BEPS Targets Commonly Used Canada-U.S. Hybrid Structures

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In 2013 the OECD, working together with the G-20, adopted a 15-point action plan to address the perceived problem of base erosion and profit-shifting practices by taxpayers, which was identified by the G-20 as a significant fiscal issue for its member countries. The OECD adopted a remarkably ambitious timetable for implementing the BEPS action plan, which provides for 15 actions to be delivered by 2015, with a number of actions to be delivered in 2014. The focus of this article is action 2 of the BEPS action plan, which called for the publication of a report containing recommendations for addressing BEPS in the context of structures involving mismatched treatment of items as a result of hybrid entities or hybrid instruments. The concern with such structures is that they can result in the double nontaxation of income in some cases. The resulting 10-chapter report, “Neutralising the Effects of Hybrid Mismatch Arrangements,” was released by the OECD on September 16, 2014, as part of a package of seven reports addressing different aspects of the BEPS action plan. As suggested by the title of the hybrid arrangement report, the OECD has clearly concluded that hybrid mismatch arrangements are bad and need to be neutralized. The report is just under 100 pages long and includes a number of recommendations for addressing a wide range of hybrid arrangements.

This article is not an attempt to comprehensively review the hybrid arrangement report or look at its many recommendations in detail. Rather, this article merely takes a peek at the report through the lens of some structures commonly seen in Canada-U.S. cross-border financings. The structuring of such financings has become more complicated since the 2007 adoption of the fifth protocol to the Canada-U.S. treaty, which includes its own set of anti-hybrid rules containing numerous traps for the unwary planner. The introduction of yet another set of domestic anti-hybrid rules, such as the ones proposed by the hybrid arrangement report, would make the planning in this area only more dangerous.

**U.S.-Inbound Repos**

One key proposal in the hybrid arrangement report would target repo structures. Repos are sometimes used by Canadian entities to finance their U.S. operations. In a typical repo structure, the U.S. entity that requires the financing issues preferred shares to one of its U.S.
affiliates (the “borrower”), which sells the preferred shares to the Canadian financing entity for cash. The U.S. seller/borrower then directly or indirectly enters into a forward share purchase agreement to repurchase the preferred shares from the Canadian purchaser/lender. Under a substance-over-form approach, the repo arrangement is characterized for U.S. federal income tax purposes as a borrowing, with the payments made by the issuer of the preferred shares being characterized as deductible interest payments. The interest payments on the repo are generally exempt from U.S. withholding tax under Article XI of the Canada-U.S. treaty. From a Canadian perspective, on the other hand, most practitioners are comfortable that the Canadian purchaser would be respected as the owner of the preferred shares, in accordance with the form of the arrangement. Dividends paid on the preferred shares are respected as being dividends for Canadian purposes and are exempt from income taxation in the hands of the recipient under Canada’s foreign affiliate exempt surplus rules.

The hybrid arrangement report recommends that the country in which the payer of a payment is resident deny a deduction for the payments made under the arrangement when the recipient entity’s jurisdiction does not tax the income. Since the payments under the repo are not taxable in Canada, the recommendation would be for the United States to deny the deduction for the interest paid by the U.S. seller/borrower. In the United States, such a disallowance would require legislative action by Congress. In the likely event that Congress does not adopt the recommendation of the hybrid arrangement report, the report contains a corollary defensive rule to be adopted by payee jurisdictions. Under the defensive rule, the payee jurisdiction (here, Canada) would impose a rule that would make the payment received under a hybrid arrangement taxable if the paying jurisdiction does not apply a hybrid mismatch rule to eliminate the mismatch.

Loan to a ULC

Another recommendation made by the hybrid arrangement report could affect loans by a U.S. affiliate to a Canadian unlimited liability company (ULC) treated as a wholly owned disregarded entity of its U.S. shareholder for U.S. tax purposes. The report recommends that payments made by an entity that is disregarded in the payee jurisdiction (for example, payments by the ULC to its U.S. owner) are not deductible in the paying entity’s jurisdiction unless the income against which the deduction is being offset is currently includible in the payee jurisdiction. An example in the report explains that this rule would be invoked if the paying entity is able to surrender the tax benefit of the deduction to one of its affiliates through a consolidation regime, in which the income against which the affiliate offsets the deduction is not includible in the payee jurisdiction because the affiliate is characterized as a corporation in that jurisdiction. While this particular example is not relevant in the ULC borrower scenario (because Canada lacks a consolidation regime for affiliated corporations), a similar result can be achieved through the use of a reverse hybrid subsidiary of the ULC (for example, a Canadian limited partnership [LP] that elects to be treated as a corporation for U.S. purposes by filing a check-the-box election). The ULC would then include the income of the LP for Canadian purposes and use the interest deduction to offset its share of the LP’s income, while from a U.S. perspective the income of the LP reverse hybrid would not be includible by the U.S. owner of the ULC.

