Debt or Equity? The Characterization of Hybrid Financial Instruments Under the Jurisprudence of Barejo Holdings v. C (2021 FCA) for Canadian tax purposes

Dívida ou patrimônio? A caracterização de instrumentos financeiros híbridos sob a jurisprudência de Barejo Holdings v. C (2021 FCA) para fins fiscais canadenses

¿Deuda o capital? La caracterización de los instrumentos financieros híbridos según la jurisprudencia de Barejo Holdings v. C (2021 FCA) para fines fiscales canadienses

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Abstract

Financial innovation concerns basic derivatives (i.e., forward, futures, options and swaps), but there is no reason for it to be so confined. Essentially, the term derivatives subsumes all hybrids and synthetic instruments or arrangements; often, if not usually, they will be some combination of a primary asset or obligation (i.e., debt and equity) with one or a combination of the four main "derivatives." The Canadian courts have established that the hybrid financial instrument should be characterized for tax purposes as debt one or equity, based on the substance of the transaction. In this context, the Canadian Courts in *Barejo* provide the test for determining whether a hybrid financial instrument is a debt for income tax purposes.

Keywords: Financial innovation, derivatives, hybrid financial instruments, synthetic instruments, debt-equity hybrids, Canadian income tax system, tax characterization, Income Tax Act (ITA), substance-over-form, Barejo Holdings ULC v. Canada, hybrid mismatch arrangements, OECD Hybrids Report, tax arbitrage, debt classification, equity classification, cross-border transactions, section 94.1 ITA, subsections 18.4(10) and (11), common shares, preferred shares, Canada Deposit Insurance Corp. v. Canadian Commercial Bank, tax deductibility, economic substance, capital-raising transactions, transfer pricing, withholding tax, financial instrument jurisprudence.

Resumo

A inovação financeira diz respeito aos derivativos básicos (ou seja, contratos a termo, futuros, opções e swaps), mas não há motivo para que se restrinja apenas a eles. Essencialmente, o termo "derivativos" engloba todos os instrumentos ou arranjos híbridos e sintéticos; frequentemente, se não geralmente, consistem em alguma combinação de um ativo ou obrigação principal (ou seja, dívida e capital próprio) com um ou mais dos quatro principais derivativos. Os tribunais canadenses estabeleceram que o instrumento financeiro híbrido deve ser caracterizado, para fins fiscais, como dívida ou capital, com base na substância da transação. Nesse contexto, os tribunais canadenses, no caso Barejo, fornecem o teste para determinar se um instrumento financeiro híbrido constitui dívida para fins de imposto de renda.

Palavras-chave: inovação financeira, derivativos, instrumentos financeiros híbridos, instrumentos sintéticos, híbridos de dívida e capital, sistema canadense de imposto de renda, caracterização fiscal, Lei do Imposto de Renda (ITA), primazia da substância sobre a forma, *Barejo Holdings ULC v. Canada*, arranjos híbridos incompatíveis, Relatório da OCDE sobre híbridos, arbitragem fiscal, classificação de dívida, classificação de capital, transações transfronteiriças, seção 94.1 da ITA, subseções 18.4(10) e (11), ações ordinárias, ações preferenciais, *Canada Deposit Insurance Corp. v. Canadian*

Commercial Bank, dedutibilidade fiscal, substância econômica, transações de captação de recursos, preços de transferência, imposto retido na fonte, jurisprudência sobre instrumentos financeiros.

Resumen

La innovación financiera abarca los derivados básicos (es decir, *forwards*, futuros, opciones y swaps), pero no hay razón para que se limite únicamente a ellos. Esencialmente, el término "derivados" incluye todos los instrumentos o arreglos híbridos y sintéticos; a menudo, si no es que usualmente, consisten en alguna combinación de un activo u obligación principal (es decir, deuda y capital) con uno o más de los cuatro derivados principales. Los tribunales canadienses han establecido que los instrumentos financieros híbridos deben caracterizarse, para fines fiscales, como deuda o capital, según la sustancia de la transacción. En este contexto, los tribunales canadienses, en el caso Barejo, proporcionan el criterio para determinar si un instrumento financiero híbrido constituye deuda para efectos del impuesto sobre la renta.

Palabras clave: innovación financiera, derivados, instrumentos financieros híbridos, instrumentos sintéticos, híbridos de deuda y capital, sistema canadiense de impuesto sobre la renta, caracterización fiscal, Ley del Impuesto sobre la Renta (ITA), prevalencia de la sustancia sobre la forma, *Barejo Holdings ULC v. Canada*, mecanismos híbridos desajustados, Informe de la OCDE sobre instrumentos híbridos, arbitraje fiscal, clasificación de deuda, clasificación de capital, transacciones transfronterizas, sección 94.1 de la ITA, subsecciones 18.4(10) y (11), acciones ordinarias, acciones preferentes, *Canada Deposit Insurance Corp. v. Canadian Commercial Bank*, deducibilidad fiscal, sustancia económica, transacciones para la obtención de capital, precios de transferencia, impuesto de retención, jurisprudencia sobre instrumentos financieros.

Introduction

The Canadian income tax system is grounded in several fundamental fiscal concepts that, essentially, are applied to describe the elements and consequences of financial activity. However, essential aspects of financial activity seem to exist apart from or despite those concepts. Moreover, financial innovation in the international marketplace generates changes in the form and nature of financial flows that call into question the utility, adequacy, and relevance of traditional tax policy norms and their statutory manifestations.[1]

1 J. Scott Wilkie. (1995). "Looking Forward into the Past: Financial Innovation and the Basic Limits of Income Taxation". *Canadian Tax Journal, 43*(5), 1144-1166 [*Looking Forward into the Past: Financial Innovation and the Basic Limits of Income Taxation*].

From the financial instrument perspective, the basics of the Canadian tax system's architecture distinguish between indebtedness and equity.[2] The term financial instrument comprises any "evidence of the legal relationship arising from the provision of money, property, or a promise to pay money or property by one person to another in consideration for a promise by the other person to provide money or property at some future time or times or upon the occurrence or non-occurrence of some future event of events."[3] From the tax policy perspective, the core of this classification is the category of "basic building block financial instruments," which include both "financing transactions" or "capital-raising transactions" and "financial instruments." The raising capital transactions traditionally include standard forms of debt obligations, issues of shares by corporations, and leasing transactions. The term financial instruments (also "financial products" and "financial arrangements") tend to be equated with forwards, futures, swaps, and the option of contracts, which are referred to as "derivatives" given that their value derives from, or based on, some specified assets or financial index.[4]

The concept of "financial innovation" is the design of new financial instruments by combining these building-block instruments. Indeed, financial innovation is concerned with basic derivatives (i.e., forward, futures, options and swaps), but there is no reason for it to be so confined.[5] Essentially, the term derivatives subsumes all hybrids and synthetic instruments or arrangements; often, if not usually, they will be some combination of a primary asset or obligation with one or a combination of the four main "derivatives."[6] Therefore, it is feasible to develop hybrid financial instruments such as debt-equity hybrids under financial innovation because they have legal rights and obligations commonly associated with debt and equity instruments.

