HYBRID ENTITIES IN CROSS BORDER TRANSACTIONS:

- THE CANADIAN EXPERIENCE
- THE U.S. RESPONSE
- B.E.P.S. – THE O.E.C.D. END GAME

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PROFESSIONAL BIOGRAPHY

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I. Introduction

From the day the I.R.S. proposed regulations[1] abandoning the historic four-factor test for entity characterization,[2] hybrid entities have become a popular tool for the international tax adviser. The reason is obvious. The use of a hybrid – which is an entity treated as a partnership or a branch in one country and as a separate entity in a second country – enables a taxpayer to avail itself of disjunctures in the tax systems of two countries.[3] The result is that a transaction could be deductible in one jurisdiction and not taxable – or not currently taxable – in the other jurisdiction. The benefits were quickly apparent to investors based in Canada, and in the early years, perhaps no other group of foreign-based investors has availed itself of the planning opportunity to the extent that Canadians have. In part, this was spurred by the adoption of an income tax treaty between the U.S. and the Netherlands which ended certain cross-border financing arrangements that were prevalent between Canadian parent companies and U.S. affiliates.[4]

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1 Treas. Regs. §§301.7701-2 and 301.7701-3.

2 To be treated as a corporation for income tax purposes, an entity was required to have more corporate characteristics than non-corporate characteristics. The principal corporate characteristics were centralization of management, limited liability, free transferability of ownership interests by members, and unlimited life. In the event an entity had only one or two of the characteristics, the entity was presumed to be a partnership.

3 Taxpayers were cautioned in the preamble to the Treasury Decision adopting the new regulations (T.D. 8697) that the Treasury and the I.R.S. would monitor carefully the uses of check-the-box entities in the international context to prevent abusive transactions, and would take appropriate action when those entities are used to achieve results that are inconsistent with the policies and rules of specific provisions of U.S. tax law or of U.S. tax treaties. The I.R.S. issued regulations regarding the qualification for treaty benefits of hybrid entities and their members in 2002. See Treas. Regs. §1.894-1(d) (T.D. 8889), discussed later in this paper.

4 A new treaty between the Netherlands and the U.S. entered into force on December 31, 1993, and contains a limitation on benefits provision that became the model for several subsequent U.S. treaties. See Article 26

Aggressive planning opportunities are not limited to inbound investors. In Notice 2003-46, the I.R.S. announced that it would withdraw a regulatory proposal under which a check-the-box election for a foreign eligible entity owned directly or indirectly by one or more U.S. Shareholders would not be recognized if an extraordinary event were to occur in close proximity to the election. An example would be the sale of shares of the disregarded entity within a period beginning one day before the election and ending twelve months after the election. In withdrawing the proposed regulation, the I.R.S. cautioned that it would rely on other principles of existing law, such as the substance-over-form doctrine, to determine the proper tax consequences of a check-the-box election when the actual sale of shares in a C.F.C. is treated as a sale of assets. Two examples of I.R.S. concern were (i) the acquisition by a C.F.C. of stock of a target C.F.C., after which the target C.F.C. is liquidated, and (ii) an actual or deemed liquidation of a lower-tier C.F.C. by its parent followed by a sale of assets. Under strictly domestic tax concepts, the I.R.S. treats the first transaction as an asset acquisition. In both examples, the sale of assets provides better tax treatment for the U.S. Shareholder group as the gain may go unrecognized.[5]

In recent years, the O.E.C.D. has focused on abusive transactions involving hybrid entities, contending that the planning mentioned above results in double no taxation, which is viewed as abusive from a governmental viewpoint. Proposals have been made by the O.E.C.D. to prevent such planning from having the desired effect. One report proposed changes in

(Limitation on Benefits). The treaty contains a grandfather clause that delayed the effective date of less favorable provisions to January 1, 1995, at the election of the taxpayer. The provision was modified by a protocol that entered into force on December 28, 2004.

5 Depending on the circumstances, the transaction may be treated as a D-reorganization or an F-reorganization.

domestic law;[6] the second proposed changes to the O.E.C.D. Model Tax Convention.[7]

This article provides an overview of the use of hybrid entities as a tool to invest in a cross-border context. It addresses: (i) the planning opportunity that preceded the use of hybrid entities, (ii) the basic pattern for its use, (iii) the U.S. legislative and regulatory response, (iv) the potential use of hybrid entities under current law, (v) recent modifications to the Canada-U.S. Income Tax Treaty designed to promote the use of certain hybrid entities but to prevent the use of others, and (vi) the B.E.P.S. proposals made by the O.E.C.D., which are designed to prevent abusive tax planning involving hybrid entities. This article is current as of January 1, 2015.

II. The Predecessor to the Hybrid – Back-to-Back Loans

Prior to the adoption by the U.S. of a policy under which treaty benefits are limited to qualified residents of a treaty jurisdiction or persons engaged in a substantial business in that jurisdiction,[8] financing of U.S. operations in a tax effective mode by a Canadian parent corporation often involved the use of a group finance company in the Netherlands.

