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# Tax Alert – Canada

## Proposed hybrid mismatch arrangement rules

EY Tax Alerts cover significant tax news, developments and changes in legislation that affect Canadian businesses. They act as technical summaries to keep you on top of the latest tax issues. For more information, please contact your EY advisor or EY Law advisor.

On 29 January 2026, the Department of Finance released two packages of draft legislative proposals for public comment. The proposals implement certain measures announced in the 2025 federal budget, as well as other previously announced measures and new technical amendments, including the much-anticipated second package of hybrid mismatch arrangement rules.<sup>1</sup>

In this Tax Alert, we provide an overview of certain proposals outlined in the second package of hybrid mismatch rules, which is intended to implement the recommendations of the report under Action 2 of the OECD/G20 Base Erosion and Profit Shifting project, titled *Neutralising the Effects of Hybrid Mismatch Arrangements* (BEPS Action 2 Report).

On 29 April 2022, the Department of Finance released draft legislative proposals and accompanying explanatory notes to address certain so-called “hybrid mismatch arrangements,” which are described as “cross-border arrangements that exploit differences in the income tax treatment of business entities or financial instruments under the laws of two or more countries that produce mismatches in tax results.”

The initial hybrid mismatch rules addressed only deduction/non-inclusion mismatches (D/NI Mismatches) arising under three types of hybrid arrangements: hybrid financial instruments arrangements, hybrid transfer arrangements and substitute payment arrangements. The first package of the rules, which generally apply after 30 June 2022, largely implemented the recommendations made in Chapters 1 and 2 of the BEPS Action 2 Report.

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<sup>1</sup> For more information on the other measures released in the two packages of draft legislative proposals, see [EY Tax Alert 2026 Issue No. 5, Draft legislative proposals released for Budget 2025 and other previously announced measures](#).



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The second package of draft legislative proposals is generally intended to implement the balance of the recommendations in Chapters 3, 4 and 6 to 8 of the BEPS Action 2 Report – namely, to address D/NI Mismatches and double-deduction mismatches arising as a result of entity hybridity as well as imported hybrid mismatches.

The draft legislative proposals also make certain technical amendments to existing hybrid mismatch rules.

The proposed measures generally apply to payments arising on or after 1 July 2026. Interested parties are invited to provide comments on the proposed amendments by 27 February 2026.

## **New types of hybrid mismatch arrangements**

### **Reverse hybrid arrangements**

The first type of new hybrid mismatch arrangement included in the proposed rules is the so-called reverse hybrid arrangement. Proposed subsection 18.4(15.1) of the *Income Tax Act* (the Act) sets out the conditions to determine whether a payment arises under a reverse hybrid arrangement, with proposed subsection 18.4(15.2) setting out the consequences.

Very generally, and consistent with the BEPS Action 2 Report, this rule is intended to target a deductible payment made to a reverse hybrid entity (as defined in proposed subsection 18.4(1)) that gives rise to a D/NI Mismatch, and where the mismatch would not arise if the payment were made directly to each entity that held a direct equity interest in the reverse hybrid entity (the hypothetical payment) and such hypothetical payment would also not give rise to a hybrid financial instrument mismatch, hybrid transfer mismatch or substitute payment mismatch amount.

More specifically, under proposed subsection 18.4(15.1), a payment arises under a reverse hybrid arrangement if all of the conditions outlined in (a) to (d) below are satisfied:

- (a) The payment is made to a reverse hybrid entity. A *reverse hybrid entity* is defined as an entity that is treated as fiscally transparent in a country but fiscally opaque in the jurisdiction in which an equity holder is resident;
- (b) Either a payer of the payment does not deal at arm's length with the reverse hybrid entity, or the payment arises under, or in connection with, a structured arrangement (defined in subsection 18.4(1));
- (c) The payment gives rise to a D/NI Mismatch; and

- (d) The mismatch is due to “hybridity.” In general, a mismatch is considered to satisfy the hybridity condition if it would not have arisen in the hypothetical payment scenario noted above. Specifically, the hybridity condition is met when the amount determined for variable A in the formula in proposed paragraph (d) is greater than the amount determined for variable B. Variable A is equal to the D/NI Mismatch arising from the payment, and Variable B is equal to the D/NI Mismatch that would have arisen if the hypothetical payment had been made directly to each investor in the reverse hybrid entity.

In addition, the final condition can also be met if the hypothetical payment would result in a hybrid financial instrument, hybrid transfer or substitute payment mismatch amount. In other words, the insertion of a reverse hybrid entity should not prevent those hybrid mismatch rules from applying.