As a result, there are tax arbitrage opportunities under hybrid instrument arrangements, given that there are material differences in the treatment of their returns.[7] Typically, the return owing to a debtholder is deductible, while the return paid by an issuer to an equity holder is non-deductible. In contrast, from the holder's perspective, the return on equity typically enjoys tax advantages relative to the return on debt.[8] Ideally, in a cross-border transaction, the paying jurisdiction treats the investment as a debt claim, the interest on

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2 Ibid.

3 Tim Edgar. (2000). The Income Tax Treatment of Financial Instruments: Theory and Practice. In Canadian tax Paper No. 105 (Canadian Tax Foundation, 2000) [*The Income Tax Treatment of Financial Instruments*].

4 Ibid.

5 Ibid.

6 Looking Forward into the Past: Financial Innovation and the Basic Limits of Income Taxation, supra note 1.

7 Charles Taylor. (2006). Hybrid Instruments and Linked Instruments, in Report of Proceedings of Fifty-Seventh Tax Conference, 2005 Conference Report (Canadian Tax Foundation), 16:1-12 [*Hybrid Instruments and Linked Instruments*].

8 Ibid.

which is deductible, while the receiving jurisdiction accords the investment equity treatment.[9] This concern has been addressed by the Organization for Economic Cooperation and Development (OECD) in the Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2—2015 Final Report ("the Hybrids Report"), published by the OECD on October 5, 2015.[10]

Hence, classifying a hybrid instrument as debt or equity significantly allocates taxing rights.[11] In this sense, although a hybrid financial instrument may have debt and equity characteristics, the Canadian courts have established that financial instruments should be characterized for tax purposes as either one or the other, based on "the substance or main thrust" of the transaction.[12] In a recent decision, the Canadian courts in *Barejo Holdings ULC v. Canada* (2020)[13] guided in determining whether hybrid security may be characterized as equity or debt.[14] However, it is essential to highlight that the courts in *Barejo* analyzed the characteristics of debt for purposes of section 94.1 of the Income Tax Act (ITA).

Therefore, in this paper, I will analyze the essential elements in the Jurisprudence of *Barejo* to determine where a hybrid financial instrument would be characterized as a debt for Canadian tax purposes. Accordingly, I attempt to answer the following questions: Given that a hybrid financial instrument has elements of equity and debt, and the Canadian courts have established that financial instruments should be characterized for tax purposes as either one or the other, based on "the substance or main thrust" of the transaction, which are the essential characteristics to determine when a hybrid instrument would be characterized as a debt for Canadian tax purposes under the recently on Jurisprudence of Barejo? In this paper, I argue that such essential elements are the following: (i) an amount or credit is advanced by one party to another party; (ii) an amount is to be paid or repaid by that other at some point in the future in satisfaction of the advance; and (iii) this amount to be paid or repaid is fixed or determinable or will be ascertainable when payment is due.

In Barejo, the Court decided on the context for the debt/equity examination by analyzing the substantive section 94.1 and other specific rules of the ITA. In this sense,

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9 Ibid.

10 OECD. (2015). Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. [*(OECD) Neutralising the Effects of Hybrid Mismatch Arrangements*].

11 Bev Dahlby and Tim Edgar". Current Tax Reading" (13). *Canadian Tax Journal, 61*(2), 541-562. [Current Tax Reading].

12 Canada Deposit Insurance Corp. v. Canadian Commercial Bank. (1992). 3 SCR at paragraph 66 [*Canada Deposit Insurance Corp. v. Canadian Commercial Bank*].

13 Barejo Holdings ULC v. Canada [2020] 4 CTC 38 (FCA) [*Barejo*].

14 Byron S. Beswick, & Michael Dolson. (2020). International Tax for Owner-Managers. In *2020 Definitive Guide to Owner-Manager Taxation Virtual Conference* (Canadian Tax Foundation, 2020), 10: 1-121 [*International Tax for Owner-Managers*].

more than the said decision is needed to address the tax policy concern regarding the mismatch of hybrid financial instruments' arrangements commonly found in cross-border transactions. Therefore, I will also analyze the proposed rules of Canada's new hybrid financial instrument arrangement of proposed subsections 18.4(10) and (11).

The roadmap of the paper is as follows: (i) building-Blocks financial instruments, (ii) financial innovation, (iii) common shares and preferred shares, (iv) rules for hybrid securities, (v) hybrid financial instruments, (vi) the hybrid instruments in the jurisprudence on Canada Deposit Insurance Corp. v. Canadian Commercial Bank, (vi) hybrid financial instruments as debts under the Jurisprudence on *Barejo,* (vii) Canada's New Hybrid Mismatch Rules.

Part I: Tax system architecture of financial instruments

1.1. The Basics: Building-Blocks Financial Instruments

The term financial instrument comprises any "evidence of the legal relationship arising from the provision of money, property, or a promise to pay money or property by one person to another in consideration for a promise by the other person to provide money or property at some future time or times or upon the occurrence or non-occurrence of some future event of events." The tax literature reduces this broad definition by making a distinction between "financing transactions" and "financial instruments."[15]

The financial transaction traditionally includes standard forms of debt obligations, issues of shares by corporations, and leasing transactions.[16] The term financial instruments (also "financial products" and "financial arrangements") tend to be equated with forwards, futures, swaps, and the option of contracts, which are collectively referred to as "derivatives" given that their value derives from, or based on, some specified assets or financial index. From the tax policy perspective, the core of this classification is the category of "basic building block financial instruments," which include both capital raising and derivative instruments.[17] This paper is focused on financing transactions and hybrid financial instruments with debt-equity features. The other forms of building-block instruments, such as forward, futures, options and swaps, are beyond the scope of this paper.

