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Hybrids in Canada and the United States: The BEPS Action 2-Based Response

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INTRODUCTION

Before the U.S.'s enactment of Tax Cuts and Jobs Act[1] in 2017 and the issue of associated reg proposals in 2018[2] that contained anti-hybrid rules and before Canada's issue of anti-hybrid proposals[3] this April 29, there were several popular hybrid-based structures used to finance Canadian- or U.S.-owned operations in the other country.

This commentary explores those new or proposed rules by reference to some of those structures and then notes, in the concluding comments, how the parties might respond to reduce the impact of those changes.

CANADIAN-OWNED U.S. OPERATING SUBSIDIARIES

An Innocent Genesis

One would never know from the ferociousness of the crusade that OECD launched (in final form in October 2015) against hybrid-based arrangements — in Action 2 of its program to counter Base Erosion and Profit Shifting — that the first hybrid situations were foisted on uninterested taxpayers over past decades by the dedication of U.S. courts to ferreting out substance over form, an approach not readily followed by courts in Canada and other countries.

This led to entities formed under U.S. state partnership law being treated, by U.S. courts, as corporations if they had three or more "corporate" characteristics[4] while they continued to be treated as flow-through partnerships in Canada and other countries.

That, with no intended planning, initially raised more problems than tax planning opportunities for U.S. and foreign owners of such hybrid entities. For example, if a Canadian was a member of a partnership that was treated under that case law as a corporation and carried on business in the United States, would the U.S. taxes paid by the deemed corporation be creditable in Canada by the Canadian partner under section 126 of the *Canadian Income Tax Act* (the "Act")?

The foregoing also led to the period discussed next.

Evolution From Mid-1970s to 2018

Background

The foregoing case law development of hybrid entities as one of the three key components of hybrid planning — the other two being hybrid instruments

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[1] Pub. L. No. 115-97 (Dec. 22, 2017).

[2] Dep't of the Treasury, IRS, "Rules Regarding Certain Hybrid Arrangements" 26 CFR Parts 1 and 301 [Reg-104352-18]. See also the last paragraph in Section B.3-(A). *See* Nathan Boidman and Michael Kandev, *Expected Adverse Effects of Proposed U.S. Anti-Hybrid Regulations on Inbound Financing by Canadian MNEs*, Tax Notes Int'l, Feb. 11, 2019, p. 623.

[3] *See* Nathan Boidman and Michael Kandev, *Anti/Hybrid Rules Arrive (Finally) in Canada*, Tax Notes Int'l, June 20, 2022, p. 1525.

[4] *Morrissey v. Commissioner*, 296 U.S. 344 (1935).

and hybrid characterization of arrangements with more than one component none of which are necessarily hybrid per se — was, initially, primarily relevant to domestic U.S. questions stemming from the usual preference of a U.S. individual for flow-through entity treatment rather than corporate entity treatment to avoid the double tier taxation inherent in the latter.[5]

That preference, coupled with the usual preference from a pure non-tax standpoint for a corporate-type vehicle to carry on business rather than a partnership-type vehicle, led to two significant developments: one under non-tax law that facilitated a second under tax law, all of which was of interest to Canadian and other foreign parties doing business in the United States.

The non-tax development was the establishment of state law providing the creation of limited liability companies (LLCs)[6] that have two significant corporate characteristics: a separate patrimony and limited liability. The subsequent tax development was the addition of the ''check the box'' rules[7] that allowed entities formed under partnership law or LLC law or even under certain corporate law statutes (e.g., Canadian unlimited liability companies (ULCs)) to elect either (partnership-like) flow-through treatment or (corporate-like) corporate non-flow-through treatment.

That provided the basis for the first major Canada-into-U.S. hybrid financing arrangement, as discussed next.

Simple LLC Financing Structure

Relying on the foregoing developments, a Canadian corporation seeking to acquire (or finance the expansion of) a U.S. operating subsidiary would form an LLC, not elect corporate status under the check-the-box rules, and fund it with capital, and the LLC would on-lend to a U.S. subsidiary in the U.S. group at market rate interest.

With the United States treating the LLC as a flow-through and Canada treating it as a separate person, interest payments would reduce U.S. taxable operating income — attracting (during the '90s) a treaty-based U.S. WHT of 10% — and would attract no Canadian tax under Canada's foreign affiliate system.[8]

The U.S. Response

The United States shut down this structure by enacting, in 1997, §894(c), which denied the treaty reduction of the Code 30% WHT otherwise applicable.[9]

The Canadian Response

The Tower LLC Structure

First Iteration

The 1997 addition of Code §894(c) led to several new structures, one which was a direct successor as it also featured a flow-through LLC known as a ''Tower.'' That saw an LLC owned indirectly by Canco through a U.S.-formed partnership of which it was a 99% owner that checked the box to be a corporation and owned a flow-through Nova Scotia Unlimited Liability Company (ULC) that owned the LLC that loaned to a U.S. subsidiary of the group.

