92)(c)(ii)(A).

- Step 2: The payer of the importing payment has a total of \$100 deductible in respect of each such series; the recipient of the importing payment has a total of \$90 deductible in respect of each such series; and, for each series, there is an entity (i.e., the entity that makes a payment to the payer of the mismatch payment) that has a total of $20 deductible.

- Step 3: For each of the three series of payments, $20 is determined to be the lowest total amount deductible by an entity.

- Step 4: The lowest amounts determined under Step 3 for each series are aggregated, resulting in a paragraph (b) amount of $60.

Subsection 18.4(15.94) applies in respect of payments arising on or after July 1, 2026.

Imported hybrid mismatch — application

ITA
18.4(15.95)

New subsection 18.4(15.95) sets out how the hybrid mismatch rules apply where it is determined that there is an amount of an imported hybrid mismatch in respect of an importing payment.

Paragraph 18.4(15.95)(a) deems subsection 18.4(4) to apply in respect of the importing payment. As such, the usual conditions for the application of subsection 18.4(4), which are contained in subsection 18.4(3), need not be met. In particular, this obviates the need for a deduction component of a hybrid mismatch arrangement. In the context of the hybrid mismatch rules, the existence of a deduction component indicates that the type of mismatch in question concerns a Canadian tax deduction. There is no need for that condition in the case of an imported hybrid mismatch, which necessarily involves a Canadian tax deduction.

Paragraph 18.4(15.95)(b) deems the amount of the imported hybrid mismatch to be a hybrid mismatch amount for a taxation year for the purposes of subsection 18.4(4), except to the extent that deductions have been denied in respect of the importing payment in preceding taxation years. This rule serves two functions. First, it adapts the “hybrid mismatch amount” concept to the case of imported hybrid mismatches, to ensure that subsection 18.4(4) can apply in respect of such mismatches. Second, it ensures that, in the first taxation year for which there is otherwise a deductible amount in respect of the importing payment, the deduction is denied to the extent of the amount of the imported hybrid mismatch. If the deduction denied is less than the amount of that imported hybrid mismatch, then subsection 18.4(15.95) may apply in subsequent taxation years, with the deductions in those subsequent years in respect of the importing payment being denied to the extent of the remaining amount of imported hybrid mismatch (until that amount is exhausted).

Subsection 18.4(15.95) applies in respect of payments arising on or after July 1, 2026.

Deemed ordinary income — inclusion/non-deduction

ITA

18.4(16.1)

In general terms, new subsection 18.4(16.1) applies in respect of a payment made by an investor in a hybrid entity to the hybrid entity that is included in the taxable income of the hybrid entity without a specific offsetting tax relief or refund (and thus is ordinary income of the hybrid entity) but is not deductible by the investor because it is disregarded under the tax laws of the investor's country (an "inclusion/non-deduction" mismatch). Where the relevant conditions are met, this subsection deems an amount in respect of the payment to be ordinary income of the investor in respect of the country where the investor is resident. Generally, in order for there to be dual inclusion income of a hybrid entity or investor dual inclusion income of an investor in a hybrid entity, an amount must be ordinary income of the hybrid entity, in respect of one country, and the investor, in respect of another country – with one of those countries being Canada – because the hybrid entity is treated as fiscally transparent in the investor country.

More specifically, subsection 18.4(16.1) applies to deem a particular amount in respect of a payment to be ordinary income of an investor (in a hybrid entity) in respect of a country, for a given taxation year (if the country is Canada) or a foreign taxation year (if the country is not Canada), where four conditions are met.

First, the hybrid entity must be the recipient of the payment.

Second, the particular amount must be ordinary income of the hybrid entity in respect of the country where it is resident, for a foreign taxation year (if it is resident in a country other than Canada) or a taxation year (if it is resident in Canada).

Third, it must be determined that no amount in respect of the payment is deductible in computing the income or profits of any entity (which could be the investor or another entity), whether for Canadian or foreign income tax purposes.

