SPECIAL REPORTS

BEPS on Hybrids: A Canadian Perspective

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On March 19, 2014, the OECD released two discussion draft papers on hybrid mismatch arrangements[1] in response to action 2 of the July 2013 action plan on base erosion and profit shifting.[2] In December we commented from a Canadian perspective on the action plan, in general, and on BEPS action 2 in particular.[3] We stated that the OECD had little to teach the tax policymakers of the major industrialized countries and that there was nothing substantially new in the area of tax planning, including regarding hybrid mismatch arrangements. But the OECD is nothing if not persistent, and if one were to evaluate the developments in the months that have passed since our December article by reference to the constant reiteration of (and rhetoric accompanying) the missionary zeal and dedication with which the OECD is imbued to stamp out every conceivable international tax planning strategy and the prodigious volume of interim reports that it has issued during this period,[4] one would likely conclude that the BEPS initiative is already a success. But we remain skeptical and examine, from a Canadian perspective,[5] the March 19 hybrid drafts.

I. A Bit of History

Once upon a time, for purposes of tax law in the United Kingdom, the United States, and Canada, a corporation was a corporation, a partnership was a

[1] OECD, Public Discussion Draft: BEPS Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements (Recommendations for Domestic Laws) (OECD, Mar. 19, 2014), *available at* http://www.oecd.org/ctp/aggressive/hybrid-mismatch-arrangements-discussion-draft-domestic-laws-recommendations-march-2014.pdf (hereinafter the ''domestic draft''); OECD, Public Discussion Draft: BEPS Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements (Treaty Issues) (OECD, Mar. 19, 2014), *available at* http://www.oecd.org/ctp/treaties/hybrid-mismatch-arrangements-discussion-draft-treaty-issues-march-2014.pdf (hereinafter the ''treaty draft,'' and, collectively with the domestic draft, the ''hybrid drafts''). *See also* comments received on these drafts that were published on May 7, 2014, *available at* http://www.oecd.org/tax/aggressive/comments-action-2-hybrid-mismatch-arrangements.pdf.

[2] OECD, Action Plan on Base Erosion and Profit Shifting (Paris: OECD Publishing, 2013) (hereinafter the ''action plan''). *See also* OECD, Addressing Base Erosion and Profit Shifting (Paris: OECD Publishing, 2013); OECD, Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues (Mar. 5, 2012), *available at* http://www.oecd.org/tax/exchange-of-tax-information/HYBRIDS_ENG_Final_October2012.pdf.

[3] Nathan Boidman and Michael Kandev, ''BEPS: The OECD Discovers America?'' *Tax Notes Int'l*, Dec. 16, 2013, p. 1017.

[4] *See* http://www.oecd.org/ctp/calendar-planned-stakeholders-input-2013-2014.pdf.

[5] Unless otherwise specified, section references in this article are to the Income Tax Act (Canada), R.S.C. 1985 c. 1 (5th Supp.).

partnership, a trust was a trust, a share was a share, a debt was debt, and so forth; life was simple this way. But before World War II, in what was probably the first crack in this monolithic paradigm, there were tax decisions in the United States that treated partnerships or trusts that have more than two of four corporate characteristics (that is, limited liability, continuity of life, transferability of interests, and central management) as corporations.[6] These developments suggested to tax planners that when a country has ongoing cross-border business or investment relations with the United States and is seen as not departing from traditional form-driven characterizations,[7] there could be tax arbitrage opportunities from the differing characterization of a legal entity or relationship. And thus may have been born the first ''hybrid'' entity and the precursor of all that has since developed.

Given the historic role of Canada in (1) the historic and ongoing constant flow of dealings between Canada and the United States; (2) the entity characterization gap between the two countries because of the U.S. adoption of check-the-box rules about 20 years ago;[8] and (3) the 2007 Canada-U.S. tax treaty protocol that contains what are probably the most intricate hybrid entity rules of any treaty, it seems appropriate to examine the March 19 hybrid drafts from a Canadian perspective and from a conceptual perspective and particularly focus on the substantive aspects that appear problematic.

II. Background to the Hybrid Drafts

The March 19 hybrid drafts respond to action 2 of the 2013 action plan under which the OECD proposed to develop model treaty provisions and recommendations regarding the design of domestic rules to neutralize the effect (for example, double nontaxation, double deduction, long-term deferral) of hybrid mismatch arrangements. The action plan identified five specific areas of work:

- changes to the OECD model tax treaty to ensure that hybrid instruments and entities (as well as dual resident entities) are not used to obtain the benefits of treaties unduly;
- domestic law provisions that prevent exemption or nonrecognition for payments that are deductible by the payer;
- domestic law provisions that deny a deduction for a payment that is not includable in income by the recipient (and is not subject to taxation under controlled foreign company or similar rules);
- domestic law provisions that deny a deduction for a payment that is also deductible in another jurisdiction; and
- when necessary, guidance on coordination or tie-breaker rules if more than one country seeks to apply the rules to a transaction or structure.

In response to action 2, the hybrid drafts make up two papers, one dealing with ''Recommendations for Domestic Laws'' and one with ''Treaty Issues.'' The domestic draft (which is both lengthy and complex) recommends amendments to domestic laws to negate the tax consequences of hybrid mismatch arrangements. The types of targeted arrangements are classified in three categories:

- hybrid financial instruments and transfers;
- hybrid entity payments; and
- imported mismatches and reverse hybrids.

The treaty draft (which is shorter) examines treaty issues relating to dual resident entities, transparent entities, and the interaction with the action 6 draft report on ''Preventing the Granting of Treaty Benefits in Inappropriate Circumstances,'' which was released on March 14.

We comment on the domestic draft and the treaty draft, focusing only on specific aspects of these drafts, and we do not purport to exhaustively review or analyze these documents.

III. Comments on the Domestic Draft

A. Meaning of 'Hybrid Mismatch Arrangement'

The OECD defines the key expression ''hybrid mismatch arrangement'' in the domestic draft as a profit-shifting arrangement that uses a hybrid element in the tax treatment of an entity or instrument that produces a mismatch in tax outcomes regarding a payment that is made under that arrangement and results in a lower aggregate tax burden for the parties to the arrangement.[9]

The two mismatch scenarios that are targeted are payments that are deductible under the rules of the jurisdiction of the payer and not included in the income of the recipient (so-called deduction/no inclusion or D/NI outcomes) and payments that give rise to double deductions from the same expenditure (a double deduction or DD outcome).[10] Fundamentally, the distinction between the two outcomes is tenuous. A basic aspect of cross-border tax planning relating to financing is that deductible interest at source is converted, through various techniques, into nontaxable

[6]*See Morrissey v. Commissioner*, 296 U.S. 344 (1935); IRC section 7701.