This particular structure is not commonly seen in practice because of the anti-hybrid rules contained in the Canada-U.S. treaty. In particular, Article IV(7)(b) would result in the imposition of Canadian withholding tax on the interest payments by the ULC to its U.S. owner. However, another variation more frequently used is for the loan to the ULC to be made by another member of the U.S. owner’s affiliated group. In the latter structure, the interest payments made by the ULC are not disregarded under the check-the-box rules but are viewed instead as having been made by the U.S. owner to its affiliate and are eliminated in the group’s consolidated return (subject to the potential application of the U.S. dual consolidated loss (DCL) rules).

Loan by a Reverse Hybrid Canadian LP

One structure that used to be quite popular for financing U.S.-owned Canadian operations involves the use of a Canadian LP that elects to be treated as a corporation for U.S. tax purposes. The U.S. financing entity contributes capital to the partnership in exchange for an interest in the partnership, and the partnership then uses the proceeds of the contribution to make loans to its Canadian corporate affiliates. Interest payments made by the affiliates to the partnership are deductible in Canada (subject to applicable thin cap rules), while the income earned by the partnership is viewed as having been earned by the U.S. partner for Canadian tax purposes. From a U.S. perspective, the interest income is earned inside a Canadian corporation and is not characterized as subpart F income under section 954(c)(3) or (6). The popularity of this structure has declined since the anti-hybrid rules of the fifth protocol to the Canada-U.S. treaty came into force, since the interest payments are no longer eligible for treaty relief from Canadian withholding taxes.

Under the hybrid arrangement report, the benefits of this structure would be eliminated entirely because the report recommends the disallowance of the deductions in Canada for the interest payments made to an entity that is a reverse hybrid from the owner’s perspective.

1There is a minority view to the contrary among some Canadian observers.
Alternatively, the report suggests that the LP not be treated as fiscally transparent for Canadian purposes. The report also recommends that the recipient jurisdiction capture the income under its CFC legislation (effectively recommending that section 954(c)(3) and (6) not be permitted to apply to such payments).

**Tower Structures**

One commonly used financing structure for Canadian-owned U.S. operations that has survived the adoption of the anti-hybrid rules of the fifth protocol is the tower structure. A full description of all the components of tower structures is beyond the scope of this article, but the key element is a U.S. LP that elects to be treated as a corporation for U.S. federal income tax purposes. Interest paid by the partnership is deductible for U.S. tax purposes against income of affiliated U.S. corporations (either by reason of consolidation or through the use of hybrid payments), while the same interest payments are deductible in Canada by the Canadian partners of the partnership.

The hybrid arrangement report would target tower and similar structures through the recommended adoption of a DCL regime in the investor’s jurisdiction (here, Canada), under which the deductions for interest payments would be limited to the income earned by the entity as seen in Canada. Since tower structures are designed to avoid such income from being earned, such a rule would effectively disallow the interest deductions in Canada. As a backup measure, the hybrid arrangement report recommends the paying entity jurisdiction (here, the United States) disallow the deduction instead if the investor jurisdiction does not have a DCL regime. The United States currently has an outbound DCL regime, but the proposal would also add a defensive inbound DCL regime. The rules would also target dual resident entities, which are covered under the existing U.S. regime.

**Foreign Holding Company Structures**

It has become common for financing structures between the United States and Canada to use a holding company in a treaty-friendly jurisdiction. In one variation, a Luxembourg corporation is used to make a loan to a U.S. operating subsidiary, with Luxco using a hybrid instrument, such as convertible preferred equity certificates (CPECs), to generate interest deductions that offset the interest income earned by Luxco. Anticipating that some jurisdictions that have favorable holding company regimes might not be eager to adopt the recommendation of the hybrid arrangement report, the report contains a recommendation that countries prevent the use of holding companies in recalcitrant jurisdictions through legislation targeting such “imported mismatch structures.” The proposal would be for the paying entity’s jurisdiction to disallow a deduction if there is an imported mismatch. This refers to when an investment is routed through a third country that did not adopt the hybrid mismatch arrangement above. In the U.S.-inbound financing example involving Luxco, this proposal would have the United States disallowing the interest deduction on the payment to Luxco if it is relying on a hybrid instrument to route the funds to a related party and if Luxembourg does not adopt the OECD proposal described above to disallow the deduction for the interest paid by Luxco on CPECs.

**Conclusion**

As the foregoing examples show, the recommendations in the hybrid arrangement report would affect a broad range of cross-border financing transactions and would, if they were all adopted, go a long way toward achieving the ambitious goal of the drafters to eliminate double nontaxation effects that result from hybrid instruments and entities. Given the current deadlock on Capitol Hill, the near-term prospects for legislation in the United States on this front seem dim, and the likelihood of Canadian action seems small as well, but at some point one or both countries could adopt at least some of the proposals in the hybrid arrangement report.