Finally, it must be the case that the particular amount would have been deductible in computing the income or profits of the investor for a taxation year or foreign taxation year if the payment were not disregarded under the tax laws of the investor country. This hypothetical test will not be satisfied if the disregarding of the payment is not the only reason for the non-deductibility of the particular amount. Accordingly, if the particular amount would still not be deductible even if the payment were not disregarded (e.g., because of a general interest deductibility limitation rule), then the test is not met and this subsection does not apply to deem the particular amount to be ordinary income of the investor.

Where the conditions in this subsection are met, the taxation year or foreign taxation year in which the particular amount would have been deductible (if the payment were not disregarded under the tax laws of the investor country) is the year for which the investor is deemed to have ordinary income in respect of the investor country. Notably, any deemed ordinary income of an investor in respect of a country for a foreign taxation year must still meet the timing condition in subparagraph (a)(ii) of the "dual inclusion income" definition in subsection 18.4(1) (or otherwise be permitted by the Minister of National Revenue pursuant to subsection 18.4(19.1)) in order for that ordinary income to give rise to dual inclusion income.

Subsection 18.4(16.1) applies in respect of payments arising on or after July 1, 2026.

Deemed ordinary income — hybrid-to-hybrid payments

ITA
18.4(16.2)

Like new subsection 18.4(16.1), new subsection 18.4(16.2) deems an investor in a hybrid entity to have ordinary income in certain circumstances where the investor would not otherwise have ordinary income in respect of a payment (to match the ordinary income of the hybrid entity) because the payment is disregarded under the tax laws of the investor country.

In general terms, under subsection 18.4(16.2), an investor in hybrid entities is deemed to have ordinary income in respect of a payment where the payment is made by one of the hybrid entities (and funded out of its ordinary income) to another of the hybrid entities and is disregarded under the tax laws of the investor country but not under the tax laws of the country where the hybrid entities are resident – such that the payment gives rise to ordinary income of the recipient hybrid entity in respect of the country where it is resident but, in the absence of this subsection, does not give rise to ordinary income of the investor in respect of the country where it is resident.

More specifically, this subsection applies to deem a particular amount in respect of a payment to be ordinary income of an investor in respect of a country, for a given taxation year (if the country is Canada) or foreign taxation year (if the country is not Canada), where the conditions in paragraphs (a) to (g) are met.

First, the payer and recipient of the payment must be hybrid entities resident in the same country (other than the investor country) and the investor must be an investor in both of those hybrid entities (paragraphs (a) to (c)).

Second, the particular amount must be ordinary income of the recipient hybrid entity in respect of the country where it is resident, for a foreign taxation year (if it is resident in a country other than Canada) or a taxation year (if it is resident in Canada) (paragraph (d)).

Third, the particular amount must not be ordinary income of the investor in respect of any country (paragraph (e)).

Fourth, it must be the case that, if the payment had not been disregarded under the tax laws of the investor country, the particular amount would have been ordinary income of the investor in respect of the investor country for the given taxation year or foreign taxation year (paragraph (f)). This hypothetical test is only satisfied if the reason that the particular amount is not ordinary income is because the payment was disregarded. Accordingly, if the particular amount would not be ordinary income (e.g., because it would be sheltered by an offsetting tax relief that is specific to the particular amount) if the payment were not disregarded, then the hypothetical test is not met and this subsection does not apply.

Finally, it must be the case that the payment can reasonably be considered to have been funded by an amount that would, in the absence of the deeming rule in subsection 18.4(16.4), be ordinary income of the payer hybrid entity (paragraph (g)). If the deduction that the payer hybrid entity is permitted in respect of the payment for income tax purposes is taken against income that would, in the absence of subsection 18.4(16.4), be ordinary income, then this generally leads to the conclusion that the payment was funded by ordinary income.