[7]Such as Canada. *See, e.g.*, Boidman and Kandev, ''Foreign Entity Classification and the Meaning of 'Corporation'/'Société' in the Income Tax Act,'' (2009) 57(4) *Can. Tax J.* 880-904.

[8]U.S. Treas. reg. section 301.7701-2 and -3.

[9]Domestic draft, paras. 17 and 18.

[10]*Id.* at paras. 20 and 21.

receipts at residence; whether there is a DD outcome is merely a function of whether there is external debt financing. Significantly, as both D/NI and DD arrangements are defined by the OECD to involve a ''payment,'' notional deductions granted by a domestic law that do not involve an actual payment, such as a deemed interest deduction for equity capital,[11] are explicitly outside the scope of the proposed rules.[12] Also, D/NI outcomes are defined by the OECD to involve non-inclusion in the recipient's income (that is, exemption of the item of income). This ignores the possible complexity of domestic tax treatment of the recipient and various legislative means to ensure low or no taxation of a particular item of income. Thus, deductible payments that are included in income in the hands of the recipient are outside the scope of the domestic draft regardless of the actual tax imposed by the payee jurisdiction.[13]

Regarding the classification of hybrid arrangements, the OECD notes that there are two distinct categories of hybridity: hybrid entities, in which the same entity is treated differently under the laws of two or more jurisdictions; and hybrid instruments, in which there is a conflict in the treatment of the same instrument under the laws of two or more jurisdictions. Further, the OECD explains that within the latter category there is a further subdivision that can be made between hybrid transfers, which are arrangements regarding an asset when taxpayers in two jurisdictions take mutually incompatible positions in relation to the nature of the ownership rights in that asset, and hybrid financial instruments, which are financial instruments that result in taxpayers taking mutually incompatible positions in relation to the character of the same payment made under the instrument.

The domestic draft, however, is not organized precisely along those lines. The recommendations in the report target three categories of hybrid mismatch arrangements:

- hybrid financial instruments (including transfers), in which a deductible payment made under a financial instrument is not treated as taxable income under the laws of the payee's jurisdiction;
- hybrid entity payments, in which differences in the characterization of the hybrid payer result in a deductible payment being disregarded or triggering a second deduction in the other jurisdiction; and
- reverse hybrid and imported mismatches, which cover payments made to an intermediary payee that are not taxable on receipt. This covers two kinds of arrangements:
  - arrangements in which differences in the characterization of the intermediary result in the payment being disregarded in both the intermediary jurisdiction and the investor's jurisdiction (reverse hybrids); and
  - arrangements in which the intermediary is party to a separate hybrid mismatch arrangement and the payment is set off against a deduction arising under that arrangement (imported mismatches).

B. Hybrid Financial Instruments and Transfers

The first type of hybrid mismatch arrangement considered by the domestic draft is hybrid instruments. The OECD begins by defining hybrid financial instrument as any financing arrangement that is subject to a different tax characterization under the law of two or more jurisdictions so that a payment under that instrument gives rise to a mismatch in tax outcomes (paragraph 60). Typically, this would be an instrument that is seen as debt by the source country and as equity in the residence country and, as a result, deductible interest at source would be seen as a dividend eligible for the participation exemption at residence. From a Canadian standpoint, an example of a hybrid financial instrument is mandatory redeemable preferred shares (MRPS) issued by a Luxembourg corporation.[14] They are treated as debt that gives rise to deductible interest in Luxembourg, but Canada treats them as share equity. The OECD also provides more complex examples of cases when the mismatch in tax outcomes may not be attributable to a general difference in the way the instrument is characterized for tax purposes but rather to a specific difference in the tax treatment of a particular payment made under the instrument.[15] In these kinds

[11]Such rules exist in Belgium, Brazil, and Italy, and are being considered in Luxembourg.

[12]*See* domestic draft, para. 21.

[13]For example, in Canada dividends distributed by a foreign affiliate out of exempt surplus are included in the income of the Canadian corporate parent, but are subsequently deducted in computing the parent's taxable income. This, instead of an actual exemption, is an intentional tax policy choice that allows for deductible interest on financing an investment in a foreign affiliate. One should ask whether this method of ensuring no taxation would be caught by the proposals, or whether dividends received in countries that are subject to a 5 percent inclusion regime would be caught.

[14]*But see* discussion regarding imported mismatches.

[15]Examples of such instruments and payments provided in the domestic draft, at para. 64:

- a subscription or sale of shares with a deferred purchase price component that is treated as giving rise to a deductible expense for the share subscriber and a nontaxable receipt for the share issuer;
- a deduction claimed by an issuer for the premium paid on converting a mandatory convertible note, while the holder of the note treats the premium as an exempt gain;
- an issuer that claims a deduction for the value of an embedded option in an optional convertible note while the holder ignores the value of the option component (or gives it a lower value than the issuer); and

(Footnote continued on next page.)

of mismatches, both jurisdictions treat the instrument as having the same general character (for example, a debt instrument), but technical differences in the way each jurisdiction taxes the instruments mean that some payments made under the instrument will give rise to D/NI outcomes.[16]

This part of the domestic draft also covers so-called hybrid transfers. The OECD defines them as a particular type of collateralized loan arrangement or derivative transaction in which the counterparties to the same arrangement in different jurisdictions both treat themselves as the owner of the loan collateral or subject matter of the derivative (paragraph 65). This difference in the way the arrangement is characterized can lead to payments made under the instrument producing D/NI outcomes.