If all of the conditions in proposed subsection 18.4(15.1) are satisfied such that a payment arises under a reverse hybrid arrangement, proposed subsection 18.4(15.2) provides that:

- (a) The amount of the reverse hybrid mismatch, in respect of the payment, is generally the amount by which the amount determined for Variable A in the formula in proposed paragraph 18.4(15.1)(d) (see discussion above) exceeds the amount determined for Variable B in that formula.

In essence, the amount of the reverse hybrid mismatch is the difference between the D/NI Mismatch in respect of the actual payment and the total of all amounts each of which is the D/NI Mismatch that would have arisen if the payment had been made directly to each investor, and which would not be the amount of a hybrid financial instrument, hybrid transfer or substitute payment mismatch.

- (b) The deduction component, if any, of the D/NI Mismatch is the deduction component of the reverse hybrid arrangement.

The consequence is that paragraph 18.4(3)(b) would then apply, resulting in subsection 18.4(4) denying a deduction in respect of the payment to the extent of the reverse hybrid mismatch amount. The purpose of proposed subsection 18.4(15.2) is to link proposed subsection 18.4(15.1) to the operative rule in subsection 18.4(4), ensuring that the operative rule applies to restrict the amount otherwise deductible under Part I of the Act in respect of a payment arising under a reverse hybrid arrangement.

### **Disregarded payment arrangements**

Proposed subsection 18.4(15.3) sets out the conditions for determining if a payment arises under a disregarded payment arrangement, the second category of new hybrid mismatch arrangements in the proposed rules.

Where a payment is considered to arise under a disregarded payment arrangement, proposed subsection 18.4(15.4) applies and 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 D/NI Mismatch amount satisfying the causal test exceeds the dual inclusion income of the hybrid entity.

Following the recommendations in Chapter 3 of the BEPS Action 2 Report, the proposed rules intend to target a payment to a hybrid entity resulting in a D/NI Mismatch because the payment is disregarded under the income tax laws of the country in which the recipient is resident.

Under proposed subsection 18.4(15.3), a payment arises under a disregarded payment arrangement if the following conditions are met:

- (a) A payer of the payment is a hybrid entity;
- (b) A payer of the payment does not deal at arm's length with the recipient of the payment or the payment is made as part of a structured arrangement;
- (c) The payment gives rise to a D/NI Mismatch; and
- (d) It can reasonably be considered that the D/NI Mismatch arises in whole or in part because the payment is disregarded under the income tax laws of the country in which the recipient is resident (the hybridity condition).

Similar to the test used in determining the hybridity condition in subparagraph 18.4(10)(d)(i) for hybrid financial instrument arrangements, the hybridity condition for a disregarded payment arrangement may also be satisfied if it would be so satisfied if any other reason for the D/NI Mismatch were disregarded, i.e., if the same D/NI Mismatch outcome would result if all other causes of the mismatch (e.g., the tax-exempt status of the recipient) were absent, the hybridity condition is met.

The term "hybrid entity" is defined in proposed subsection 18.4(1) to mean an entity (i) that is resident in a country, and (ii) any portion of the income, profits, expenses or losses of which is treated as income, profits, expenses or losses of another entity that is resident in another country under the laws of that other country (i.e., fiscally opaque in one country and treated as fiscally transparent in a second country).

If all of the conditions in proposed subsection 18.4(15.3) are satisfied such that a payment arises under a disregarded payment arrangement, proposed subsection 18.4(15.4) provides that:

- (a) The amount of the disregarded payment mismatch for a taxation year is equal to the portion of the amount of the D/NI Mismatch arising from the payment that meets the hybridity conditions and is attributable to the taxation year, and not already neutralized under another of the hybrid mismatch rules (i.e., hybrid financial instrument mismatch, hybrid transfer mismatch, substitute payment mismatch or reverse hybrid mismatch) and not offset by an amount of dual inclusion income or investor dual inclusion income;

- (b) The deduction component, if any, of the D/NI Mismatch is the deduction component of the disregarded payment arrangement in respect of the payment; and
- (c) The foreign deduction component, if any, of the D/NI Mismatch is the foreign deduction component of the disregarded payment arrangement in respect of the payment.

“Investor,” in a hybrid entity, is a new term included in proposed subsection 18.4(1) and means a particular entity:

- ▶ That directly or indirectly holds an equity interest in the hybrid entity; and
- ▶ Treats the hybrid entity’s income, profits, expenses or losses (or, if any such amounts existed, would treat such an amount) as the particular entity’s own income, profit, expenses or losses, under the tax laws of the jurisdiction in which the particular entity is resident.

