taxnotes® international

Volume 102, Number 5 ■ May 3, 2021

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Reprinted from *Tax Notes International*, May 3, 2021, p. 633

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In this article, the authors consider the Tax Court of Canada's recent *Emergis* judgment involving hybrid financing arrangements and examine the impact that it and anti-hybrid initiatives might have on multinationals. They conclude the result should have been different from the *FLSmidth* case, which addressed a similar tower structure and foreign tax deductibility question. They outline how tax law has changed to make hybrid structures less effective and perhaps drive taxpayers back to cross-border financing structures used in the pre-hybrid era.

In international tax matters, particularly those involving hybrid arrangements, events seem to repeat themselves. In 1997 the United States ushered in the anti-hybrid-rule era with the enactment of IRC section 894(c), aimed primarily at U.S. hybrid entity intercompany financing arrangements used by Canadian multinational enterprises. That was 16 years before the OECD and the G-20 "discovered America"[1] by initiating the base erosion and profit-shifting project, action 2 of which focused on stamping out hybrid arrangements. In February 2012, a year before the onset of the BEPS project, we wrote in these pages[2] about the Canadian *FLSmidth*[3] case, which involved a hybrid entity "tower" financing by a Canadian group of a U.S. target. Now, some nine years later, we see a different version of the tower structure at issue in *FLSmidth* coming before the Tax Court of Canada (TCC) in *Emergis*,[4] which the taxpayer again lost.

The purpose of this article is twofold: first, to review *Emergis* and the nature and operation of section 20(12) of the Canadian Income Tax Act, the Canadian rule that undermined the taxpayers in *Emergis* and *FLSmidth*; and second, to set the financing arrangements seen in both cases in the international tax context regarding hybrid financing arrangements. We conclude with the observation of another, ironic incidence of fiscal déjà vu: how ongoing initiatives against hybrid arrangements may be driving multinationals to adopt structures that were seen in the pre-hybrid era.

Emergis and ITA Section 20(12)

The issue in *Emergis* was whether in computing its income from a specific business or property, a Canadian corporation could deduct under ITA section 20(12) U.S. tax on interest paid to it by a partnership formed under U.S. law that was owned by the taxpayer and one of its

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

[2] Boidman and Kandev, "Tax Court of Canada Shaves Benefits of Hybrid Entity Financing Structure," *Tax Notes Int'l*, Feb. 6, 2012, p. 455.

[3] *FLSmidth Ltd. v. The Queen*, 2012 TCC 3, *aff'd* 2013 FCA 160.

[4] *Emergis v. The Queen*, 2021 TCC 23.

Canadian subsidiaries, and to which the taxpayer had lent money. The partnership had elected to be treated under U.S. law as a corporation so that the United States saw the interest as paid by a U.S. corporation. Before 2008 that interest was subject to a treaty-reduced 10 percent U.S. withholding tax. The reason the taxpayer claimed only a deduction and not a credit under ITA section 126 for the U.S. withholding tax is that there was no net Canadian tax on the interest against which the credit could be claimed (and in any event, the taxpayer had no direct foreign-source income from a Canadian tax perspective).

The taxpayer's loan to the reverse hybrid partnership on which the interest was paid was part of a so-called tower structure, which was developed after the 1997 enactment of IRC section 894(c) eliminated the benefits of the much simpler limited liability company financing structures previously used by Canadians in financing U.S. acquisitions.[5]

The taxpayer in *Emergis* was doing a U.S. target acquisition at a price of $542 million.[6] It set up a U.S. corporation (USCorp) to carry out the acquisition and funded USCorp in part with equity of $242 million and the balance with an internal loan of $300 million provided through a tower structure that involved the following elements:

- the taxpayer contributed $33 million to the capital of a partnership and loaned $267 million to the partnership;
- the partnership invested the aggregate $300 million in the shares of a Nova Scotia unlimited liability company (NSULC), a Canadian corporation that elected to be a disregarded entity for U.S. tax purposes;
- NSULC contributed $300 million to a wholly owned LLC disregarded for U.S. tax purposes; and
- LLC loaned $300 million at arm's-length interest to USCorp, which, together with its equity of $242 million, then had $542 million and carried out the acquisition.

Over time, USCorp paid interest to the LLC, which made dividend distributions to NSULC, which paid dividends to the partnership, which paid interest to the partners (as lenders) and distributed its relatively nominal net profit to the partners.

From a Canadian tax perspective, the LLC was a controlled foreign affiliate[7] that received interest income from another foreign affiliate, USCorp. That interest was recharacterized as active business income under ITA section 95(2)(a)(ii) and paid as a tax-free, exempt surplus dividend to NSULC,[8] which paid a dividend to the partnership, which in turn paid interest and made distributions to its partners. Under ITA sections 96, 20(1)(c), and 112, there was no Canadian tax on those flows from the ULC and the partnership to its two partners.