The partnership was funded mainly by market-rate-interest loans from the Canadian parent. The LLC distributed its interest income to the ULC which distributed to the partnership which paid interest to the Canadian parent.

Because the United States ignored the LLC and the ULC, it saw interest payments to the partnership (being treated as a U.S. corporation) and offsetting interest payment by the partnership to the Canadian parent. The small spread earned by the partnership was taxed at corporate rates by the United States, and there was 10% WHT on the interest paid by the partnership.

There was no tax in Canada on this arrangement, and any interest incurred by Canco to fund the partnership could be deducted against Canadian-source income of the group.

The U.S. Response and Iteration 2

The United States responded to the Tower by writing a reg that has always seemed invalid —namely a regulation under Code §894(c) denying the partnership in the Tower a deduction for the interest paid to a related party.[10]

What is the invalidity? The §894(c) rule deals with withholding tax. How can that provide a basis to write rules respecting deductibility?

In any event there was a second iteration available if the financing of the U.S. group was being funded by third-party loans to the parent. If those loans were made instead to the partnership (so that interest was

[5] The double tax (arising when tax is imposed on a dividend from a U.S. corporation to a U.S. individual that is paid out profits already taxed at the corporate level) was full or complete for many years and then became partial when a reduced rate of 15% was adopted for most dividends.

[6] Wyoming was the first state to do so in 1977.

[7] Reg. §301.7701-1 et seq. All section references are to the U.S. Internal Revenue Code, as amended (the ''Code''), or the Treasury regulations thereunder, unless otherwise indicated.

[8] See the Code constraints then extant under §163(j) and §385 and, in Canada, the base foreign affiliate system provided for by Act sections 90 to 95 and 113 and the Income Tax Regulations part 5900 made thereunder.

[9] For§894(c) not to apply, Canada would have had to also treat the LLC as a flow-through, which it did not.

[10] Reg. 1.894-1(d)(2)(ii)(B).

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paid to a third-party lender), interest deductibility for the partnership would be restored.

The Canadian response at inception was nil, and the subsequent treatment in the United States and Canada is addressed under ''Post-2017 Current Era,'' below.

The Branch Structure

Other post-§894(c) solutions were quite different from the Tower in one or both of the following ways.

First, having no hybrid entity but rather a hybrid effect. Second, seeking to reduce the 10% cost in the LLC structures seen above.

For example, Canco establishes a group financing company (FinanceCo) in Country X, which has a 25% corporate tax rate and a treaty with the United States exempting interest payments, and Canco funds FinanceCo with capital that is on-lent to a U.S. operating subsidiary.

Ordinarily that would not be very attractive.

But it would be attractive if (1) FinanceCo established a branch in a fourth country — Country Y, (2) the branch handled the loan to the United States, (3) neither Country X or Country Y taxed the branch, and (4) the U.S.-Country X treaty still applied.

The arrangement provided the intended tax results in the United States and Canada unless affected by a U.S.-Country X treaty change. See below for post-2017 treatment.

The Repo Structure

Another post-§894(c) solution saw a Canadian-owned U.S. subsidiary that owned the common and fixed-value fixed-dividend preferred stock of a second-tier U.S. subsidiary sell the prefs to the Canadian parent or to a Canadian or third-country subsidiary and agree to repurchase them, say, five years later.

The United States would see a loan (with deductible interest equal to the dividend ticket on the prefs) secured by the prefs, while Canada would see the ''buyer'' as the owner of the prefs, receiving dividends.

The arrangement provided the intended tax results in the United States and Canada, although leaving untested whether a Canadian court would also recharacterize the arrangement as a secured loan. For the post-2017 treatment, see below.

Redeemable Preferred Shares With Hybrid Equity-Debt Character

Another post-§894(c) solution saw a Canco, seeking to acquire or expand a U.S. operating group, forming a Country X FinanceCo, funding it with redeemable preferred shares that were treated by Canada as equity and by Country X as debt, with FinanceCo on-lending to a U.S. member of the group which paid deductible treaty-protected interest to FinanceCo.

The dividend payments on the prefs were deductible in Country X and the interest paid to FinanceCo was treated in Canada as deemed active business income as were the ensuing dividend payments under Canada's FA system.

The arrangements provided the intended tax results in the United States and Canada.

The Post-2017 Current Era

Brief Overview of the U.S. Changes

The foregoing shows the pivotal role the United States has played before the advent of BEPS in creating the hybrid scene and in taking first steps (in 1997) — along with its joint treaty action with Canada (discussed below) in 2007 — to rein it in.

That the OECD and fellow travellers were simply following the lead of the United States with its Action 2/BEPS proposals was obvious — as was the U.S. move in its 2017/18 initiatives to use Action 2 as a springboard to completing the work it started in 1997.