Fundamentally, this part of the domestic draft dealing with hybrid transfers involves a bit of confusion of genres. On the one hand, it covers repo financings. From a Canadian perspective, such financings would simplistically involve a U.S. holding company selling cumulative dividend preferred shares in a U.S. operating subsidiary to the group's Canadian parent subject to a forward purchase agreement whereby the preferred shares would be repurchased by the U.S. holding company after a defined term. The United States treats this structure based on an economic substance analysis as a loan by the Canadian parent to the U.S. holding company secured with the shares of the U.S. operating subsidiary; Canadian courts have yet to consider whether Canada sees the Canadian parent as the bona fide owner of the shares of the U.S. operating company for the duration of the arrangement so that the preferred dividends on the shares may be eligible for Canada's participation exemption, but apparently this has been the generally held view.[17]

On the other hand, the domestic draft also deals with so-called foreign tax credit generators. Such structures, which involve the use of repos, conceptually aim at allowing a taxpayer in one country to double dip the tax that would in any event be paid by a taxpayer in another country and use such tax as a foreign tax credit. Generally, such arrangements are highly contrived and are different in nature from bona fide repo financings. In Canada, such an arrangement was at issue before the Tax Court in *4145356 Canada Ltd. v. Canada*,[18] which, simplistically, involved a subsidiary of the Royal Bank of Canada claiming, through the use of a repo and a reverse hybrid partnership, a Canadian foreign tax credit for U.S. tax paid within the corporate group of Bank of America. The taxpayer was successful in this case on the technical grounds that were at issue before the court. Surprisingly, no antiavoidance arguments were before the court. The government subsequently enacted a series of anti-foreign-tax-credit-generator rules, which are intended to prevent such structures, but which unfortunately have also proven to be too broad.[19]

The domestic draft's recommended response to these type of hybrid arrangements is summarized in the report as follows:

> [81] The response recommended in this Consultation Document is to neutralise the effect of mismatches that arise under hybrid financial instruments through the adoption of a *linking rule* that would seek to align the tax outcomes for the payer and payee under a financial instrument. The Consultation Document recommends that the *primary response* should be to *deny the payer a deduction for payments made under a hybrid financial instrument* with *the jurisdiction of receipt applying a secondary or defensive rule that would require a deductible payment to be included in income in the event the payer was located in a jurisdiction that did not apply the primary rule*. The Consultation Document further recommends that jurisdictions that have a dividend exemption as part of their policy to alleviate double taxation should not apply the exemption to deductible payments as a matter of domestic law. Because hybrid transfers are, in effect, a species of financial instrument, this Consultation Document recommends that they should be included within the linking rule. The complete summary of recommendations is set out in the box below.
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> [82] *Further, in order to prevent taxpayers in a repo transaction claiming two tax credits in respect of the same source taxation, this Consultation Document recommends that a taxpayer's entitlement to direct tax credits under a hybrid transfer be restricted in proportion to*

- an issuer that bifurcates an interest-free shareholder loan into its equity and debt components and then accrues the equity component over the life of the loan while the holder treats the entire amount as a loan for the principal sum.

[16]Examples of such instruments include the optional convertible notes at issue in the New Zealand case of *Alesco New Zealand Limited v. Commissioner of Inland Revenue*, [2013] NZCA 40. In that case, an Australian corporation financed its New Zealand subsidiary with optional convertible notes that gave rise to currently deductible interest in New Zealand that was not recognized in Australia. The New Zealand government challenged the structure under its general antiavoidance rule and won. The taxpayer obtained leave to appeal to the Supreme Court, but the case was settled before hearing. It is understood that the settlement favored the tax authorities.

[17]Such view is expressed in the Department of Finance technical explanations to the anti-foreign-tax-credit generator rules, referred to at note 19 *infra*. Also the case referred to at note 18 *infra* implicitly rejected recharacterization of the repo.

[18]2011 TCC 220.

[19]*See* section 126(4.11)-(4.13). *See also* section 91(4.1)-(4.7) and reg. section 5907(1.03)-(1.09).

the taxpayer's net income under the arrangement (see the box below). [Emphasis added.]

In essence, the OECD's primary rule gives the source country priority to tax the amount of the payment by denying its deduction at source. Coordination or linking with the residence country is effected by a secondary defensive rule that would deny nonrecognition only to the extent that the payer country does not apply the primary rule.

This recommendation to eliminate the D/NI outcome of hybrid instruments raises several material issues. First, the tax treatment of hybrid instrument payments raises a fundamental issue of source versus residence taxation. It is inherently unclear whether in the context of a hybrid instrument the base eroded is that of the source or residence state.[20] The domestic draft postulates that this is not important.[21] However, the OECD's recommendation gives priority to source taxation by allowing the source country to deny the relevant deduction. Residence taxation is only a secondary defensive rule. A conflict between traditional source and residence countries seems to be looming in this regard. For example, Germany (a traditional residence country) recently adopted a tax rule to prevent exemption or nonrecognition for distributions to a German recipient that are deductible by the payer.[22] This rule would seem to preempt the primary rule of the OECD proposal by eliminating the tax mismatch that would in the first place trigger it. More significantly even, on November 25, 2013, the European Commission issued a proposal to amend the parent-subsidiary directive that aims at the same result as the German rule.[23]

Second, the OECD's suggested primary response is effectively a limitation on interest deduction. But countries typically have sophisticated cross-border interest limitation rules, such as thin capitalization provisions. Hybrid arrangements are not new, hence one could ask why there has not already been a wave of changes to adopt denial of interest on hybrid instruments. A possible answer is that source countries are generally prepared to accept a level of interest-bearing internal debt financing by foreign investors as an inducement to inbound capital flows. Simplistically, related-party cross-border debt financing is a tax break given by the source country to encourage foreign direct investment. So why would a source country care whether the interest is taxed upon receipt? Bluntly put, this is none of its concern. And historically, tax law design has not conditioned deductibility of payments on their tax treatment for the recipient. If a source country wishes to reduce the level of tax incentives provided to inbound investors, it can simply tighten the deduction limitations already in place. For example, effective in 2013, Canada decreased the debt-equity ratio of its thin capitalization rule from 2 to 1 to 1.5 to 1.

Third, except as a measure to preempt a source state anti-hybrid rule, it is not obvious why a residence country would want to adopt a rule that denies nonrecognition of a payment that is deductible at source. Arguably, the appropriate benchmark to analyze outbound investment is equity financing that would generate dividends eligible for participation exemption treatment. Hence, if such an anti-hybrid rule were adopted, the likely behavioral response of a resident multinational enterprise may be to revert to the use of straight equity (unless another workaround of residence country taxation is found), which may increase the tax base at source but would not result in extra tax revenue at residence. At best, a residence country has no motivation to adopt such a rule and, at worst, it would see a disincentive in hurting its resident MNEs.[24]

C. Hybrid Entity Payments

The second hybrid technique considered in the domestic draft involves exploiting differences in the treatment of an entity or arrangement across two jurisdictions to produce DD or D/NI outcomes from payments made by that entity.