1.2. Financial Innovation

Broadly, a product, instrument, strategy, or arrangement is financially innovative when it permits the consequences of owning primary assets or assuming primary obligations to

15 The Income Tax Treatment of Financial Instruments, supra note 3.

16 Ibid.

17 Ibid.

be synthesized or simulated by determining the performance of those assets or liabilities without a direct connection by a taxpayer to them.[18] As such, the concept of "financial innovation" is the design of new financial instruments by combining the building-block instruments (i.e., both capital raising and derivative instruments).[19]

Therefore, financial innovation is concerned with basic derivatives (e.g., forwards, futures, options, and swaps), but there is no reason for it to be so confined. Essentially, the term derivatives subsume all hybrids and synthetic instruments or arrangements; often, if not usually, they will be some combination of a primary asset or obligation (e.g., debt and equity) with one or a combination of the four main "derivatives."[20]

The distinction between the basic building-block instruments and the newer instruments that are the product of the process of financial innovation captures roughly the aspect of this process that causes difficulty for income tax systems based on traditional concepts and principles.[21] In essence, developing innovative financial instruments involves reallocating risk by repackaging the cash flows associated with the basic instruments in an unconventional manner. For tax purposes, the result is often the conversion of a cash flow with a known tax treatment into a cash flow for which the appropriate treatment into cash flow for which the appropriate treatment is unknown.[22]

1.3. Financing transactions

1.3.1. Debt and Equity

The Canadian tax rules distinguish between indebtedness and equity in the financial area. The financial return (i.e., interests) on indebtedness is predictable and specific according to normative financial criteria, as they are taxed on a modified accrual basis. Generally, it is expected to have a quality of income only upon the passage of time limits on its taxation.[23] On the other hand, the financial return associated with equity is less specific, given that there is no assurance of earnings or their distribution. Moreover, the primary form of equity implies the possibility of shifting in value, resulting in gain or loss in respect of invested capital.[24]

In that context, all corporate securities may be categorized as "classical debt," "classical equity," or a combination of both, known as "hybrid securities." Each type of security

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18 Looking Forward into the Past: Financial Innovation and the Basic Limits of Income Taxation, supra note 1.

19 Ibid.

20 Looking Forward into the Past: Financial Innovation and the Basic Limits of Income Taxation, supra note 1.

21 The Income Tax Treatment of Financial Instruments, supra note 3.

22 Ibid.

23 Looking Forward into the Past: Financial Innovation and the Basic Limits of Income Taxation, supra note 1.

24 Ibid.

contains certain rights and obligations that reflect a different allocation among investors of the right to participate in corporate profits, the risk of loss, and the power of control.[25]

Investors holding classical debt obligations enjoy the right to fixed interest payments and some assurance of a return on their capital contributions. Investors holding classical equity stock enjoy an unlimited right to participate in corporate profits and voting rights concerning specific corporate affairs; however, they must specifically bear a greater risk than debt investors that a return on the investment will not be realized and the original capital contribution will be lost. "Hybrid securities combine various rights and obligations in a manner that affects an allocation of corporate profits, loss exposure, and control between the two classical extremes. Examples of hybrid securities include preferred shares, income bonds, debt convertible into equity, and debt with profit participation rights beyond a fixed amount of interest."[26]

Under the Income Tax Act (ITA), the tax treatment of debt obligations differs from that of equity stock. Moreover, all corporate securities are one or the other. The differences have prompted tax planners to devise corporate securities that attract a desired tax treatment without sacrificing specific corporate finance goals. Hybrid securities have proven valuable vehicles for realizing these planning goals.[27]

1.3.2. Common shares

One of the basic forms of financial instruments is shares. Shares are the link between the shareholders and the corporations. They measure the shareholder's interest and, in some cases, the extent of the shareholder´s liability for corporate actions.[28]

The ITA defines common and preferred shares in subsection 248 (1). A common share is defined as "a share the holder which is not precluded under reduction or redemption of the capitalist stock from participating in the corporation's assets beyond the amount paid up on that share and a defined rate of dividend." A preferred share is "a share other than a common share."[29]

While a share represents all the shareholder´s rights in a corporation, a dividend is a distribution by the corporation to the shareholder by those rights. The corporation might pay the distribution in cash by transferring other corporation assets or by issuing further shares in the corporation. Depending on the applicable corporate law, a dividend would be

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25 Tim Edgar. (1990). "The Classification of Corporate Securities for Income Tax Purposes". *Canadian Tax Journal, 38*(5), 1141-1188 [The Classification of Corporate Securities for Income Tax Purposes].

26 Ibid.

27 Ibid.

28 Ibid, at p. 1:14.

29 Rachel Gervais, John Sorensen, David Steven, and Walsh Dave. (2020). Taxation of Private Corporations and Their Shareholders, 5th ed. (Canadian Tax Foundation) [*Taxation of Private Corporations and Their Shareholders*], at p. 3:3.

paid out of profits, capital, or otherwise. Since shares do not represent loans by the shareholders to a corporation, a dividend does not constitute the repayment of a debt or interest on a debt. Debt is a liquidated demand for money; interest is compensation for using the money, which forms the subject matter of the demand.[30]

One of the rights typically attached to a share is a right to a portion of the corporation's property when it is wound up or dissolved. For instance, a traditional common share typically carries with it the right to vote, the right to receive dividends, and the right to a portion of any residual property of the corporation on dissolution. However, modern corporate statutes allow nearly unlimited combinations of rights and restrictions to be attached to the shares. Therefore, for the purpose of the Act, common shares are defined solely concerning the right to the corporation of the corporation's surplus assets on dissolution. Then, to ensure no gaps in the definitions, preferred shares are defined simply as any share that is not commercial.[31]

1.3.3. Corporate debts

The other basic form of financial instrument is debt. For example, a corporation can be capitalized by debt. The terms of the debt can vary from situation to situation; for example, the debt may be either secure or insecure, with or without interest and payable either on demand or over a specified term; this assumes, of course, a minimum issued share capital. There is no definition or limitation on the use of debt for the Act's purpose other than the thin capitalization rules of subsection 18(4) and those sections that can, in limited circumstances, reduce the adjusted cost base (ACB) of debt or result in the imputation of interest.[32]

Capitalizing a corporation with debt makes it easier for investors to receive a return on their invested capital or repayment by the corporation without triggering a deemed dividend. A deemed dividend may be triggered when a corporation purchases or redeems its shares. The debt can be repaid, which is a non-taxable event for the individual who capitalizes on the corporation.[33]

When a shareholder borrows funds personally and loans these funds to a corporation, the deductibility that she has incurred generally depends on whether the loan is made for the purpose of earning income. Consequently, as long as there is no sham or other such transaction, the sufficiency of the income should not be at issue. Therefore, if interest is charged on the loan to the corporation, the interest incurred by the shareholders is generally deductible. Therefore, if interest is charged on the loan to the corporation, the interest

30 Ibid, at p. 1:15.

31 Ibid, at p. 1:16.

32 Ibid, at p. 3:4.

33 Ibid.

incurred by the shareholder is generally deductible.[34] Furthermore, when interest is not charged on the loan, but it can be demonstrated that the loan impacts the shareholder's income (e.g., by increasing the potential for dividends), the interest incurred by the shareholder is also generally deductible.[35]