The TCJA added to the Code §245A (for inbound payments, paralleling the Canadian Act section 113(5) proposals discussed below) and §267A (for outbound payments, paralleling the Canadian section 18.4 proposals discussed below) to help counter cross-border hybrid mismatch structures used by foreign multinationals to finance U.S. acquisitions and operations arrangements seen to erode the U.S. corporate tax base. They are intended to reflect both the October 2015 Action 2 report and the follow-up 2017 report respecting branch mismatch arrangements.

The §267A rule is simple enough, stating that no deduction is allowed for a ''disqualified related-party amount'' that is not taxed in the hands of the related party and involves a hybrid instrument or hybrid entity (the latter bringing to mind the discussion above respecting Code §894(c) and LLCs).

The devil is in the details of provisions under both §267A and the dual consolidated loss rules of §1503(d) and §7701, as provided by the proposed regulations issued Dec. 20, 2018 as well as the final regs issued in April 2020. Congress had left much of the rulemaking under these sections to the IRS, and in the case of §267A had provided an unusually detailed grant of regulatory authority instructing the IRS to issue guidance as follows:

> 1. Rules for treating certain conduit arrangements which involve a hybrid transaction or a hybrid entity as subject to the deduction disallowance rule of §267A(a);
>
> 2. Rules for the application of §267A to branches or domestic entities;

3. Rules for treating certain structured transactions as subject to §267A(a);

4. Rules for treating a tax preference as an exclusion from income for purposes of applying the definition of ''disqualified related-party amount'' if such tax preference has the effect of reducing the generally applicable statutory rate by 25% or more;

5. Rules for treating the entire amount of interest or royalty paid or accrued to a related party as a disqualified related-party amount if such amount is subject to a participation exemption system or other system which provides for the exclusion or deduction of a substantial portion of such amount;

6. Rules for determining the tax residence of a foreign entity if the entity is otherwise considered a resident of more than one country or of no country;

7. Exceptions from §267A(a) with respect to (A) cases in which the disqualified related-party amount is taxed under the laws of a foreign country other than the country of which the related party is a resident for tax purposes, and (B) other cases which the Secretary determines do not present a risk of eroding the federal tax base; and

8. Requirements for record-keeping and information reporting in addition to any requirements imposed by the information reporting rules for certain foreign-owned U.S. corporations in §6038A.

Before correlating specific proposals with the five structures discussed above, the following points from the regs may be noted.

First, the proposed regs disallow an interest or royalty deduction for a ''specified payment'' that is a ''disqualified hybrid amount'' or a ''disqualified imported mismatch amount'' or that triggers an anti-avoidance rule.

Second, the first category (''disqualified hybrid amounts'' under Reg. §1.267A-2) are the heart of the rules and comprise five categories.

Third, the associated anti-hybrid proposed reg deals with the dual consolidated loss rules under Code §1503(d) and, as discussed below, is relevant to the residual (iteration 2) Tower structure.

Fourth, as noted earlier, the final version of the §267A regulations were issued in April 2020, and are generally applicable for tax years ending after December 20, 2018.

Brief Overview of the Canadian Changes

Although Canadian multinationals were at the head of the line of those who bought into the hybrid opportunities afforded by the U.S. developments seen above, it is only now that Canada is preparing legislation to adopt the Action 2 recommendations.[11]

Further to the April anti-hybrid proposals, Canada is adopting new rules in two phases: the first comprising the rules to rein in deduction/non-inclusion results involving hybrid financial instrument or hybrid transfer arrangements or substitute payment arrangements. Those pertaining to hybrid entity and imported hybrid and branch arrangements will be seen in the second phase. But the outbound variant of imported hybrid arrangements is essentially covered by the proposed §113(5) dividend exclusion denial rule discussed below in respect of hybrid redeemable preferred share structures.

The April 29 installment is to apply to post-June 30 payments — even in respect of pre-existing arrangements. The second set is supposed to apply no earlier than 2023.

Finally, new Act sections 12.7 and 113(5) will deal with inbound hybrid payments and section 18.4 with outbound hybrid payments — and section 18.4(12) strikes repo structures (see below).

Application of the Amended Laws to the Four Canada-Into-U.S. Structures Discussed Above

Second Iteration of the Tower

When we left this structure above, before the current era, it was providing a double deduction (of interest expense). It relied on hybrid entities not hybrid financial instruments. Since the proposed Canadian rules (phase 1) deal with neither (double deductions nor hybrid entities), they do not affect the structure.

However, the structure is shut down in the United States by the new DCL regulations. They operate to deny the hybrid U.S. partnership a deduction for the interest it pays to the third-party lender.[12]

Branch Structure

When we left this structure above, before the current era, it was obtaining a treaty rate on interest payments from the United States while avoiding corporate tax in country of the group lender by using a branch mismatch.