According to the OECD, the most common DD hybrid technique involves the use of a hybrid subsidiary that is treated as transparent under the laws of the investor's tax jurisdiction and opaque under the laws of the jurisdiction where it is established or operates. This hybrid treatment can result in the same item of expenditure incurred by the hybrid being deductible under the laws of both the investor and subsidiary jurisdictions. Similarly, the same structure can be used without involving a hybrid entity provided the subsidiary jurisdiction allows permanent establishments to consolidate for tax purposes with other resident companies. A similar hybrid effect can be achieved by a structure in which the entity, while not hybrid, is a member of more than one tax consolidation group.

According to the OECD, the same basic hybrid technique can also be used to engineer D/NI outcomes. The most basic structure involves a payment made by a hybrid entity to its investor that is deductible under the laws of the payer's jurisdiction but disregarded under the laws of the investor jurisdiction.

[20]The OECD acknowledges this in the action plan at p. 15.

[21]Domestic draft, para. 27(a).

[22]For a description, see Thomas Töben, Stephan Viskorf, and Hardy Fischer, ''Legislature Approves Long-Awaited Tax Reforms,'' *Tax Notes Int'l*, June 17, 2013, p. 1167.

[23]Proposal for a council directive amending Directive 2011/96/EU on the common system of taxation applicable in the case of parent companies and subsidiaries of different member states, COM(2013) 814 final, 2013/0400 (CNS).

[24]In the Canadian context, the December 2008 report to the government by a high-profile advisory panel clearly discouraged pursuing any such disincentive. *See infra* note 25.

Regarding the DD category above, the simple scenario involving a borrowing by a hybrid partnership is seen in a Australia-Canada context in which Canada would treat an Australian borrower partnership as a flow-through while Australia would treat the partnership as a corporation resident in Australia. A rather more complex variation on the same idea is the Canada-U.S. ''tower structure'' in which a Canadian parent becomes the majority partner of a U.S. borrower partnership that is treated as a corporation for U.S. purposes, that in turn capitalizes a Canadian unlimited liability company (ULC) that capitalizes a U.S. limited liability company that lends at interest to the U.S. operating subsidiary.

Regarding the D/NI outcomes above, the structure described at paragraphs 175-177 of the domestic draft, involving a loan by a bank to a parent and then a loan by the parent to the hybrid, was (with some significant additional elements) popular with Canadian groups operating in the United States before the regulation change in 2000 under section 894(c) of the U.S. Internal Revenue Code. That change led to parties using the tower structure noted above, which is a modified version of the structure described at paragraphs 164-165, involving a loan by the bank to the hybrid, not to the parent. In a U.S.-to-Canada context, the equivalent structure would involve a U.S. parent borrowing and on-lending to a U.S.-transparent Canadian ULC that would operate in Canada through a partnership that checks the box as a corporation for U.S. purposes.

The domestic draft's recommendations to neutralize the tax benefits of hybrid entity payments are summarized in paragraphs 180-182 of the domestic draft as follows:

> [180] As noted in the discussion above, hybrid payments that trigger duplicate deductions only raise base erosion and profit shifting issues when the deduction is permanently set-off against income which is not subject to tax in both jurisdictions (i.e. dual inclusion income). The most direct way of addressing this kind of hybrid mismatch would be, therefore, to prevent these deductions from being used against any income that was non-dual inclusion income in one jurisdiction. This, however, would entail parallel rules in both jurisdictions designed to restrict the use of the deduction in one or other of the jurisdictions. Such a rule would be complicated to apply because it would require taxpayers and tax administrations in one jurisdiction to have good information and understanding of the treatment of income and deductions under the laws of the other jurisdiction. Accordingly this Consultation Document recommends a simpler linking rule that only focuses on whether the payment gives rise to a deduction in the subsidiary jurisdiction that *could be* offset against dual inclusion income. The rule would also have a primary/secondary structure so that it would need to be applied only in one jurisdiction rather than both.
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> [181] The DD rule isolates the hybrid element in the structure by identifying a deductible payment made by a hybrid in the subsidiary jurisdiction (referred to as the ''hybrid payment'') and the corresponding ''duplicate deduction'' generated in the jurisdiction of the investor (see paragraph (a) of the recommendations below). *The primary recommendation is that the duplicate deduction cannot be claimed in the investor jurisdiction to the extent it exceeds the claimant's dual inclusion income (income brought into account for tax purposes under the laws of both jurisdictions)* (see paragraph (d) below). *A secondary or defensive rule applies to the hybrid in the subsidiary jurisdiction to prevent the hybrid claiming the benefit of a hybrid payment against non-dual inclusion income if the primary rule does not apply.* In the case of both the primary and secondary rule excess deductions can be carried forward by a taxpayer and offset against future dual inclusion income. In order to prevent stranded losses, it is recommended that excess duplicate deductions should be allowed to the extent that the taxpayer can establish, to the satisfaction of the tax administration, that the deduction cannot be set-off against the income of any person under the laws of the other jurisdiction (see paragraphs (e) and (g) below).
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> [182] The D/NI rule defines a disregarded payment as one that is made cross-border to a related party where the tax treatment of the payer results in the payment being disregarded under the laws of the payee jurisdiction (see paragraph (b) below). *The deduction that is generated by a disregarded hybrid payment cannot exceed the taxpayer's dual inclusion income (see paragraph (f) below). As a secondary rule the payee would be required to include such excess deductions in income (see paragraph (h) below).* [Emphasis added.]

In essence, the OECD proposal is to eliminate the DD effects of hybrid entity payments by denying the deduction at residence, as a primary rule, or by denying the deduction at source, as a secondary defensive rule. Similarly, the D/NI effects of hybrid entity payments would be thwarted by limiting the deduction at source to the taxpayer's dual-inclusion income, failing which the disregarded hybrid entity payment must be included in income by the recipient. Fundamentally, both solutions favor source, instead of residence, taxation, which, as noted above, would likely be controversial.