1.3.4. Preferred shares

Numerous provisions of the ITA emphasize the significance of having common or preferred shares for income tax purposes. For example, subsection 85(1) allocates the ACB of property transferred to a corporation first to preferred shares and then, if the balance remains, to common shares.[36]

Before 1987, specific corporate borrowers and lenders began to reduce the after-tax cost of borrowing funds while increasing the after-tax return for lenders by converting interest payments that are deductible for a payer but included in the payee's income into non-deductible intercorporate dividends that may be received by a shareholder tax-free. As hybrid securities, preferred shares and income bonds were used to realize this result since, historically, they have been treated as equity for income tax purposes while providing a risk and return mix that contains some classical debt elements.[37] In 1978 and again in 1987, significant legislative measures discouraged what the Department of Finance regarded as abusive use of share capital to convert the taxable interest income of a shareholder into tax-free intercorporate dividends.[38]

The current preferred share rules were enacted as part of the 1987 tax reform package, which included amendments to the definitions of "term preferred shares" and "short-term preferred shares." In addition, a somewhat narrower definition of "specified financial institution" (SFI) was added to subsection 248(1) of the ITA. As such, the SFI includes banks, trust companies, credit unions, insurance corporations, corporations whose principal business is lending money to or purchasing debt obligations issued by arm's-length parties, and corporations controlled by or related to any of the preceding corporations.[39]

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34 Ensuring that interest is deductible on borrowed funds is often essential to capitalize a corporation. Generally, if a taxpayer does not fall within the purview of paragraph 20 (1)(c), the interest constitutes a non-deductible capital expense. Paragraph 20 (1)(c) states that to be deductible, interest must be paid or payable in respect of the taxation year in which it is sought to be deducted and must be paid under a legal obligation to pay interest on borrowed money. In addition, borrowing money must be used to earn non-exempt income from a business or property, and the amount of interest must be reasonable. Cited from Taxation of Private Corporations and Their Shareholders, supra note 30, at p. 3:41.

35 Taxation of Private Corporations and Their Shareholders, supra note 30, at p. 2:28.

36 Ibid.

37 The Classification of Corporate Securities for Income Tax Purposes, supra note 26.

38 Taxation of Private Corporations and Their Shareholders, supra note 30, at p. 3:5.

39 In addition, the concept of the restricted financial institution (RFI) was added by way of an amendment to subsection 248(1). Generally, a corporation that qualifies as an SFI is an RFI, except for those corporations that are

In addition to denying the intercorporate dividend deduction in respect of dividends that SFIs receive on term preferred shares and short-term preferred shares, the current preferred share rules may render an issuer that pays dividends on a taxable preferred share or a short-term preferred share subject to tax under part VI.1. In addition, specific recipients of dividends that are paid on a taxable preferred share may be required to pay tax under part IV.1.[40]

The Federal Court of Appeal held that the definition of a "preferred share" was designed to combat a particular activity that was prevalent between SFIs and corporations that could not utilize interest deductions.[41] As a result, the court refused to interpret the definition of " preferred share" more broadly than the commercial understanding of the parties that issued and received the shares to fit the shares within the definition.[42]

Although a term preferred share is not legally classified as a debt instrument, it typically contains such terms as an early maturity date or retraction privileges that are exercisable on specific dates before maturity, periodic adjustment of the interest rate, or, in some cases, a mandatory purchase or sinking fund; and restrictions on the issuance of senior or equal-ranking shares together with restrictions on the payment of dividends or the distribution of capital.[43]

These provisions give the share the appearance of a debt instrument. However, there is one critical difference between a term-preferred share and a standard debt instrument: the holders of term-preferred shares rank behind secured and unsecured creditors on a windup or liquidation of a debtor corporation.[44]

SFIs only by reason of the fact that they are either controlled by or related to another SFI. A corporation that RFI control is also an RFI, but the test for control is not as broad as that imposed in respect of SFIs to the extent that it is not necessary to consider shares that are held by parties that do not deal at arm's length with the RFI. Cited from Taxation of Private Corporations and Their Shareholders, supra note 30, at p. 3:6.

40 Ibid.

41 See Canada v. Citibank Canada 2002 FCA 128 [Canada v. Citibank Canada].

42 Ibid.

43 "In general terms, for the purposes of the current rules, a term preferred share is a share that is issued after November 16, 1978 and that can reasonably be regarded as a debt substitute. Any one of the following attributes results in a share's being regarded as a term preferred share: 1) The issuer or any other person can be required to redeem, acquire, or cancel the share, or to reduce its PUC, at any time. This catches a share that, by its terms or otherwise (for example, in a shareholders' agreement), is required to be redeemed or acquired on a fixed date. 2) The owner of the share can cause its redemption, acquisition, or cancellation, or can cause its PUC to be reduced at any time. This catches a share that is subject to retraction or put rights. A share that is redeemable at the option of an issuing corporation is not necessarily a term preferred share unless there is a reasonable expectation that the share will be redeemed. 3) The share is guaranteed by the issuing corporation or any other person. 4) The share is convertible, directly or indirectly, into debt or into a share that, if issued, would be a term preferred share. 5) The share is held by an SFI that controls the issuing corporation." Quoted from Taxation of Private Corporations and Their Shareholders, supra note 30, p. 3:5.

44 Taxation of Private Corporations and Their Shareholders, supra note 30, at p. 1:16-117.

Moreover, the CRA has issued technical interpretations addressing whether preferred securities are shares or debt. The subject of the first technical interpretation is whether interest payable on preferred shares is deductible. The CRA stated that the interest is not deductible because preferred shares are not debts and do not represent borrowed money. Accordingly, in the second technical interpretation, the CRA concluded that preferred shares are not bonds, debenture, notes or similar obligations for regulation 4900 (1)(h) because they are not debts.[45]

1.4. Hybrid Financial instruments

Hence, financial innovation has led to the development of debt-equity hybrid financial instruments, which are hybrids in the sense that they have legal rights and obligations commonly associated with debt and equity instruments.[46]

Hybrid instruments have been in existence for several centuries and take many forms. (e.g., certain classes of preference shares, convertible notes, capital-protected equity loans, profit-participating loans, perpetual debt, endowment warrants, equity swaps, and so on). Hybrid instruments continue to be developed because both issuers and holders have perceptions that these instruments embody certain advantages over traditional instruments concerning pricing/yield/cost, risk, insurance, hedging, control, gearing, cash flow conservation and flexibility, convertibility, diversification, optionality, and taxation—information asymmetry between managers within corporate structures on the one hand. On the other hand, outside investors, as the perceived scope for "convertible arbitrage" and domestic/foreign tax asymmetries may also be influential.[47]

From the tax policy point of view, the significance of financial innovation for the integrity of the tax system is accepted without the need to delve into specific aspects or examples of financial innovation.[48] However, the system depends on the ability to identify the nature of assets and obligations according to norms grounded in the most basic of taxation principles. Outside these limits, the system can become disoriented.[49] Indeed, tax analysis tools grounded in typical financial assets and liabilities lose much of their force when confronted with arrangements seemingly formulated outside traditional legal and financial bounds.[50]

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45 Ibid, at p.1:17.

