U.S. releases anti-hybrid regulations

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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.

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By

Jennifer Hanna, Siwei Chen

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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