Regarding the DD rule in particular (as the D/NI rule raises substantially the same issues as the ones discussed in the previous section), the Canadian experience is quite apropos. As part of the federal 2007 budget, Canada adopted an anti-double-dip provision, section 18.2, but two years later repealed it before the provision ever came into effect as initially scheduled in

2011. Subsection 18.2(2) would have disallowed interest expense except to the extent ''specified financing expense'' (subsection 18.2(3)) exceeded ''aggregate double-dip income'' (subsection 18.2(1)). The denial would have been permanent; there was to be no carryforward of the loss deduction. This outbound anti-double-dip provision would have forced a Canadian MNE to choose between an interest deduction in Canada or in the country of its foreign operating subsidiary. This regime was strongly criticized by many, including the Finance Ministry's Advisory Panel on Canada's System of International Taxation, which recommended it be repealed.[25] As a result, and quite uniquely, the federal government repealed the provision as part of the 2009 budget.[26]

The reason for this welcome retreat was undoubtedly the realization by the government that (1) the commercially proper primary location of a financing expense is in the country of residence of an MNE and therefore an anti-double-dip provision could significantly hurt Canadian MNEs, and (2) to force a Canadian MNE to forgo a deduction in the country of operations of its subsidiary and thus a reduction of its tax therein would simply serve to reduce the MNE's overall profitability and value and ultimately reduce the level of Canadian taxable dividends and capital gains its shareholders would realize; all in all it would be a lose-lose situation from a Canadian perspective.

This Canadian experience is instructive regarding the OECD's current proposals. The primary rule regarding DD outcomes in the hybrid draft is both inconsistent with commercial realities and would be unacceptable to countries that realize that such a rule would significantly hurt their resident MNEs. As to the secondary defensive rule, it boils down to the same issues as the ones discussed above: Besides the complexity involved in properly designing such a rule, a source country is free to decide what deductibility limitations it wants to adopt for cross-border interest, but whether a deduction is taken at residence has typically been an irrelevant consideration for obvious reasons.

D. Reverse Hybrid and Imported Mismatches

The last category of hybrid mismatch arrangements considered by the domestic draft are so-called imported mismatch structures, including mismatches that arise from the use of reverse hybrids.

This part of the document begins with the description of a basic imported mismatch using a reverse hybrid. The OECD specifies that the mismatches at issue involve payments to a hybrid entity instead of payments made by a hybrid entity. The hybrid in this case is usually described as a reverse hybrid because the hybrid is treated as opaque by its foreign owner and transparent under the jurisdiction where it is established. The domestic draft goes on to describe, at paragraphs 199-201, a scenario involving three countries but acknowledges that the structure can be implemented directly between two countries. This was effectively the case between Canada and the United States. Before the adoption of IRC section 894(c), a common Canada-to-U.S. financing structure involved a Canadian parent using equity to finance a U.S. LLC that is disregarded in the United States but treated as a corporation in Canada, which would lend to the U.S. operating subsidiary.[27] Conversely, in a U.S.-to-Canada context, before the fifth protocol, a typical arrangement would see a Canadian limited partnership owned by subsidiaries of the U.S. parent lend at interest to the Canadian operating corporation.[28] U.S. outbound structures involving a third country are also common and are a play on IRC section 954(c)(6).

The domestic draft, at paragraph 207, describes another form of imported mismatch arrangement, this one using a hybrid financial instrument. The example is well-known in a Canada-to-U.S. context: A Canadian MNE would invest in MRPS of a Luxembourg financing company (see discussion above) that would lend at interest to the group's U.S. operating subsidiary.[29]

Finally, at paragraphs 211-213, the document describes a third type of imported mismatch arrangement — one using hybrid entities. Under this structure, A Co, resident in Country A, establishes a wholly owned

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[25] *See* http://www.apcsit-gcrcfi.ca.

[26] Much was written about this controversial provision. *See* Brian Mustard, ''Section 18.2: The Anti-Tax-Haven Initiative,'' *2007 CTF Conference Report*, 23:1-31.

[27] From a U.S. perspective, the LLC is fiscally transparent and interest paid to it would be subject to withholding tax as limited by the Canada-U.S. tax treaty. For Canadian tax purposes the LLC would be treated as a corporation. Interest paid to it would be exempt from foreign accrual property income attribution under section 95(2)(a)(ii) and could be distributed to a Canadian corporate parent as tax-free dividends from exempt surplus. The arrangement would allow for interest stripping of the U.S. tax base, at the treaty withholding rate, combined with nontaxation in Canada at the corporate level.

[28] From a Canadian perspective, the partnership is fiscally transparent, and interest paid to it would be subject to withholding tax as limited by the Canada-U.S. tax treaty. For U.S. tax purposes, the partnership would check the box to be treated as a corporation. Interest paid to it would be exempt from subpart F income treatment under IRC section 954(c)(2) and would not be recognized in the United States. The arrangement would allow for interest stripping of the Canadian tax base, at the treaty withholding rate, combined with long-term deferral for U.S. tax purposes.

[29] From a Canadian perspective, the interest paid by the U.S. subsidiary is not subject to FAPI attribution as a result of section 95(2)(a)(ii) and, because the MRPS are seen as shares in Canada, dividends on them could be distributed to a Canadian corporate parent as tax-free dividends from exempt surplus. From a Luxembourg perspective, only a narrow margin is taxed since the interest receipt is substantially offset by the coupon on the MRPS, which is treated as interest in Luxembourg.

subsidiary, B Co, which in turn owns a wholly owned subsidiary, B Co Sub, both resident in Country B. A Co lends money to B Co, B Co uses the money to acquire equity in B Co Sub, and B Co Sub then lends money to Borrower Co, resident in Country C. In this case, B Co is a hybrid that is treated as transparent under the laws of Country A. Country A disregards the separate existence of B Co and, as a result, ignores the loan (and by extension the interest on the loan) between A Co and B Co. This part of the structure therefore gives rise to an interest deduction under the laws of Country B but no corresponding inclusion under the laws of Country A. B Co Sub is a reverse hybrid entity from the perspective of Country A. It is treated as transparent for tax purposes under the laws of Country B but is treated as a separate taxable entity under the laws of Country A. Interest payable under the loan between Borrower Co and B Co Sub is deductible under the laws of Country C and included in income under Country B law. Country B treats B Co Sub as a transparent entity and will include its income in B Co's income. However, the income will be offset by the interest deduction under the loan arrangement between A Co and B Co.