46 Current Tax Reading, supra note 11.

47 Richard Wood. (1999). "The Taxation of Debt, Equity, and Hybrid Arrangements". *Canadian Tax Journal, 47*(1), 49-80 [*The Taxation of Debt, Equity, and Hybrid Arrangements]*.

48 Looking Forward into the Past: Financial Innovation and the Basic Limits of Income Taxation, supra note 1.

49 Ibid.

50 Ibid.

Therefore, when the tax system does not recognize an arrangement, there are two choices: the arrangement is outside the system entirely (a suspicious conclusion), or the limits of analysis and interpretation of the existing law must be stretched to achieve a result that is at least rational in its immediate context.[51]

Part II: Determining When a Hybrid Financial Instrument is a Debt Under the Canadian Tax Rules

2.1. Tax Policy Concern

Because there are significant differences in the treatment of the returns on different financial instruments, hybrid instruments generate tax arbitrage opportunities, such as hybrid mismatch arrangements.[52] Typically, the return paid by an issuer to an equity holder is non-deductible, while the return owing to a debtholder is deductible.[53] By contrast, from the holder's perspective, the return on equity typically enjoys tax advantages relative to the return on debt.[54] Ideally, in a cross-border transaction, the paying jurisdiction treats the investment as a debt claim, the interest on which is deductible. However, the receiving jurisdiction accords the investment equity treatment.[55]

Therefore, classifying a hybrid instrument as debt or equity has actual results for allocating taxing rights.[56] For example, depending on the taxpayer's status and circumstances, advantages can be gained by using hybrid instruments to selectively characterize returns as dividends or as interest, including structuring a debt-like instrument to yield frankable returns or an equity-like instrument to yield interest returns. Additionally, the uncertainty inherent in a "risky" (equity) instrument would be broken up using derivatives and reconstituted to form a "safe" (debt) instrument. Still, the tax treatments of the individual parts of such transactions must add to the treatment of the reconstituted whole.[57] These

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51 Ibid.

52 Hybrid Instruments and Linked Instruments, supra note 7.

53 Ibid.

54 Ibid.

55 Ibid.

56 Current Tax Reading, supra note 11.

57 Moreover, most hybrid instruments entail a capital amount (principal or issue value/price) and periodic payments. Both the capital amount and periodic payments could be either contingent or non-contingent. Thus, there are four combinations of returns, only one of which (non-contingent capital amount and non-contingent periodic payment) is clearly and unambiguously debt. However, at least two cases (contingent capital amount/non-contingent periodic return and non-contingent capital amount/contingent periodic return) are not unambiguously either debt or equity. Therefore, applying known debt and equity treatments to contingent and non-contingent cash flows/returns is not self-executing, creating taxpayer and investor uncertainty and involves a substantial discontinuity at the debt/equity borderline. Said debt/equity discontinuity ensures that a minor change in the terms/conditions/characteristics attaching to some hybrid financial arrangements would substantially change

developments have created additional potential for tax arbitrage and avoidance, inequity, administrative and policy complexity, and taxpayer uncertainty.[58]

Based on the above, the Hybrids Report by the OECD addresses the concern about hybrid mismatch arrangements. According to the OECD, hybrid mismatch arrangements exploit differences in the tax treatment of an entity or instrument under the laws of two or more tax jurisdictions to achieve double non-taxation, including long-term deferral. These common arrangements result in substantially eroding the taxable bases of the countries concerned, negatively impacting competition, efficiency, transparency, and fairness.[59]

Therefore, the report contains a set of recommendations regarding changes to domestic law and the OECD Model Tax Convention. According to the OECD, these recommendations will neutralize hybrid mismatches by ending multiple deductions for a single expense, deductions without corresponding taxation or the generation of multiple foreign tax credits for one amount of foreign tax paid.[60] Note that the Department of Finance released the Legislative Proposals Relating to the *ITA* — Hybrid Mismatch Arrangements based on the Hybrids Report of the OECD.

2.2. The hybrid instruments in Jurisprudence on Canada Deposit Insurance Corp. v. Canadian Commercial Bank

Although a financial instrument may have debt and equity characteristics, the Supreme Court of Canada (SCC) in *Canada Deposit Insurance Corp. v. Canadian Commercial Bank* (SCC 1992)[61] has established that the instrument should be characterized for tax purposes as either one or the other based on "the substance or main thrust" of the transaction.[62]

In this case, the issue before the SCC was whether advances made to a distressed bank gave rise to debt or equity to rank the claims against the bank's estate during its liquidation.[63] The SCC found that if a transaction contains debt and equity features, an effort would be made to determine the true "substance" of the relationship between the parties.[64]

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the tax treatment of the whole instrument. The change in the tax treatment is far out of proportion to the change in the financial character of the instrument. Moreover, the approach's non-self-executing nature would create a potential for anomalies in tax treatments. Thus, the absence of international harmonization of "debt" and "equity" definitions also generates cross-border tax arbitrage opportunities difficulted to address." Cited from The Taxation of Debt, Equity, and Hybrid Arrangements, supra note 50.

58 The Taxation of Debt, Equity, and Hybrid Arrangements, supra note 50.

59 (OECD) Neutralising the Effects of Hybrid Mismatch Arrangements, supra note 10, at p. 11-12

60 Ibid.

61 Canada Deposit Insurance Corp. v. Canadian Commercial Bank, supra note 12, at paragraph 66.

62 Mike Collinge. (2016). Debt or Equity. *Canadian Tax Highlights*, 24(1), 1 [*Debt or Equity (2016)*].

63 Ibid.

64 Derek G. Alty, & Brian M. Studniberg. (2014). The Corporate Capital Structure: Thin Capitalization and the 'Recharacterization' Rules in Paragraphs 247(2)(b) and (d), Corporate Tax Planning feature. *Canadian Tax*

Furthermore, the SCC emphasized the importance of the parties' intention, as demonstrated by the words used in the relevant agreements. This task primarily depends on the meaning of the words chosen by the parties to reflect their intention in the agreements. Accordingly, the court recognized the instrument as having a hybrid nature yet held that it contained elements reflecting a debtor-creditor relationship.[65]

In evaluating the instrument's features, the SCC pointed out that only some elements must be given the same weight when addressing the characterization issue. As the SCC is searching for the substance of a transaction, it should avoid focusing on any secondary aspects of the instrument.[66] In concluding that the hybrid instrument would be characterized as a debt, the Court identified essential elements such as there was nothing in the express terms of the agreements to support a conclusion that the money was advanced as an equity investment; however, there were terms to support a characterization of the agreements as constituting a loan, including those relating to repayment and indemnity should the borrower fail to make full repayment. Accordingly, the SCC considered that the overall balance favoured a debt characterization (even though interest was payable only in limited circumstances).[67]

Finally, it is essential to remark that the recent decision of the Tax Court of Canada (TCC) and the Federal Court of Appeal (FCA) in *Barejo* provides more guidance for determining whether a hybrid instrument may be characterized as equity or debt for Canadian tax purposes.