If the conditions in this subsection are met, the particular amount is deemed to be ordinary income. In order for that ordinary income to give rise to dual inclusion income or investor dual inclusion income, however, the timing condition in the "dual inclusion income" or "investor dual inclusion income" definition must still be satisfied (or the Minister of National Revenue must permit dual inclusion income or investor dual inclusion income pursuant to subsection 18.4(19.1)).

If a particular amount that is deemed to be ordinary income under subsection 18.4(16.2) is included in dual inclusion income or investor dual inclusion income that is used to reduce a hybrid mismatch amount or investor hybrid payer mismatch amount (or to facilitate the reinstatement of all or a portion of a previously denied deduction under paragraph 20(1)(zz) or (aaa)), then the rules against double counting in subsections 18.4(16.3) and (16.4) will apply. For more information, see the commentary to those subsections.

Subsection 18.4(16.2) applies in respect of payments arising on or after July 1, 2026.

No double counting — conditions

ITA
18.4(16.3)

New subsection 18.4(16.3) sets out the conditions for the application of the rule in subsection 18.4(16.4) in respect of a payment, which rule is intended to prevent the double use of an ordinary income amount where the deeming rule in subsection 18.4(16.2) applies.

There are three conditions in this subsection. First, there must be a deemed ordinary income amount in respect of a payment as a result of the application of subsection 18.4(16.2). Second, that deemed ordinary income must be included in computing the dual inclusion income of a hybrid entity for a taxation year or investor dual inclusion income of an investor in a hybrid entity for a taxation year. This will be the case where that deemed ordinary income in respect of a country – which will necessarily be ordinary income of an investor in a hybrid entity – is matched by corresponding ordinary income of the hybrid entity in respect of another country and the relevant timing requirement in the "dual inclusion income" or "investor dual inclusion income" definition is met. Finally, the dual inclusion income or investor dual inclusion income in which the deemed ordinary income is included must be applied in computing a hybrid mismatch amount or investor hybrid payer mismatch amount, or the amount of a deduction under paragraph 20(1)(zz) or (aaa).

Where the above conditions are met, subsection 18.4(16.4) applies in respect of the relevant payment.

Subsection 18.4(16.3) applies in respect of payments arising on or after July 1, 2026.

No double counting — consequences

ITA
18.4(16.4)

New subsection 18.4(16.4) deems a certain amount in respect of a payment to not be ordinary income where the conditions in subsection 18.4(16.3) are met. This is necessary in order to ensure there is not effectively a double counting of this amount as ordinary income where subsection 18.4(16.2) has deemed the amount to be ordinary income of an investor in the hybrid entity recipient of the payment, since subsection 18.4(16.2) applies (in accordance with the condition in paragraph 18.4(16.2)(g)) in respect of a payment that is funded out of ordinary income of a payer hybrid entity. Without subsection 18.4(16.4), the amount out of which the payment was funded would remain ordinary income notwithstanding that another entity (the investor in the recipient hybrid entity) is deemed to have an amount of ordinary income in respect of the payment.

For example, assume an investor is deemed to have $100 of ordinary income, in respect of a payment made by a hybrid entity, in respect of a country other than Canada for a foreign taxation year as a result of the application of subsection 18.4(16.2). Assume also that the hybrid entity that is the recipient of the payment has $100 of matching ordinary income in respect of Canada for a taxation year that coincides with the foreign taxation year, such that that hybrid entity has $100 of dual inclusion income for the taxation year. If that $100 of dual inclusion income is used to reduce the amount of a disregarded payment mismatch or hybrid payer mismatch, such that a lower amount of deduction is denied under subsection 18.4(4) than would have otherwise been the case, then $100 of the ordinary income of the payer hybrid entity out of which the payment was funded is deemed to not be ordinary income. This prevents subsection 18.4(16.2) from having the effect of duplicating dual inclusion income or investor dual inclusion income amounts.

For more information, see the commentary on subsection 18.4(16.3).

Subsection 18.4(16.4) applies in respect of payments arising on or after July 1, 2026.