Such structures are commonly used in U.S. outbound cases that rely on the U.S. check-the-box regulations. The structure described above is similar to a Dutch BV1/BV2 structure.[30] Another variation to the same effect is the Dutch CV/BV structure.[31]

Regarding imported mismatches, the report makes the following recommendations at paragraphs 218 and 219:

> [218] In respect of imported mismatch arrangements other than reverse hybrids, comprehensive hybrid mismatch rules in the investor or the intermediary jurisdiction should be sufficient to prevent imported mismatches being structured through those jurisdictions. The simplest and most direct way of avoiding the effect of imported hybrid mismatch arrangements is, therefore, for all countries to adopt the same set of hybrid mismatch rules. This approach would ensure that the arrangement was neutralised in the jurisdiction where the hybrid technique is deployed and there would be no resulting mismatch that could be exported into a third jurisdiction. A comprehensive solution where all countries signed up to the same set of hybrid mismatch rules would also generate compliance and administration efficiencies and certainty of outcomes for taxpayers.
>
> [219] It is still necessary, however, to address reverse hybrid structures and provide measures designed to protect the payer jurisdiction from imported mismatches generally. This Consultation Document therefore makes two recommendations designed to neutralise the mismatch in tax outcomes caused by reverse hybrids:
>
> (a) introduction of rules designed to neutralise reverse hybrids by:
>
> (i) requiring income of, or payments to, a reverse hybrid to be included under the laws of the investor jurisdiction; and
>
> (ii) recharacterising certain reverse hybrids by requiring income of, or payments to, a reverse hybrid to be included under the laws of the intermediary jurisdiction if not included under the laws of the investor jurisdiction.
>
> (b) rules that would allow the payer jurisdiction to deny the deduction for payments made to an offshore structure including an imported mismatch structure or reverse hybrid where the parties to the mismatch are members of the same control group or the payer has incurred the expense as part of an avoidance arrangement.

Essentially, under this proposal the order of taxing priority is as follows: First the residence country is allowed to tax through the operation of its CFC or similar rules. Failing that, the intermediary country is allowed to tax by recharacterizing the hybrid entity, and failing that, the source country is allowed to deny deductibility.

This part of the domestic draft is arguably the most important. The notion of imported mismatch is newly coined and was not used in the action plan, suggesting the OECD's evolving understanding about this subject. The domestic draft clarifies the meaning of the term ''imported mismatch arrangement'' only at paragraph 206, defining the notion as ''hybrid structures created under the laws of two jurisdictions where the effects of the hybrid mismatch are imported into a third jurisdiction.'' The OECD further observes, at paragraph 206,

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[30] This structure typically involves U.S. parent, which wholly owns a Dutch BV (BV1), which owns another BV (BV2). BV1 is a corporation for Dutch tax but elects to be treated as a disregarded entity for U.S. tax purposes. BV2 is treated as a corporation for both Dutch and U.S. tax purposes. U.S. parent grants a loan to BV1, which is disregarded in the United States; BV1 uses equity to finance BV2, which then lends to operating subsidiaries in the group that check the box to be transparent in the United States. BV1 and BV2 form a fiscal unity in the Netherlands and are taxed only on the spread between the inbound and outbound loan. From a U.S. perspective, BV2 is owned directly and operates the businesses of the operating subsidiaries.

[31] U.S. Parent, together with an affiliate, forms a Dutch limited partnership (CV), which elects to be treated as a foreign corporation for U.S. tax purposes. The CV is a fiscally transparent partnership for Dutch tax purposes. The CV wholly owns a Dutch BV, which is a corporation for Dutch tax purposes and elects to be treated as a disregarded entity for U.S. tax purposes. The CV is largely funded with equity and uses its equity to grant a loan to BV. The BV lends to operating subsidiaries in the group that are treated as disregarded entities for U.S. purposes.

that once a hybrid mismatch has been engineered between two jurisdictions without effective hybrid mismatch rules, it is a relatively simple matter to shift the effect of that mismatch into a third jurisdiction (through the use of an ordinary loan, for example). The report also states, at paragraph 207, that imported mismatches rely on the absence of effective hybrid mismatch rules in the investor and intermediary jurisdictions in order to generate the mismatch in tax outcomes, which can then be ''imported'' into the payer jurisdiction. Therefore, according to the OECD, the primary and most effective way of dealing with imported mismatches is to ensure that every jurisdiction adopts effective hybrid mismatch rules. This wish is reiterated at paragraph 218. These statements implicitly foreshadow why the BEPS action 2 initiative will likely fail: Because tax planning often involves countries that are intermediary between source and residence countries, and those third countries are sometimes quite happy and willing to accommodate tax planning structures, a definitive uprooting of hybrid mismatch arrangements is possible only if all countries adopt the same set of hybrid mismatch rules. Obviously, this is impossible.

Regarding the specific recommendations concerning reverse hybrids, the ordering of the rules could be said to be totally surprising. First, the residence country typically would not take any action to prevent the arrangement as from its perspective it allows for a resident MNE to reduce its foreign tax burden to the benefit of the residence country's economy. To this point, Canada's rule in section 95(2)(a)(ii), which prevents Canada's CFC income attribution rules in the context of outbound financing structures, specifically embodies this policy. Also relevant in this regard are the several positive Canada Revenue Agency rulings approving Luxembourg MRPS financing structures.[32] Second, it is preposterous to expect that a typical intermediary country would ever take adverse tax action to prevent an imported mismatch arrangement because its economy typically benefits from it. Third, the source country, being last in the OECD's proposed ordering, is probably the only country that may attempt action against these arrangements, but the tax policy factors involved (discussed above) and the procedural and informational challenges make this highly unlikely too. Finally, if the above three points are accurate, they would seem to render irrelevant any ordering of the rules.