2.3. Hybrid Financial Instruments as Debts Under the Jurisprudence on *Barejo*

2.3.1. Scope

As previously mentioned, the Canadian courts have established that a hybrid financial instrument should be characterized for tax purposes as debt one or equity, based on the substance of the transaction. In this context, the Canadian courts in *Barejo* provide the test for determining whether a hybrid financial instrument is a debt for income tax purposes.[68]

In this case, the TCC applied jurisprudence from outside the tax context—most notably, from the bankruptcy and insolvency context—and followed the analyzed decision in *Canada Deposit Insurance Corp. v. Canadian Commercial Bank*. Accordingly, the TCC

Journal, 62(4), 1159-1202 [The Corporate Capital Structure: Thin Capitalization and the 'Recharacterization' Rules].

65 Ibid.

66 Ibid.

67 Ibid.

68 Debt or Equity (2016), supra note 65.

in *Barejo* was asked to rule on whether the notes constituted debt for the ITA to determine whether Barejo Holdings was required to include a set of shares under the Foreign Accrual Property Income (FAPI) rules under section 94.1 (i.e., an antideferral regime for passive income obtained abroad, which has the same ratio of the CFC rules) or the subsection 95(1) deemed interest accrual rules for "prescribed debt obligations" for the taxation years under appeal Such provisions applied only if the notes constituted "debt" for section 94.1 or "debt obligations" for subsection 95(1).[69] Accordingly, if the notes were considered debt for Canadian tax purposes, Barejo Holdings was required to include an amount in respect of the notes in computing its foreign accrual property income. In contrast, no income inclusion was required if the notes did not constitute debt.[70]

2.3.2 Background

The appellant, Barejo Holdings ULC ("Barejo Holdings"), along with other investors, held shares in GAM Diversity Inc. ("GAM Diversity"), an open-ended investment company incorporated in the British Virgin Islands. Before a 2001 reorganization, GAM Diversity held a portfolio of interests in hedge funds and mutual funds ("the assets"). The assets were managed by an independent third-party Bermuda corporation, Global Asset Management ("GAM").[71]

In anticipation of legislative changes to the FAPI rules and the offshore investment fund regimes, GAM Diversity was reorganized in 2001 such that exclusively Canadian-resident investors owned their pro-rata share of the assets ("the reference assets") through GAM Diversity. All non-Canadian-resident investors owned their pro rata share of the assets through a separate corporation. As part of this reorganization, GAM Diversity changed its name to St. Lawrence Trading ("SLT"). In due course, SLT was a "foreign affiliate" and a "controlled foreign affiliate" (CFA) of Barejo Holdings within the meaning of these terms under subsection 95(1) of the ITA for the taxation years in issue.[72]

Later, as part of the reorganization, SLT sold the reference assets to non-resident affiliates of two Canadian banks ("the purchaser banks") for US$966 million. SLT used the proceeds from the sale to purchase a "note" from each of two other non-resident affiliates of the purchaser banks ("the issuer banks"), which notes were issued under the terms of note purchase agreements between SLT and the respective issuer banks.[73]

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69 John Sorensen, Carrie Aiken, Steve Marshall, Tim Barrett, & Kyle B. Lamothe. (2016). Current Cases. *Canadian Tax Journal, 64*(1), 207-228 [Current Cases (2016)].

70 International Tax for Owner-Managers, supra note 14.

71 Current Cases (2016), supra note 16.

72 Ibid.

73 Ibid.

The notes' terms were described in various documents, including the note purchase agreements under which the notes were issued, the notes themselves, the circular issued by GAM Diversity to its shareholders outlining the reorganization, and a term sheet for the notes attached to the circular.

The TCC found that the terms and conditions of the notes included elements of both debt and equity: (i) the notes had a specified term of 15 years, with early maturity in the case of certain termination events; (ii) each note ranked *pari passu* with all unsecured obligations of the relevant Issuer; (iii) the Notes were non-interest bearing (and expressly stated to be as such) except in the case of default; (iv) no fixed amount was payable on maturity or termination of the Notes. Instead, the amount payable on maturity or termination was the value, or proceeds realized from the disposition, of the Reference Assets, with no minimum or maximum limit. Thus, the amount payable was ascertainable only at the time payment was required and could potentially exceed the issue price of the notes, and (iv) the Banks guaranteed and provided indemnities for the notes, with a guarantor liable "as if it were the sole principal debtor and not merely as surety." Accordingly, the circular described the notes as "Total Return Linked Notes."[74]

The value of the notes tracked the value of the reference portfolio, and the amount payable on maturity or early termination was determined by the value of the reference portfolio on the date of maturity or early termination. At all times, the reference portfolio continued to be actively managed by GAM as a condition of the agreements, and weekly valuations were to be submitted to SLT. The economic exposure of SLT to the reference assets and reference portfolio was the same before and after the reorganization. Before the reorganization, SLT's predecessor owned the reference assets (which were actively managed by GAM). After the reorganization, SLT owned the notes, whose value continued to track the reference portfolio. GAM continued managing the reference portfolio.[75]

The Appellant argued that the notes could not be a debt for the Act because (1) a debt is an obligation to pay a sum that is certain or reducible to a certainty, and (2) a debt cannot exist unless and until the amount to be paid is certain or can be made sure from facts that are known or knowable. Barejo Holindgs argued that the value of the notes was not specific or ascertainable until maturity, and therefore, the notes could not be a debt for the ITA. However, the TCC agreed with the Crown, holding that the notes were debt. The taxpayer has appealed to the FCA, who also agreed with the Crown.[76]

74 Ibid.

75 Ibid.

76 Debt or Equity (2016), supra note 65.

2.3.3. Core Elements of Debts

As an initial matter, the TCC in *Barejo* concluded that the characterization of security must be based on the text, context, and purpose of the Act's provisions at issue.[77] The Court summarized the essential characteristics of a debt for purposes of the provision relevant in that case as follows:[78]

(i) an amount or credit is advanced by one party to another party;

(ii) an amount is to be paid or repaid by that other at some point in the future in satisfaction of the advance and

(iii) this amount to be paid or repaid is fixed or determinable or will be ascertainable when payment is due.