From a U.S. tax perspective, both NSULC and LLC were disregarded, and the partnership was a deemed U.S. corporation that used $300 million to make a loan to USCorp. It also received interest from USCorp, which it paid as interest to the taxpayer on the taxpayer's $267 million loan to it. As noted above, it was the U.S. withholding tax on that interest paid to the taxpayer that gave rise to the dispute under section 20(12).

The government denied the ITA section 20(12) deduction because, although the interest was paid in respect of income from a specific property source — the taxpayer's loan to the partnership — (the first condition in section 20(12)), the U.S. withholding could also reasonably be regarded as having been paid by a corporation in respect of income from a share of the corporation's foreign affiliate (the second condition, which operates as an exclusion). The TCC held that while the U.S. withholding tax clearly was paid on interest, not income, from a share, through a wide reading of the expressions "reasonably be regarded" and "in respect of," it could be seen as having been paid in respect of income from the shares of the LLC, a foreign affiliate of the corporate taxpayer.

[5] Those structures involved a Canadian acquirer establishing a U.S. corporation to acquire a U.S. target and directly partially funding it with capital stock as required by U.S. debt-equity rules under IRC sections 163(j) and 385 and indirectly funding the balance by establishing a limited liability company funded with capital stock the LLC loaned at market interest rates to the U.S. acquisition corporation.

[6] All amounts in this article are in U.S. dollars.

[7] ITA section 95(1).

[8] ITA sections 90 and 113(a).

The court's holding was based on the rationale developed in *FLSmidth*. In that case, the loan to the reverse hybrid partnership was not made by the Canadian partner but instead was received from an arm's-length financing institution. Therefore, in *FLSmidth* there was no U.S. withholding tax on interest. Instead, the ITA section 20(12) issue involved the U.S. corporate tax imposed on the partnership in respect of the profit spread between its interest revenue and interest expense, which was not at issue in *Emergis*.

Regarding section 20(12), in *FLSmidth* the TCC held:

> [63] I disagree with the appellant's position that the words "can reasonably be regarded" in subsection 20(12) do not enable the Minister to look through NSULC. *It seems to me that this phrase, on its own, is a specific provision enabling the Minister to evaluate the economic substance of a transaction regardless of its legal form*. . . .
>
> [65] For these reasons, I conclude that the language of subsection 20(12) supports the respondent's position that the U.S. tax paid by the limited partnership were paid in respect of income from the shares of LLC and that the tax could therefore reasonably be regarded as having been so paid. [Emphasis added.]

The Federal Court of Appeal (FCA) in *FLSmidth* did not agree or disagree with the TCC's analysis. Rather, it held that the taxpayer could not succeed on the facts whether the words "in respect of" in section 20(12) are to be read broadly or narrowly.

In *Emergis* Justice Réal Favreau stated:

> [68] Although Emergis' arguments have some merit, I am not convinced I should depart from the interpretation of subsection 20(12) given by Paris J [in *FLSmidth*]. I agree with the Respondent that the words "in respect of" are very broad. . . .
>
> [74] . . . Given the flow of funds in this tower structure, there is some connection between the interest income paid by [reverse hybrid partnership] USGP and the dividends paid by LLC to USGP, which were reclaimed and reported by Emergis through its partnership interest in USGP.
>
> [75] The [broad] language used in subsection 20(12) was clearly intended to capture indirect flows of income considering that corporate structure involving foreign affiliates often contain several tiers.

In our view and with due respect, the *FLSmidth* analysis should not have been extended to deny the ITA section 20(12) deduction in *Emergis*. In *FLSmidth* the U.S. corporate tax at issue — imposed on a U.S. corporation from the U.S. tax perspective — had no equivalent from a Canadian perspective.[9] That dissonance seems to have invited the type of scrutiny that led to the TCC's radical and overbroad reading of the phrases "can reasonably be regarded" and "in respect of" in the second condition of section 20(12).[10] In fact, the TCC in *FLSmidth* seems to have thought that the wording of section 20(12) in that context allowed it to recharacterize the taxpayer's bona fide legal relationships in line with the perceived economic realities of the tower structure.[11]

However, the straightforward U.S. withholding tax on outbound interest in *Emergis* — imposed on a Canadian corporation from the U.S. tax perspective — should not have generated the same type of dissonance, the same kind of broad interpretation of the second condition in section 20(12), and the same policy-driven result. Rather, in *Emergis* the prima facie treatment was so simple and clear: Emergis paid U.S. withholding tax directly in respect of its specific source of property income under the ITA — its loan to the U.S. partnership — (satisfying the first condition in section 20(12)), and that source was not a share of its foreign affiliate (so the exclusion in the second condition in section 20(12) should

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[9] By contrast, see ITA section 212(13.1) for the Canadian comparable to the U.S. withholding tax on the interest paid in *Emergis*.

[10] Economic substance over legal substance, which the FCA did not adopt in *FLSmidth*.

[11] *See Shell Canada Ltd. v. Canada*, [1999] 3 S.C.R. 622, at para. 39, for the proposition that a recharacterization like that is not permitted to address perceived tax avoidance concerns.

not have applied). We understand that the taxpayer in *Emergis* is appealing to the FCA.