Dual inclusion income — special cases

ITA
18.4(19.1)

In order to generate dual inclusion income or investor dual inclusion income of an entity for a taxation year, the ordinary income of the entity in respect of a country other than Canada must generally be for a foreign taxation year that begins on or before the day that is 12 months after the end of the taxation year. However, subsection 18.4(19.1) provides that, if, in the opinion of the Minister of National Revenue, the circumstances of a case are such that it would be just and equitable to take into account, in determining the dual inclusion income or investor dual inclusion income of an entity for a taxation year, an amount that is ordinary income of an entity, in respect of a country other than Canada, for a foreign taxation year that begins more than 12 months after the end of the taxation year, the amount shall be taken into account.

Subsection 18.4(19.1) applies in respect of payments arising on or after July 1, 2026.

Resident in a country

ITA
18.4(19.2)

New subsection 18.4(19.2) clarifies that any reference in section 12.7 or 18.4 to an entity being "resident" in a country is intended to mean that the entity is resident (i.e., subject to comprehensive taxation) in that country for income tax purposes according to the laws of the country. Accordingly, the use of the term "resident" in this subsection does not preclude instances in which an entity is subject to comprehensive taxation (i.e., treated as resident) in a country by reason of its domicile, citizenship, place of management, place of incorporation or any other criterion of a similar nature. In addition, if the entity is not treated as resident under the laws of a country because of the application of a tax treaty tie-breaker clause, it is not resident in that country for the purposes of sections 12.7 and 18.4.

New subsection 18.4(19.2) applies in respect of payments arising on or after July 1, 2026.

Anti-avoidance

ITA
18.4(20)

Subsection 18.4(20) is an anti-avoidance rule that is intended to prevent the avoidance of the hybrid mismatch rules. In general terms, this rule applies where one of the main purposes of a transaction or series of transactions is to avoid the application of subsection 12.7(3), 18.4(4) or 113(5), or to limit the consequences of any of those provisions, and certain other conditions are met. These other conditions are intended to capture situations that, in substance, meet the essential characteristics of hybrid mismatch arrangements, as informed by the BEPS Action 2 Report, notwithstanding that one or more of the precise technical requirements of the rules is not met. Where applicable, subsection 18.4(20) is intended to ensure that a transaction is subject to the same consequences as if the avoided hybrid mismatch rule had applied.

As the hybrid mismatch rules are being amended to incorporate additional hybrid mismatch arrangements (i.e., reverse hybrid arrangements, disregarded payment arrangements and hybrid payer arrangements), the following key amendments are made to this anti-avoidance rule:

- “double deduction mismatch” references are added to the preamble;
- new subsection 12.7(4) is added to the list of rules referred to in the avoidance test in paragraph (a); and
- the list of conditions in paragraph (b), which aim to capture the essential characteristics of hybrid mismatch arrangements, is consequentially amended to address the characteristics of these various hybrid mismatch arrangements.

More specifically, there are four main changes to paragraph (b). First, a reference to “deduction/non-inclusion” is added to existing subparagraph (b)(ii), to clarify that the condition in that subparagraph is relevant in the case of arrangements producing deduction/non-inclusion mismatches but not ones producing double deduction mismatches.

Second, the existing subparagraph (b)(iii) is replaced with a new condition, which reflects the policy that the hybrid mismatch rules (other than subsection 113(5)) generally apply in respect of deduction/non-inclusion mismatches that result from differences in the income tax treatment of an entity under the laws of two or more countries (i.e., the hybrid mismatch rules applicable in respect of reverse hybrid mismatch arrangements and disregarded payment arrangements), in addition to where such mismatches result from differences in tax treatment that are attributable to the terms or conditions of a transaction or series (as set out in subparagraph (b)(ii)).

Third, existing subparagraph (b)(iii) is renumbered as subparagraph (b)(iv) and amended to incorporate the additional reason, for a deduction/non-inclusion mismatch or other outcome, described in clause (b)(iii)(A) (i.e., because a hybrid entity participates in the transaction or series of transactions that includes the payment). Although this subparagraph uses language similar to the “causal test” in subparagraph 18.4(15.3)(d)(ii), applicable in relation to disregarded payment arrangements, it is intended to apply more broadly, including to arrangements that avoid the disregarded payment arrangement rules.