E. Final Observations on the Domestic Draft

Our comments regarding the domestic draft are not intended to be comprehensive. The following are some final observations:

- As noted above, from a source country perspective the treatment of hybrid mismatch arrangements is a question of interest deductibility. Hence, it is surprising that the OECD's work on action 2 does not proceed in parallel with the work on action 4 regarding interest stripping. Similarly, for imported mismatches, coordination would be required between action 2 and action 3, regarding CFC rules.
- Much of the attention of the comments received on the domestic draft focuses on the finer points relating to the drafting of anti-hybrid rules. For example, one item that has attracted much attention is the OECD's discussion of whether the anti-hybrid rules should be drafted in a top-down or bottom-up fashion (see paragraphs 119 and 120), in which the former style of drafting refers to starting with a broadly inclusive rule and providing for exceptions, while the latter style of drafting refers to a targeted approach that attacks only arrangements that have been identified as problematic.[33] Although these issues are important, they remain superficial compared with the fundamental concerns with the action 2 initiative as discussed above.

III. Comments on the Treaty Draft

A. Introduction

The first objective of action 2 as set out in the action plan was to develop proposals to change the OECD model tax treaty to ensure that hybrid instruments and entities (as well as dual resident entities) are not used to unduly obtain the benefits of treaties.[34] Together with the domestic draft, on March 19, 2014, the OECD issued the much shorter accompanying treaty draft dealing with treaty issues. This document first examines treaty issues related to dual resident entities, then includes a proposal for a new treaty provision dealing with transparent entities, and finally addresses the issue of the interaction between the recommendations included in the domestic draft and provisions of tax treaties.

B. Dual Resident Entities

As for the first objective, the report has two focuses. First, it refers to a recommendation in the March 14 action 6 BEPS report on treaty abuse for a revision of article 4(3) of the model that would read as follows:

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[32] *See* Rulings 2010-0375111R3, 2011-0400531, and 2012-0452291R3. *See also* Technical Interpretation 2012-0439741I7.

[33] *See* Amanda Athanasiou, ''OECD's Hybrid Mismatch Proposals Too Drastic, Commentators Say,'' *Tax Notes Int'l*, May 19, 2014, p. 608.

[34] We have previously noted that an issue with this objective was that its scope was not entirely clear because the purpose of hybrid instruments and entities was not necessarily to ''obtain the benefits of treaties unduly,'' although dual resident entities may be seen to have this as their purpose. Of course, treaty rules can address the use of hybrid instruments or entities in financing arrangements. *See supra* note 3.

> 3. Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, the competent authorities of the Contracting States shall endeavour to determine by mutual agreement the Contracting State of which such person shall be deemed to be a resident for the purposes of the Convention, having regard to its place of effective management, the place where it is incorporated or otherwise constituted and any other relevant factors. In the absence of such agreement, such person shall not be entitled to any relief or exemption from tax provided by this Convention except to the extent and in such manner as may be agreed upon by the competent authorities of the Contracting States.

Second, it expresses concern that the latter may not be adequate and that countries should consider adopting a rule seen in Canada and in the U.K. ''according to which an entity that is considered to be a resident of another State under a tax treaty will be deemed not to be a resident under domestic law'' (paragraph 8).

Regarding this first portion of the treaty draft, from a Canadian perspective there is nothing new or surprising. On the one hand, many Canadian treaties already resolve corporate dual residence on the basis of mutual agreement. On the other hand, section 250(5), which is noted at footnote 1 of the treaty draft, is Canada's domestic ''boot out'' rule, should a corporation be deemed by a tax treaty to not be resident in Canada. As we have previously noted: The OECD discovers America.

C. Hybrid Entities

As for the second objective of the treaty draft, paragraph 11 of the report contains the OECD's proposal:

> 11. The Partnership Report, however, did not expressly address the application of tax treaties to entities other than partnerships. In order to address that issue, as well as the fact that some countries have found it difficult to apply the conclusions of the Partnership Report, it is proposed to include in the OECD Model Tax Convention the following provision and Commentary,[35] which will ensure that income of transparent entities is treated, for the purposes of the Convention, in accordance with the principles of the Partnership Report. This will not only ensure that the benefits of tax treaties are granted in appropriate cases but also that these benefits are not granted where neither Contracting State treats, under its domestic law, the income of an entity as the income of one of its residents.
>
> *Replace Article 1 of the Model Tax Convention by the following (additions to the existing text appear in **bold italics**)*:
>
> *Article 1*
>
> PERSONS COVERED
>
> 1. This Convention shall apply to persons who are residents of one or both of the Contracting States.
>
> ***2. For the purposes of this Convention, income derived by or through an entity or arrangement that is treated as wholly or partly fiscally transparent under the tax law of either Contracting State shall be considered to be income of a resident of a Contracting State but only to the extent that the income is treated, for purposes of taxation by that State, as the income of a resident of that State.***

The OECD's proposal is essentially an updated version of article 1(6) of the 2006 U.S. model income tax treaty,[36] hence, again, it is nothing new.

Canada's experience regarding treaty hybrid provisions is instructive. As part of the 2007 fifth protocol to the Canada-U.S. tax treaty were included two sets of hybrid provisions: Article IV(6) and (7). Article IV(6) is intended as the beneficial rule and was long awaited in order to allow Canadian treaty benefits on income derived by a U.S.-owned LLC, which historically Canada refused to provide because an LLC is not a resident of the United States for the purposes of the treaty. Article IV(7) is the adverse anti-hybrid rule, which came into force in 2010 and which has two prongs. Article IV(7)(a) is the prong that many expected to see in the treaty. It prevents the use of reverse-hybrid limited partnership financing structures used by U.S. MNEs to finance their Canadian operations[37] by denying treaty benefits, in much the same way as does IRC section 894(c) in a reverse situation. Paragraph (b) of Article IV(7), the inclusion of which was totally unexpected, denies treaty benefits on income received from an entity that is opaque in the source country but transparent in the residence country of the owner, such as a U.S.-owned Canadian ULC. We noted in our December 2013 article that Article IV(7) was included at the request of the United States to limit financing structures it saw as achieving undue deferral of tax recognition for U.S. purposes, but bizarrely, if a structure is caught by its provisions, the effect is a windfall gain, in the form of unreduced withholding tax, to Canada. This last rule has been a huge headache in a Canada-U.S. context. The most substantial difficulty has been its application to dividends paid by a ULC to a U.S.

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[35]New paras. 26.3 to 26.16 to the commentary on article 1.

[36]That provision reads:

> An item of income, profit or gain derived through an entity that is fiscally transparent under the laws of either Contracting State shall be considered to be derived by a resident of a State to the extent that the item is treated for purposes of the taxation law of such Contracting State as the income, profit or gain of a resident.