The first phase of the new Canadian rules do not appear to affect this structure, but in the United States it is struck down by Prop. Reg. §1.267A-2(e) and §1.267A-4.

[11] But it is not Canada's first excursion into hybrid-related law. The 2007 protocol to the U.S. treaty added anti-hybrid rules and there are several provisions in the Act and regulations intended to facilitate the ownership of U.S. interests through LLCs.

[12] For a detailed discussion, *see* Nathan Boidman and Michael Kandev, *Expected Adverse Effects of Proposed U.S. Anti-Hybrid Regulations on Inbound Financing by Canadian MNEs*, Tax Notes Int'l, Feb. 11, 2019, p. 623, 627–628.

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Repo Structure

When we left this structure above before the current era it was seeing the United States allowing an interest deduction in respect of its view of the transaction — a secured loan, while it was thought Canada would respect the form and see a flow of potentially exempt dividends.

Both countries have struck this structure: the United States under Prop. Reg. §1.267A-2(a)(3) (including *Ex.* 2), and Canada under Act section 18.4(12).

Hybrid Preferred Share Structure

When we left this structure above before the current era, it was providing interest deductions for U.S. subsidiaries with a shelter from third country taxation by payment of amounts on the redeemable prefs that were viewed as deductible interest for FinanceCo but exempt dividends for Canco.

This structure has been hit by laws not only in Canada and the United States but in third countries as well. In the United States, ''imported mismatch'' rules have been adopted to deny the interest deduction. See Reg. §1.267A-4 *Ex.* 8. And in Canada proposed Act section 113(5) will render the dividends on the prefs taxable.

Other Structures Worth Noting

There are other hybrid structures that have attracted a following and that can be expected to be affected by the crusade. By way of example consider an interest free loan by a Canadian parent to a Country X FinanceCo that on lends at market interest to an operating U.S. subsidiary. That would produce taxable income in County X unless it allows FinanceCo a ''notional interest deduction'' in respect of the interest-free loan.

In Canada it would attract proposed section 18.4(9) that would include the national interest in Canco's income. In the United States this would appear to be caught by the imported mismatched rule referred to above.

U.S.-OWNED CANADIAN OPERATING SUBSIDIARIES

Overview

Compared to the foregoing (Canadian-owned U.S. operating subs) there has been little use of hybrid planning into Canada by U.S. groups since the advent of anti hybrid rules in the 2007 fifth protocol to the Canada-U.S. treaty — particularly article 1v(7) that countered the Canadian version of the U.S. plan dissolved by §894(c).[13]

The (One) Structure Targeted by the Canadian Proposals

It did not take much imagination to foresee that at the very top of the Canadian proposals' hit list would be rules to counter a hybrid (United States into Canada) plan that had so incensed the Canadian government that they were moved to issue a warning to practitioners that it was being attacked under pre-hybrid law.[14]

The plan saw a U.S.-owned Canadian subsidiary capitalized with debt and equity, with interest to be paid (to the parent) to be funded by prepayments to be made to the Canadian sub by an affiliate disregarded LLC in respect of a forward sale by the Canadian sub of its treasury shares to the LLC which is funded by the U.S. parent.

The technical notes issued by the government respecting the hybrid proposals provides an example in its discussion of hybrid financial instrument arrangements that is consistent with the foregoing plan and which will see the interest payments disallowed.[15]

On the U.S. side, there appears to be no specific anti-hybrid reg on point. Whether it is otherwise countered is a different question.

CONCLUDING COMMENTS

The foregoing shows that, as a result of legislative initiatives since 2017 based on the Action 4 BEPS recommendations of October 2015, the first frontier for successful deployment of cross-border Canada-U.S. hybrid-based tax planning strategies is already on life support — and that's even before Canada has implemented the second phase of its anti-hybrid plans.

Therefore, effective Canada-U.S. cross-border strategies will have to incorporate techniques other than those in the hybrid space (such as those simply providing a low-tax environment and an effective treaty network) and even then be responsive to the further

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[13] That Canadian version saw a U.S. parent of a Canadian operating subsidiary establish a partnership under Canadian provincial partnership law, check the box on it to treat it as a corporation, fund it with equity that was on-loaned to the operating Canadian sub at market interest. Canada treated the interest as paid through the partnership to the U.S. parent and thus eligible for the then 10% treaty what rate, while the United States saw it as paid to the hybrid partnership, as a CFC and thus protected from Subpart F attribution by the same country exception under §954(c)(4).

[14] CRA Notice to Tax Professionals of July 5, 2019 (no longer available on CRA's website).

[15] *See* Act sections 18.4(4), (10), and (11).

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challenges raised by the OECD-led Inclusive Infrastructure's Pillar Two 15% global minimum tax initiative.

A daunting task indeed.

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