In the case of a deduction component of the D/NI Mismatch, the consequence is that conditions in proposed paragraph 18.4(3)(b) should be satisfied, resulting in subsection 18.4(4) denying a Canadian deduction in respect of the payment to the extent of the hybrid mismatch amount in respect of the payment.

Conversely, in the case of a foreign deduction component of the D/NI Mismatch, the conditions in subsection 12.7(2) should be satisfied, resulting in subsection 12.7(3) requiring an inclusion in Canadian taxable income of an amount equal to the hybrid mismatch amount in respect of the payment.

### **Hybrid payer arrangements**

The third category of new hybrid mismatch arrangement in the proposed rules is the so-called hybrid payer arrangement. Proposed subsection 18.4(15.5) sets out the conditions for determining if a payment arises under a hybrid payer arrangement.

Where a payment is considered to arise under a hybrid payer arrangement, proposed subsection 18.4(15.6) determines the amount of the hybrid payer mismatch and ensures subsection 18.4(4) applies only to the extent the double deduction mismatch amount exceeds the hybrid payer’s dual inclusion income. When the hybrid entity is a partnership, proposed subsection 18.4(15.7) determines the investor hybrid payer mismatch amount and ensures that proposed subsection 12.7(4) applies to generate 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. Following the recommendations in Chapters 6 and 7 of the BEPS Action 2 Report, the proposed rules intend to target a payment made by a hybrid entity that results in a double deduction mismatch.

Under proposed subsection 18.4(15.5), there is a payment under a hybrid payer arrangement if the following conditions are met:

- (a) A payer of the payment is a hybrid entity;
- (b) In the case of a hybrid payer that is a hybrid entity resident in Canada, (i) the hybrid entity does not deal at arm's length with an investor in the hybrid entity or the payment is made as part of a structured arrangement, and (ii) no foreign hybrid payer mismatch rule applies, in respect of the payment, in computing the relevant foreign income or profits of at least one investor in the hybrid entity;
- (c) In the case of a hybrid payer that is a multinational entity resident in a country other than Canada, no foreign hybrid payer mismatch rule of that country applies, in respect of the payment, in computing the multinational entity's relevant foreign income or profits, for a foreign taxation year; and
- (d) The payment gives rise to a double deduction mismatch.

Unlike the other types of hybrid mismatch arrangements in section 18.4, the conditions for a hybrid payer arrangement do not include an explicit hybridity condition. However, the amount of the hybrid payer mismatch or the investor hybrid payer amount is reduced by any applicable dual inclusion income or investor dual inclusion income.

The proposed legislation adds the following definitions in subsection 18.4(1) that are relevant to a hybrid payer arrangement:

- ▶ "Hybrid payer" is defined as a payer that is a dual resident, a hybrid entity or a multinational entity, each of which is also defined in the legislative proposals.
- ▶ "Foreign hybrid payer mismatch" is defined as a foreign hybrid mismatch rule 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.
- ▶ "Multinational entity" is defined as an entity that is resident in a particular country and operates through a permanent establishment in another country; the term "permanent establishment" takes its meaning from either the tax treaty between those two countries or from section 8201 of the *Income Tax Regulations* if there is no tax treaty defining "permanent establishment."

### **Imported mismatch arrangements**

The fourth category of new hybrid mismatch arrangements in the proposed rules is the imported mismatch arrangements.

These rules, contained in proposed subsections 18.4(15.8) to (15.94), target arrangements where there is a sufficient link between a deductible payment made by a Canadian entity (the importing payment) to a non-arm's length nonresident (or under a structured arrangement) where there is a deducting entity involved in an offshore hybrid mismatch.

Pursuant to proposed subsection 18.4(15.8), an offshore hybrid mismatch is essentially a D/NI Mismatch or double deduction mismatch that would arise if the Canadian hybrid mismatch rules applied between two nonresidents.

Thus, the first step is to determine whether an offshore mismatch exists, which involves hypothetically applying the Canadian hybrid mismatch rules to offshore payments. If an offshore mismatch exists, the second step is to determine the offshore hybrid mismatch amount under proposed subsection 18.4(15.9), which is essentially the amount of the equivalent mismatch that would arise if the Canadian rules applied directly. The third step is to determine whether a payment arises under an imported hybrid mismatch arrangement in respect of the offshore hybrid mismatch amount under proposed subsection 18.4(15.92), which essentially involves testing whether there is a sufficient link between the Canadian deduction and the offshore hybrid mismatch. This step generally involves identifying an uninterrupted chain of payments and receipts that are part of the same series as the importing payment. The final step is to compute the imported hybrid mismatch amount under proposed subsection 18.4(15.94).