[37]*See supra* note 28.

parent. Such distribution would be taxable at an unreduced 25 percent Canadian withholding rate even though the dividend would come from Canadian after-tax income and even though the U.S. recipient may be fully taxable in the United States. To partially alleviate the adverse and unwarranted effects of Article IV(7)(b), the Canadian government accommodates a technique that is effectively the economic equivalent of a dividend without being one from a corporate law perspective.[38] Nonetheless, in many situations problems remain regarding distributions, most notably when a ULC is owned by a U.S. LLC.[39] At the same time, it has been possible to more easily avoid the rule in the case of interest, the type of payment that was apparently originally targeted.

In comparison with the above, the OECD proposal, as it refers only to income derived by or through a hybrid entity, effectively corresponds to Article IV(6) and (7)(a) of the Canada-U.S. tax treaty, but does not seem to cover Article IV(7)(b) situations. In light of how controversial this latter rule has been, the OECD's choice in this regard is welcome. Beyond this, it is questionable whether an overall OECD model amendment is needed. The United States, because of its check-the-box regime, has been the main source of hybrid entities, and accordingly, U.S. treaties tend to include the U.S. model hybrid entity provision. Whether other countries would want such a provision should presumably be resolved on a bilateral basis. However, as a cautionary tale, the Canadian four-year experience with the hybrid rules in the Canada-U.S. tax treaty shows that these rules are arbitrary and capricious. On the one hand, it has been possible to avoid their intended adverse effects relatively easily, including through the use of third-country interposed entities. On the other hand, these rules have created some unintended traps for the unwary (for example, especially regarding the application of Article IV(7)(b) to distributions).

Of course, and this relates to the treaty draft's third coordination objective, the avoidance of anti-hybrid rules would be made more difficult by the adoption of the anti-treaty-shopping rules discussed in the OECD's action 6 draft. Thus in Canada, although previously the CRA had expressed positive views regarding the avoidance of Article IV(7) through the use of a third-country interposed entity, at the 2013 Canadian International Fiscal Association branch seminar it observed as follows in light of the government's recently declared concerns with treaty shopping:

> taxpayers should not expect the Income Tax Rulings Directorate to look favourably upon a ruling request involving an interposing entity located in a third jurisdiction designed to avoid the application of paragraph (7) of Article IV of the Treaty.[40]

D. Final Observations on the Treaty Draft

A final observation regarding the treaty draft relates to trusts. As explained in proposed new paragraph 26.11-26.13 of the OECD model commentaries, the OECD's proposal for a new article 1(2) of the OECD model is also intended to deal with trusts, which explains some particularities with the provision and differences from the 2006 U.S. model. From a Canadian perspective, again, this is nothing new: Article IV(1) of the Canada-U.S. treaty includes a rule dealing specifically with estates and trusts that states that a trust will receive treaty benefits only to the extent that it or its beneficiaries are taxed in the residence state on the relevant income.

IV. Conclusion

At the outset, it is hard to not be impressed with the OECD's hard work within a virtually impossible time frame to produce an extensive analysis of the vast and highly complex area of tax law as it relates to hybrid mismatch arrangements.

Complexity aside, hybrid mismatch arrangements are merely a means to an end that is conceptually fairly simple: An MNE would typically want to reduce its foreign tax burden by locating deductions (which often arise from internal debt financing) within source countries, while using various planning techniques, including hybrid mismatch arrangements, to avoid recognizing a corresponding income inclusion anywhere else. Fundamentally, such planning relies on the combination of three factors. First, it is a function of the willingness of source countries to allow a measure of deductible interest on internal financing. Whether source countries do so is a matter of tax policy not different from the question whether corporate tax rates should be higher or lower. And source countries have little trouble reducing such deductions, for example by tightening thin capitalization ratios, when they deem it desirable. One matter that has not been seen as relevant, because it is not, is the tax treatment of a deductible payment on the recipient's end. Simply put: Once a source country decides that a certain amount reduces (or as the OECD would prefer, erodes) its tax base, whether the amount is taxable elsewhere is unimportant.

Second, cross-border tax planning is a function of the MNE's residence country's CFC rules. Here again some countries have been more accommodating than others: France has notoriously limiting rules, whereas

[38] *See, e.g.*, the following most recent rulings on point: 2012-0471921R3, 2012-0467721R3.

[39] *See* 2009-0345351C6. *See also* 2013-0486931E5 regarding distribution by a fiscally transparent Canadian trust.

[40] 2013-0483801C6.

Canada has overtly encouraged its MNEs to use deductible payments to reduce their non-Canadian tax burden.

Third, obviously any intermediary countries must not impose any material levels of taxation.

Against this background, it is plain that income that, through tax planning (whether or not it involves hybrids), is deductible at source without resulting in a corresponding inclusion anywhere else is not stateless income that has slipped through a loophole in the system, but rather is the result of conscious tax policy choices by the countries involved. In fact, a country's accepting such planning techniques is merely a form of economic subsidy to cross-border investment flows.

Unfortunately, the political leaders of cash-strapped nations seem to have set their eyes on this so-called stateless income as some sort of ever-elusive holy grail and the OECD's Sisyphean task is now to identify ways — some of which eschew proper tax policy — to capture it. As suggested in our comments above, we believe this task would turn out to be difficult if not impossible. The fundamental weakness of the action 2 proposals is that they expect that countries would engage in irrational legislative behavior (for example, hurt resident MNEs without a hope of increased tax revenue or take action to effectively protect the tax base of other countries). However, as noted, the fatal flaw of this project is the insurmountable difficulties relating to imported mismatches in multilateral situations. In this regard, the OECD's wish to see every country adopt anti-hybrid rules is plainly utopic and, although some countries may enact certain rules, it is unlikely that action 2 would produce massive coordinated changes throughout the OECD/G-20 membership and worldwide.

Finally, as noted above, much of hybrid mismatch arrangements trace their origins to the United States, which is also the paradigm of a residence/capital exporting state. Naturally, the success or failure of the OECD's action 2 initiative depends on U.S. support. However, aside from the practical issues involved with the U.S. deadlocked political system and the alternative to hybrid arrangements provided by IRC section 954(c)(6) (assuming its life is extended), there would be little motivation for the United States to support the OECD's anti-hybrid rules, especially in light of their pro-source-country bias, because they would ultimately hurt U.S. resident MNEs. ◆