(iv) implicit/stipulated or calculable interest rate (which can be zero).[79]

Moreover, the use of debt-like terms in the governing documentation, security rankings relative to other debt, and the parties' expressed intentions were also relevant factors to consider.[80]

The key takeaway from the decision in *Barejo* is that a financial instrument may have equity elements, participate in nature, and still be considered a debt for Canadian tax purposes. Yet, the courts considered that such a conclusion could be reached only after carefully considering all the relevant facts and circumstances and the relevant provisions of the ITA. Therefore, it is essential not only to consider the desired characterization of the funding instruments at the outset but also to ensure that the party's intentions and the terms relating to the instruments are documented to support that characterization.[81]

Although the Courts in *Barejo* provided some guidelines and features to determine when hybrid financial instruments would be characterized as debt, there is still a tax policy concern regarding tax arbitrage arrangements using hybrid instrument mismatches schemes to reduce the tax burden. In this vein, the Department of Finance has proposed a set of rules to combat these arrangements.

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77 Barejo, supra note 13, at para 52-55 and 70.

78 International Tax for Owner-Managers, supra note 14.

79 Contrary to the Tax Court of Canada decision, the Federal Court of Appeal held that the instrument doesn't need an explicit or implicit interest rate to be characterized as a debt.

80 International Tax for Owner-Managers, supra note 14.

81 Ibid.

2.4. Canada's New Hybrid Mismatch Rules

2.4.1. Overview

On April 29, 2022, in response to the policy concern about the aggressive tax planning arrangement using hybrid financial instruments addressed in the Hybrids Report of the OECD, the Department of Finance released the Legislative Proposals Relating to the ITA—Hybrid Mismatch Arrangements with explanatory notes (collectively, "the proposals").[82]

That relation is stated explicitly in proposed subsection 18.4(2), which also provides that, unless the context otherwise requires, the rules "are to be interpreted consistently with that report, as amended from time to time." Note that this is a novel approach to Canadian tax legislation, which may be questionable from a constitutional perspective.[83]

The proposals only purport to implement some of the chapters of the Hybrids Report of the OECD, given that the proposals are focused only on deduction/non-inclusion outcomes, not double deduction outcomes. Besides, they mainly focus on hybrid financial instruments rather than a broader range of scenarios. At the same time, the proposed rules depart from the hybrid report in that they target actual payments and certain notional interest deductions without any payment. There are three categories of arrangements to which the preproposals would apply. In the definition of "hybrid mismatch arrangement" in proposed subsection 18.4(1), these categories are identified:

- hybrid financial instrument arrangements,
- hybrid transfer arrangements, and
- substitute payment arrangements.

In all cases, a "payment" must "arise." Still, there is a special rule in proposed subsection 18.4(9) that relates to "notional interest expense" on a debt that would be or could reasonably be expected to be, in the absence of any "foreign expense restriction rule," deductible in computing the "relevant foreign income or profits for a foreign taxation year" of a debtor. When this rule applies, the debtor is deemed to make a payment under the debt to the creditor in respect of the debt, in an amount equal to the deductible amount, and the creditor is deemed to be a recipient of such payment. Accordingly, the mismatch condition in proposed paragraph 18.4(10)(d) is also deemed satisfactory. Accordingly, the hybrid transfer arrangements and substitute payment arrangements are beyond this paper's scope.

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82 Angelo Nikolakakis. In This Issue (2022). *International Tax Highlights, 1*(3), 1 [*In This Issue (2022)*].

83 Ibid.

2.4.2. Hybrid Financial Instrument Mismatch Arrangement Rules

A hybrid financial instrument arrangement is addressed mainly in proposed subsections 18.4(10) and (11).[84] Under the proposed rules, "hybridity" is "a mismatch is considered hybrid if it arises because the terms of a financial instrument, or transactions that are related to the financial instrument, lead the instrument, or any of the related transactions, to be treated differently under the tax laws of different countries."[85]

This category comprises situations where the payment (other than a payment under a substitute payment arrangement) arises under or in connection with a financial instrument. For these rules, a "financial instrument" is broadly defined to mean a debt, an equity interest, or any right that may reasonably be considered to replicate a right to participate in profits or gain of any entity or any other arrangement that gives rise to an equity or financing return. The payment arising from such an arrangement must give rise to a deduction/non-inclusion mismatch, which is the critical element of the proposed rules.[86]

The terms "Canadian ordinary income" and "foreign ordinary income" are defined in the proposed subsection 18.4(1). Of particular note is the fact that "foreign ordinary income" is subject to several downward adjustments, including an adjustment whereby the income is subject to tax at a nil rate (or even a rate that is lower than the highest rate imposed by the relevant foreign country on such income), or is included in income because of a foreign hybrid mismatch rule—the latter reflecting the ordering rule in the hybrids

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84 Ibid.

85 J. Scott Wilkie, Slides provided in class. (2023). Osgoode Hall Law School, York University, March 13 of 2023.

86 Whether such a mismatch exists is determined under proposed subsection 18.4(6), which has an inbound and outbound category. In the inbound category, a payment gives rise to a deduction/non-inclusion mismatch if A exceeds B, where:
A is the total of all amounts, each of which would, in the absence of this section, subsection 18(4) and subsection 18.2(2), be deductible in respect of the payment in computing the in- come of a taxpayer . . . under [part I] for a taxation year (referred to in this paragraph as the "relevant year"), and
B is the total of all amounts, each of which, in respect of the payment,
(i) can reasonably be expected to be—and is—ordinary foreign income of an entity for a foreign taxation year that begins on or before the day that is 12 months after the end of the relevant year, or
(ii) is the Canadian ordinary income of a taxpayer for a taxation year that begins on or before the day that is 12 months after the end of the relevant year.
The outbound category is similar but inverted, such that a payment gives rise to a deduction/non-inclusion mismatch if C exceeds D, where
C is the total of all amounts, each of which, in the absence of any foreign expense restriction rule, would be—or would reasonably be expected to be—deductible, in respect of the payment, in computing relevant foreign income or profits of an entity for a foreign taxation year (referred to in this paragraph as the "relevant foreign year"), and
D is the total of all amounts, each of which, in respect of the payment,
(i) would, in the absence of section 12.7, be the Canadian ordinary income of a taxpayer for a taxation year that begins
On or before the day that is 12 months after the end of the relevant foreign year, or
(ii) can reasonably be expected to be—and is— foreign ordinary income of another entity for a foreign taxation year that begins on or before the day that is 12 months after the end of the relevant foreign year.