However, to the extent that the offshore mismatch is substantially neutralized by a foreign hybrid mismatch rule, then it should not constitute an offshore mismatch. Accordingly, the imported hybrid mismatch rule should only apply in cases where a payment would create a mismatch between foreign countries that is not neutralized by a foreign hybrid mismatch rule.

If the imported hybrid mismatch rules applies, proposed paragraph 18.4(15.95)(a) provides the consequences of an imported hybrid mismatch by deeming subsection 18.4(4) to apply in respect of the importing payment. Therefore, the usual conditions for the application of subsection 18.4(4), which are contained in subsection 18.4(3), need not be met, and proposed paragraph 18.4(15.95)(b) deems the amount of the imported hybrid mismatch to be a hybrid mismatch amount for the year in order to adapt it to subsection 18.4(4), which then denies the deduction of the importing payment to the extent of the amount of the imported hybrid mismatch.

## **Other amendments**

### **Dual inclusion income**

The concepts of dual inclusion income and investor dual inclusion income are relevant to both the disregarded payment arrangement and hybrid payer arrangement rules. In general, dual inclusion income or investor dual inclusion income will reduce the amount of a disregarded payment mismatch or hybrid payer mismatch.

## **Part XIII withholding tax**

Subsection 214(18) deems any interest that is not deductible because of the current hybrid mismatch rules to be a dividend and not interest for the purposes of Part XIII of the Act.

Subsection 214(18) is also proposed to be amended such that the deeming rule may also apply to interest paid or credited by a partnership and interest that is imputed under proposed subsection 12.7(4) (in particular, related to an investor hybrid payer mismatch amount as discussed above).

In addition, proposed paragraph 214(18)(b) provides that the deeming rule does not apply to an amount that (i) arises under a hybrid payer arrangement, and (ii) is paid to a nonresident person dealing at arm's length with the payor corporation or partnership and that is not a party to a structured arrangement. This change is consistent with the recommendations in the BEPS Action 2 Report.

## **Anti-avoidance rule**

As a result of the introduction of reverse hybrid arrangements, disregarded payment arrangements and hybrid payer arrangements in the proposed hybrid mismatch rules, the specific anti-avoidance rule in subsection 18.4(20) is also proposed to be amended as follows:

- ▶ The scope of the rule is expanded to also deny a tax benefit to the extent necessary to eliminate a double deduction mismatch, or "other outcome that is substantially similar," arising from a payment;
- ▶ Proposed subsection 12.7(4) is included as one of the rules for the avoidance test described in proposed paragraph 18.4(20)(a); and
- ▶ A list of conditions is added in proposed paragraph 18.4(20)(b), which are intended to capture hybrid mismatch arrangements that have the listed essential characteristics, as informed by the BEPS Action 2 Report, notwithstanding that one or more of the precise technical requirements of the rules is not met.

## **Proposed amendment to definition of "hybrid mismatch amount" in subsection 18.4(1)**

As a result of the proposed expansion of the hybrid mismatch rules to include additional hybrid mismatch arrangements, the definition of "hybrid mismatch amount" is proposed to be amended to include the amount of a reverse hybrid mismatch, the amount of a disregarded payment mismatch and the amount of the hybrid payer mismatch in respect of a payment.

This amendment ensures that the operative rules (generally in subsections 12.7(3), (4) and 18.4(4)) will now apply to reverse hybrid arrangements, disregarded payment arrangements and hybrid payer arrangements (each of which is discussed above in more detail).

## **Amendment to D/NI Mismatch**

Subsection 18.4(6) sets out the conditions for a payment to give rise to a D/NI Mismatch. The proposed amendment to subsection 18.4(6) clarifies that the hybrid mismatch rules are expected to apply on a year-by-year basis. In particular, paragraph 18.4(6)(a) is amended to clarify that a payment gives rise to a D/NI 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. Paragraph 18.4(6)(b) is also proposed to be similarly amended.

This proposed amendment (along with similar proposed amendments to other provisions in the hybrid mismatch rules) is largely intended to be clarifying.

## **Next steps**

As previously noted, the consultation period ends on 27 February 2026; accordingly, additional amendments could be made to the legislative proposals by the Department of Finance in the next few months. We will be monitoring any further developments to these rules as they make their way through the legislative process.

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