Finally, new subparagraph (b)(v) incorporates an additional condition that reflects that the operative rule in subsection 18.4(4) is extended, and the new rule in subsection 12.7(4) is introduced, to address double deduction mismatches under hybrid payer arrangements (as set out in new subsection 18.4(15.5)).

These amendments apply in respect of payments arising on or after July 1, 2026.

Filing requirement

ITA
18.4(21)

Subsection 18.4(21) requires taxpayers to file, in their return of income for a taxation year, a prescribed form containing prescribed information, if the primary operative rule in subsection 18.4(4) or the secondary operative rule in subsection 12.7(3) applies in respect of a payment in computing their income for the year. This subsection is amended to include a reference to the operative rule in new subsection 12.7(4), which applies to cause an income inclusion for an investor in a hybrid entity where a payment arises under a hybrid payer arrangement (as set out in subsection 18.4(15.5)) and the payer is a partnership for Canadian tax purposes. For more information, see the commentary on subsections 12.7(4), 18.4(15.5) and (15.7).

This amendment applies in respect of payments arising on or after July 1, 2026.

Clause 4

Adjustment for hybrid mismatch — foreign ordinary income

ITA
20(1)(yy)

Paragraph 20(1)(yy) provides a deduction in computing a taxpayer's income for a taxation year from a business or property, generally where subsection 18.4(4) has applied to deny the taxpayer a deduction in respect of a payment for the year or a preceding taxation year, and the taxpayer demonstrates an amount is foreign ordinary income of an entity in respect of the payment.

Consequential on the expansion of the hybrid mismatch rules to cover additional types of hybrid mismatch arrangements, this paragraph is amended to ensure that the reinstatement of the previously denied deduction only applies in the case of certain arrangements for which foreign ordinary income is relevant – namely, hybrid financial instrument arrangements, hybrid transfer arrangements and substitute payment arrangements. New paragraphs 20(1)(zz) and (aaa) are introduced to provide a similar deduction for disregarded payment arrangements and hybrid payer arrangements, which are the arrangements for which dual inclusion income (or investor dual inclusion income) is relevant. For more information, see the commentary on those paragraphs.

A minor amendment is also made to this paragraph to remove the deeming rule contained in subparagraph 20(1)(yy)(ii), as this rule is relocated to new subsection 20(31).

These amendments apply in respect of payments arising on or after July 1, 2026.

Adjustment for hybrid mismatch — dual inclusion income

ITA
20(1)(zz)

New paragraph 20(1)(zz) is introduced to allow for a reinstatement in a taxation year of a deduction that was denied to a taxpayer in a prior year under subsection 18.4(4), if the taxpayer demonstrates it has dual inclusion income for the taxation year. New paragraph 20(1)(aaa) is also introduced to address similar circumstances involving investor dual inclusion income. These rules are similar to paragraph 20(1)(yy), which applies where a taxpayer's deduction for a taxation year is denied under subsection 18.4(4) and the taxpayer has foreign ordinary income in a later year.

Very generally, paragraph 20(1)(zz) applies to allow a deduction for a taxation year if the following two conditions are met.

- First, subsection 18.4(4) has applied to deny the taxpayer a deduction (referred to as the "denied amount") in respect of a payment for a prior taxation year. For the purposes of this rule, the relevant denied amount would be in respect of a payment under a disregarded payment arrangement that gives rise to a deduction/non-inclusion mismatch, or a payment under a hybrid payer arrangement that gives rise to a double deduction mismatch, where the taxpayer has insufficient dual inclusion income in the year of the denial.