report, which gives priority to a country's deduction-denial rule (except for a rule that is substantially similar in effect to proposed subsection 113(5)).[87]

The payer of the payment must not deal at arm's length with or be a specified entity with respect to a recipient of the payment, or the payment must arise under, or in connection with, a structured arrangement (discussed below). A specified entity is defined, essentially, by reference to a relationship that involves an ownership interest representing at least 25 percent of votes or value.[88]

The final set of conditions in proposed subsection 18.4(10) is (1) that it can reasonably be considered that the deduction/ non-inclusion mismatch arises in whole or in part because of a difference in the treatment of the financial instrument (or in the treatment of one or more transactions, either alone or to- gather, where the transaction or transactions are part of a transaction or series of transactions that includes the payment or relates to the financial instrument) for tax purposes under the laws of more than one country that is attributable to the terms or conditions of the financial instrument (or transaction or transactions); or (2) that it can reasonably be considered that the deduction/non-inclusion mismatch would arise in whole or in part because of such a difference if any other reason for the deduction/ non-inclusion mismatch were disregarded.[89]

2.4.3. Consequences

The consequences of the application of this regime with respect to the payment are produced under subsection 12.7(3), 18.4(4), or 113(5) of the ITA, depending on the circumstances. Subsection 12.7(3) results in an income inclusion; subsection 18.4(4) results in the denial of an income deduction; and subsection 113(5) results in the denial of a deduction in computing taxable income that would otherwise be available in respect of a dividend received on the shares of a foreign affiliate.[90]

Furthermore, under proposed subsection 214(18), interest paid or credited by a corporation resident in Canada, which is not deductible because of the hybrid mismatch rule in proposed subsection 18.4(4), is deemed to be a dividend, not interest, for part XIII of the Act. This rule, in effect, is intended to align the treatment of these interest payments with withholding tax under part XIII with the tax treatment for part I and the tax treatment under the relevant foreign tax law, and it prevents taxpayers from using hybrid mismatch arrangements as equity substitutes to avoid dividend withholding tax inappropriately.[91]

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87 In This Issue (2022), supra note 86.

88 Ibid.

89 Ibid.

90 Ibid.

91 Ibid.

While it is too soon to fully digest all the potential implications of these new rules, taxpayers would be well advised to begin reviewing their arrangements considering these developments. The proposals would apply to payments arising on or after July 1, 2022.[92]

Conclusions

The financial transaction traditionally includes standard forms of debt obligations, issues of shares by corporations, and leasing transactions. From the tax policy perspective, the core of this classification is the category of "basic building block financial instruments," which include capital raising and derivative instruments. The concept of "financial innovation" is the design of new financial instruments by combining the building-block instruments (i.e., both capital raising and derivative instruments). In this sense, all corporate securities may be categorized as "classical debt," "classical equity," or a combination of both, known as "hybrid securities." Each type of security contains certain rights and obligations that reflect a different allocation among investors of the right to participate in corporate profits, the risk of loss, and the power of control.[93]

Under the Income Tax Act (ITA), the tax treatment of debt obligations differs from that of equity stock. Because there are significant differences in the treatment of the returns on different financial instruments, hybrid instruments generate tax arbitrage opportunities, such as hybrid mismatch arrangements. Ideally, in a cross-border transaction, the paying jurisdiction treats the investment as a debt claim, the interest on which is deductible.

The Hybrids Report by the OECD addresses the concern of hybrid mismatch arrangements. According to the OECD, hybrid mismatch arrangements exploit differences in the tax treatment of an entity or instrument under the laws of two or more tax jurisdictions to achieve double non-taxation, including long-term deferral. These common arrangements result in substantially eroding the taxable bases of the countries concerned, negatively impacting competition, efficiency, transparency, and fairness. The Department of Finance released the Legislative Proposals Relating to the *ITA* —Hybrid Mismatch Arrangements based on the Hybrids Report of the OECD.

Although a financial instrument may have debt and equity characteristics, the Supreme Court of Canada (SCC) in *Canada Deposit Insurance Corp. v. Canadian Commercial Bank* (SCC 1992)[94] has established that the instrument should be characterized for tax purposes as either one or the other based on "the substance or main thrust" of the transaction. In this context, the Canadian Courts in *Barejo* test whether a hybrid financial instrument is a debt for income tax purposes. As an initial matter, the TCC in *Barejo* concluded that

92 Ibid.

93 Tim Edgar. (1990). "The Classification of Corporate Securities for Income Tax Purposes". *Canadian Tax Journal, 38*(5), 1141-1188 [The Classification of Corporate Securities for Income Tax Purposes].

94 Canada Deposit Insurance Corp. v. Canadian Commercial Bank, supra note 12, at paragraph 66.

the characterization of security must be based on the text, context, and purpose of the Act's provisions at issue. The Court summarized the essential characteristics of debt for purposes of the provision relevant in that case as follows: (i) an amount or credit is advanced by one party to another party; (ii) an amount is to be paid or repaid by that other at some point in the future in satisfaction of the advance, (iii) this amount to be paid or repaid is fixed or determinable or will be ascertainable when payment is due, and (iv) implicit/stipulated or calculable interest rate (which can be zero).

The key takeaway from the decision in *Barejo* is that a financial instrument may have equity elements, participate in nature, and still be considered a debt for Canadian tax purposes. Yet, the courts considered that such a conclusion could be reached only after carefully considering all the relevant facts and circumstances and the relevant provisions of the ITA.

Under the proposed rules, "hybridity" is "a mismatch is considered hybrid if it arises because the terms of a financial instrument, or transactions that are related to the financial instrument, lead the instrument, or any of the related transactions, to be treated differently under the tax laws of different countries." This category comprises situations where the payment (other than a payment under a substitute payment arrangement) arises under or in connection with a financial instrument.

The consequences of the application of this regime with respect to the payment are produced under subsection 12.7(3), 18.4(4), or 113(5) of the ITA, depending on the circumstances. Subsection 12.7(3) results in an income inclusion; subsection 18.4(4) results in the denial of an income deduction; and subsection 113(5) results in the denial of a deduction in computing taxable income that would otherwise be available in respect of a dividend received on the shares of a foreign affiliate. Furthermore, under proposed subsection 214(18), interest paid or credited by a corporation resident in Canada, which is not deductible because of the hybrid mismatch rule in proposed subsection 18.4(4), is deemed to be a dividend, not interest, for part XIII of the Act.

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