Hybrid Financings Then and Now

The tax years at issue in *Emergis* were 2000 and 2001, while the tax period litigated in *FLSmidth* was 2002. That is 20 years ago, and much has changed in international taxation since then.

First, effective June 12, 2002, regulations promulgated under IRC section 894(c) eliminated deductibility to the reverse hybrid partnership of intragroup interest payments such as the ones in *Emergis*. In other words, after that date, only the tower structure in *FLSmidth*, which involved external financing at the partnership level, remained viable.

Second, Canada's 2007 budget scared Canadian multinationals by introducing ITA section 18.2, which would have denied "double-dip" interest after 2011. That provision would have disallowed interest except to the extent of specified financing expense had it not been repealed, after a massive uproar, by the 2009 budget before ever applying.

Third, with the advent of the fifth protocol to the Canada-U.S. tax treaty in 2007, two factors caused the tower structure to become less appealing to taxpayers. On the one hand, the treaty withholding tax exemption on interest effective 2008 made available third-country financing structures. On the other hand, the inclusion, effective 2010, of new Article IV(7), which denies treaty benefits on distributions from a reverse hybrid partnership, made the tower "leaky." As a result, many existing towers were dismantled and migrated to simpler and more efficient structures.

Fourth, starting in 2013, the anti-hybrid initiatives undertaken by the G-20 and OECD as part of the BEPS project and the EU as part of the anti-tax-avoidance directives renewed the popularity of the tower as a direct Canada-to-U.S. structure that is strong and reliable.

Fifth, in 2017 the Tax Cuts and Jobs Act introduced new anti-hybrid provisions,[12] which were followed by the 2018 announcement of proposed regulations (REG-104352-18) under the anti-hybrid rules and the dual-consolidated loss (DCL) rules.[13] The amendments to the DCL regulations under IRC section 1503(d) harmed domestic reverse-hybrid double-dip structures, such as the tower in *FLSmidth*.[14]

While some hybrid financing arrangements have survived the anti-hybrid rules and regulations under the TCJA, the most recent international tax developments may cause cross-border financings to revert to the pre-hybrid era.

It was noted above that the tower structures in *FLSmidth* and *Emergis* were developed in response to the 1997 enactment of IRC section 894(c), which made the use of a single LLC hybrid structure ineffectual. However, what did the single LLC structure replace as the preferred structure for Canadian financings of U.S. businesses? Between the mid-1970s and -1990s, the preferred approach used no hybrids but rather a Dutch finance subsidiary. That structure lost favor and was replaced by the single LLC approach in the early 1990s because, starting with the Netherlands-U.S. treaty, the U.S. renegotiated its tax conventions to include limitation on benefits provisions.

Now, if the OECD negotiations lead to the adoption of the pillar 2 minimum tax system, and President Biden adopts tax reforms that conform with it, Canadian multinationals may reconsider the viability of simple international financing company structures that were popular before the hybrid arrangements era.

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[12] IRC sections 245A and 267A. *See* Boidman, "The Tax Cuts and Jobs Act: Canada-U.S. Comparative for Multinational Enterprises," *Tax Notes Int'l*, Mar. 19, 2018, p. 1169.

[13] *See* Boidman and 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. The anti-hybrid regulations were finalized April 7, 2020.

[14] Section 1503(d) states that the DCL of any corporation cannot reduce the taxable income of any other member of the affiliated group for that tax year or any other. The term "dual consolidated loss" is any net operating loss of a domestic corporation that is subject to an income tax of a foreign country on its income without regard to whether that income is from sources in or outside that country or is subject to such a tax on a residence basis — that is, a dual-resident corporation. The amendments to the regulations under IRC sections 1503(d) and 7701 require a domestic eligible entity, as a condition to being classified as a corporation for U.S. tax purposes, to consent to being treated as a dual-resident corporation for every tax year in which a related foreign tax resident is treated as deriving income or incurring losses of the entity, thereby force-feeding the entity into the DCL limitations.

Conclusion

This discussion points to two key factors. First, even though the objectives of the tower structures for financing U.S. acquisitions in *FLSmidth* and *Emergis* were identical and the structures almost identical, the foreign tax deduction question in *Emergis* should have been resolved in favor of the taxpayer. The FCA will take that up on appeal.

Second, and regardless of that appeal, the global tax developments since the United States first took action to limit hybrid arrangements in 1997 have severely limited hybrid entity or hybrid instrument financing arrangements and may cause taxpayers to reconsider pre-hybrid-era strategies.

Postscript

On April 19, just after we submitted this article for publication, Canada announced in its first budget since 2019 that it is joining the United States and a growing list of countries in adopting anti-hybrid rules based on the OECD's final BEPS action 2 report.

Although other changes since 2002 may have already limited the tower structures described above so as to render the Canadian budget initiative irrelevant to those hybrid arrangements, we will examine the budget's anti-hybrid proposals in a forthcoming article. ■