- Second, the taxpayer demonstrates (by providing the relevant foreign tax returns and any other relevant supporting documentation to the Canada Revenue Agency) that an amount is dual inclusion income for the taxation year. To prevent double counting, the amount of dual inclusion income must not have already been taken into account in determining the amount of a previous deduction under this paragraph nor as a reduction in determining a hybrid mismatch amount (which includes the hybrid mismatch amount that was denied under subsection 18.4(4) in the first instance).

The amount that may be deducted under paragraph 20(1)(zz) is the lesser of two amounts. The first amount, under subparagraph 20(1)(zz)(i), is determined by subtracting, from the denied amount, the total of all amounts previously deducted under paragraph 20(1)(zz) or under any other provision of the Act. The second amount under subparagraph 20(1)(zz)(ii) is the unused dual inclusion income.

A deduction under paragraph 20(1)(zz) could be relevant, for example, where a taxpayer lacks dual inclusion income because the taxpayer's business is in a start-up or high growth phase. In this case, paragraph 20(1)(zz) may be used to reinstate a denied amount in a subsequent year when the taxpayer demonstrates it has dual inclusion income.

New paragraphs 18.4(8)(b) to (d) contain additional "no double counting" rules that apply to the determination of dual inclusion income and investor dual inclusion income, which may limit the availability of such amounts for use in determining an amount deductible under paragraph 20(1)(zz) or (aaa). For more information, see the commentary on subsection 18.4(8).

Where paragraph 20(1)(zz) applies, new subsection 20(31) ensures the deduction under that paragraph takes the character of the payment that gave rise to the denied amount, by deeming the deduction under paragraph 20(1)(zz) to be in respect of the payment. For more information, see the commentary on subsection 20(31).

Paragraph 20(1)(zz) applies in respect of payments arising on or after July 1, 2026.

Adjustment for hybrid mismatch — investor dual inclusion income

ITA
20(1)(aaa)

New paragraph 20(1)(aaa) is introduced to provide a similar rule to new paragraph 20(1)(zz), but which applies where a taxpayer has an income inclusion for a taxation year under subsection 12.7(4) (which has essentially the same effect as a denial of a deduction under subsection 18.4(4)) and can demonstrate it has investor dual inclusion income for a subsequent taxation year. In that case, paragraph 20(1)(aaa) allows the taxpayer a deduction for the subsequent year that effectively reverses the income inclusion in the prior year.

Paragraph 20(1)(aaa) applies in respect of payments arising on or after July 1, 2026.

Character — adjustment for hybrid mismatch

ITA
20(31)

The existing deeming rule, contained in subparagraph 20(1)(yy)(ii), is moved to new subsection 20(31) and expanded to also apply to amounts that are deductible under new paragraphs 20(1)(zz) and (aaa). This new subsection ensures that any amounts that are deductible under paragraph 20(1)(yy), (zz) or (aaa) take the character of the payment that previously gave rise to the denial of the deduction under subsection 18.4(4) or the income inclusion under subsection 12.7(4). Thus, if the payment in question is treated as interest for Canadian income tax purposes, for example, an amount that is deductible in respect of the payment under paragraph 20(1)(yy), (zz) or (aaa) is subject to any other restrictions in the Act that apply in respect of deductions for interest expense, such as the thin capitalization rules and the excessive interest and financing expenses limitation.

Subsection 20(31) applies in respect of payments arising on or after July 1, 2026.

Clause 5

Hybrid mismatch arrangements — deemed dividend

ITA
214(18)

Subsection 214(18) deems certain amounts of interest paid or credited by a corporation resident in Canada that are not deductible because of the hybrid mismatch rule in subsection 18.4(4) to be a dividend and not interest for the purposes of Part XIII of the Act. This rule is analogous to paragraph 214(16)(a) in the thin capitalization context.

Consequential on the expansion of the hybrid mismatch rules to include additional categories of hybrid mismatch arrangement (involving reverse hybrid entities or hybrid entities), which are not inherently equity substitutes, this subsection is amended to carve payments arising under those additional hybrid mismatch arrangements out of the scope of this deemed dividend treatment.

These amendments apply in respect of payments arising on or after July 1, 2026.