

# U.S. releases anti-hybrid regulations

May 04, 2020

On April 7, 2020, the Internal Revenue Service (IRS) and U.S. Treasury Department released the final regulations and additional proposed regulations under the *Tax Cuts and Jobs Act* to curtail exploitation of differences in tax characterizations on cross-border transactions. These “hybrid entities” or “hybrid transactions” often led to cross-border transactions involving an income deduction in the U.S. without a corresponding income inclusion in a non-U.S. country or an income deduction on both sides of the border. Although many structures involving Canada and the U.S. have had to be unwound as a result of these changes, there are still other corporate tax structures available to accomplish many of the same objectives.

These regulations are generally consistent with the anti-hybrid recommendations made by the Organization for Economic Cooperation and Development (OECD)’s Base Erosion and Profit Shifting (BEPS) Project.

## What you need to know

- The final regulations released April 7, 2020, appear to be broadly consistent with the regulations proposed in December 2018, but have clarified a number of points.
- In the last year, the 2018 proposed regulations have had the effect of forcing many Canadian taxpayers to unwind their cross-border structures involving the U.S., such as repurchase agreements (REPO), towers, mandatorily redeemable preferred shares (MRPS), and interest-free loan structures.
- Financing structures that do not rely on hybrid features should still accomplish many of the same objectives, such as those involving a third country with a low corporate tax rate.

## What changed?

On April 7, 2020, the U.S. released the final version of the regulations to sections 245A(e) and 267A of the Internal Revenue Code (the Code), among others. These provisions were included in the *Tax Cuts and Jobs Act* of December 22, 2017, and proposed regulations were released in December 2018. The final regulations provided a number of clarifications on the application of the foreign hybrid mismatch rules in both outbound and inbound contexts. The IRS and Treasury also released proposed

guidance relative to the hybrid rules and certain other rules applicable to controlled foreign corporations, which are open for public comment until June 8, 2020.

These sections prevent cross-border transactions involving the U.S. to exploit hybrid mismatches, such as those situations where there is a deduction in one country and no income inclusion in the other, or where there is a deduction on both sides of the border.

The final version of the regulations included several clarifications. One such clarification provides that the determination of a hybrid arrangement should be made before applying foreign hybrid mismatch rules.

## **How are Canadian corporations impacted?**

Historically, where Canadian corporations have U.S. subsidiaries, there has been an incentive to shift profits from the U.S. into Canada owing to the lower corporate tax rates in Canada. In addition, mismatches on hybrid entities or hybrid transactions between the two countries allowed for double deductions or non-taxation in certain cases, particularly through the use of hybrid financing strategies. With the decrease in U.S. corporate tax rates and the implementation of the anti-hybrid rules, the economics and viability of these financing structures have shifted entirely.

## **What still works?**

The U.S. anti-hybrid rules do not prohibit cross-border financing through a third, low-tax country. The BEPS Project also does not prevent countries from setting low income tax rates, acknowledging that a country is not engaged in unfair tax competition simply because their fiscal policy provides for low rates of income taxation.

A relatively straightforward financing structure involves a Canadian parent corporation (Canco) that owns 100 per cent of two sister corporations: an operating company in the U.S. (USCo) and another corporation in a third, lower-tax country (Finco). Canco finances Finco with equity, and Finco uses the proceeds to make an interest-bearing loan to USCo.

USCo's interest payments to Finco should be deductible in the U.S. (subject to the extensive interest deductibility restrictions in provisions such as section 163(j) of the Code), and the interest income is taxed in Finco at the ordinary corporate tax rate in its jurisdiction. Properly structured, Finco's interest income should not be taxable to Canco when earned or distributed by Finco. If third-party financing is needed, Canco can generally deduct the interest on borrowed funds used to fund Finco. It is important that Finco be located in a country with which the United States has a tax treaty, that the limitations on benefits provisions in the tax treaty is met, and that Canada has a tax treaty or a tax information exchange agreement with Finco's country of residence.

## **Going forward**

Canadian corporations doing business in the United States must fundamentally rethink the economics of their tax strategy, possibly looking to involve a third country. These international tax plans are increasingly complex. Seeking tax advice from all relevant

jurisdictions is vital to understanding the full tax picture, ensuring tax benefits are not unexpectedly denied, and not unknowingly triggering punitive taxes. We can also expect Canada, the United States, and other OECD member states to increase their focus on substance, treaty shopping, and transfer pricing issues in their ongoing efforts at preventing BEPS.

*BLG is the Canadian member in the Tax and network, an independent tax organization which has member firms from all over the world to leverage its vast international tax and business expertise. We have the relevant experience across our network to provide the requisite breadth and depth of expertise on your next cross-border transaction.*

By

[Jennifer Hanna](#), [Siwei Chen](#)

Expertise

[International Tax](#), [Business Tax](#), [Mergers & Acquisitions](#), [Private Equity & Venture Capital](#)

## BLG | Canada's Law Firm

As the largest, truly full-service Canadian law firm, Borden Ladner Gervais LLP (BLG) delivers practical legal advice for domestic and international clients across more practices and industries than any Canadian firm. With over 800 lawyers, intellectual property agents and other professionals, BLG serves the legal needs of businesses and institutions across Canada and beyond – from M&A and capital markets, to disputes, financing, and trademark & patent registration.

[blg.com](http://blg.com)

## BLG Offices

### Calgary

Centennial Place, East Tower  
520 3rd Avenue S.W.  
Calgary, AB, Canada  
T2P 0R3

T 403.232.9500  
F 403.266.1395

### Ottawa

World Exchange Plaza  
100 Queen Street  
Ottawa, ON, Canada  
K1P 1J9

T 613.237.5160  
F 613.230.8842

### Vancouver

1200 Waterfront Centre  
200 Burrard Street  
Vancouver, BC, Canada  
V7X 1T2

T 604.687.5744  
F 604.687.1415

### Montréal

1000 De La Gauchetière Street West  
Suite 900  
Montréal, QC, Canada  
H3B 5H4

T 514.954.2555  
F 514.879.9015

### Toronto

Bay Adelaide Centre, East Tower  
22 Adelaide Street West  
Toronto, ON, Canada  
M5H 4E3

T 416.367.6000  
F 416.367.6749

The information contained herein is of a general nature and is not intended to constitute legal advice, a complete statement of the law, or an opinion on any subject. No one should act upon it or refrain from acting without a thorough examination of the law after the facts of a specific situation are considered. You are urged to consult your legal adviser in cases of specific questions or concerns. BLG does not warrant or guarantee the accuracy, currency or completeness of this publication. No part of this publication may be reproduced without prior written permission of Borden Ladner Gervais LLP. If this publication was sent to you by BLG and you do not wish to receive further publications from BLG, you may ask to remove your contact information from our mailing lists by emailing [unsubscribe@blg.com](mailto:unsubscribe@blg.com) or manage your subscription

preferences at [blg.com/MyPreferences](https://www.blg.com/MyPreferences). If you feel you have received this message in error please contact [communications@blg.com](mailto:communications@blg.com). BLG's privacy policy for publications may be found at [blg.com/en/privacy](https://www.blg.com/en/privacy).

© 2026 Borden Ladner Gervais LLP. Borden Ladner Gervais LLP is an Ontario Limited Liability Partnership.