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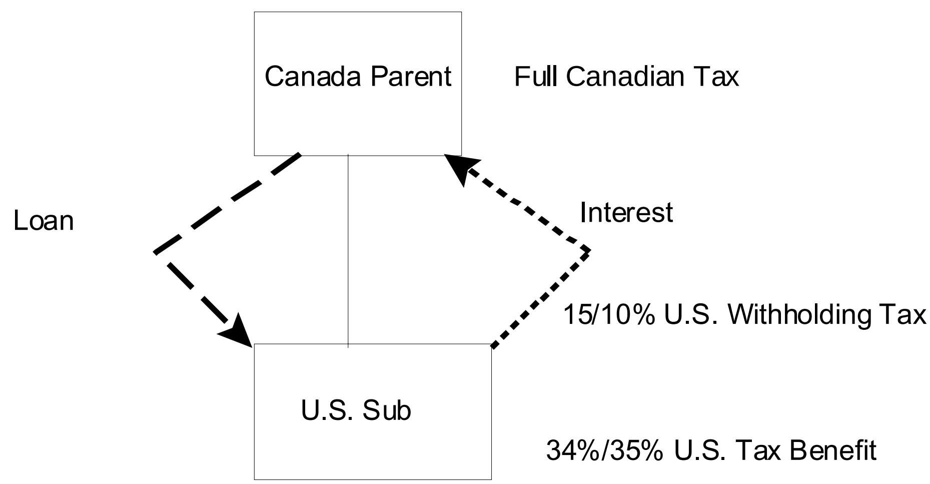
6 See http://www.oecd.org/ctp/aggressive/hybrid-mismatch-arrangements discussion-draft-domestic-laws-recommendations-march-2014.pdf.

7 See http://www.oecd.org/ctp/treaties/hybrid-mismatch-arrangements-discussion-draft-treaty-issues-march-2014.pdf.

8 See e.g., Article 26 (Limitation on Benefits) of the treaty between the U.S. and the Netherlands.

Under treaty rules in effect at the time, if a Canadian parent company loaned funds directly to the U.S. affiliate engaged in an active trade or business,[9] a 10% or 15% withholding tax[10] was imposed in the U.S. on the payment of interest and full Canadian tax would be imposed on the receipt of interest. This is illustrated in the following diagram.

Simple Loan Transaction



However, by using an intermediary finance company in the Netherlands to lend funds into the U.S., a Canadian corporation was able to achieve a

9 The standard for determining whether a trade or business is active was the Canadian standard. An investment business within the meaning of Section 95(1) of the Income Tax Act Canada would not qualify.

10 Prior to 1996, Article XI (Interest) of the income tax treaty between the U.S. and Canada provided for a withholding tax rate of 15% for interest payments. Today, interest paid by a U.S. subsidiary to its Canadian parent is exempt from U.S. withholding tax. See paragraph 1 of Article XI (Interest) as in effect on the date of this article.

reduction in U.S. income tax through the accrual of intercompany interest expense, the elimination of U.S. withholding tax on the payment of interest, and the elimination of corporate tax in Canada on the receipt of payments. Indeed, the overall Canadian tax could be reduced if the funds used in the U.S. were borrowed initially by the Canadian parent corporation. There would be relatively little tax in the Netherlands.

Historically, the rate of U.S. withholding tax on interest under the income tax treaty between the U.S. and the Netherlands is zero.[11] In the Netherlands, corporate income tax was eliminated in several ways. In some instances, a finance company was organized in the Netherlands that was a resident of the Netherlands Antilles under an arrangement between the two jurisdictions. Notwithstanding the status of the finance company within the Netherlands, it was a resident of the Netherlands for purposes of the income tax treaty between the U.S. and the Netherlands that was then in effect. Under that treaty, residence was based on the place of incorporation.[12] Alternatively, a branch was formed in Switzerland and a Dutch tax ruling was obtained allocating most of the income from the lending transaction to the Swiss branch. A separate ruling could be obtained in Switzerland. If the branch were located in a low-tax canton, the tax rate would amount to roughly 10% of the income allocated to Switzerland under the Swiss tax ruling. Finally, the Dutch finance company borrowed all or most of the funds lent to the U.S. affiliate, eliminating most of the taxable interest income in the Netherlands with deductible interest expense. The interest payments of the Dutch company were not subject to Dutch tax under the domestic law of the Netherlands. The finance company reported income in the Netherlands in the amount of the

[11] See Article VIII (Interest) of the income tax treaty between the U.S. and the Netherlands that was negotiated in 1948 ("the 1948 Treaty") and amended by several protocols.

[12] See Article II (Definitions) of the 1948 Treaty.

spread between interest income and interest expense, perhaps one-eighth of a point.

Dividends paid to a Canadian parent company by the Dutch finance subsidiary were subject to a 10% Dutch withholding tax under the terms of the Netherlands-Canada Income Tax Treaty in effect at the time. If the dividends were paid from exempt surplus for purposes of Canadian corporate tax, there was no further corporate tax liability in Canada on the receipt of the dividends. Moreover, interest income of the finance company was not treated as Foreign Accrual Property Income in the hands of the finance company if the business entity paying the interest was organized in a jurisdiction that was a treaty partner of Canada and deducted the interest expense from its active business income. Finally, if the Canadian parent company borrowed the funds used to invest in the U.S. through the foregoing structure, the interest expense was deductible in Canada.[13]

The structure that was often used is illustrated in the following diagram:

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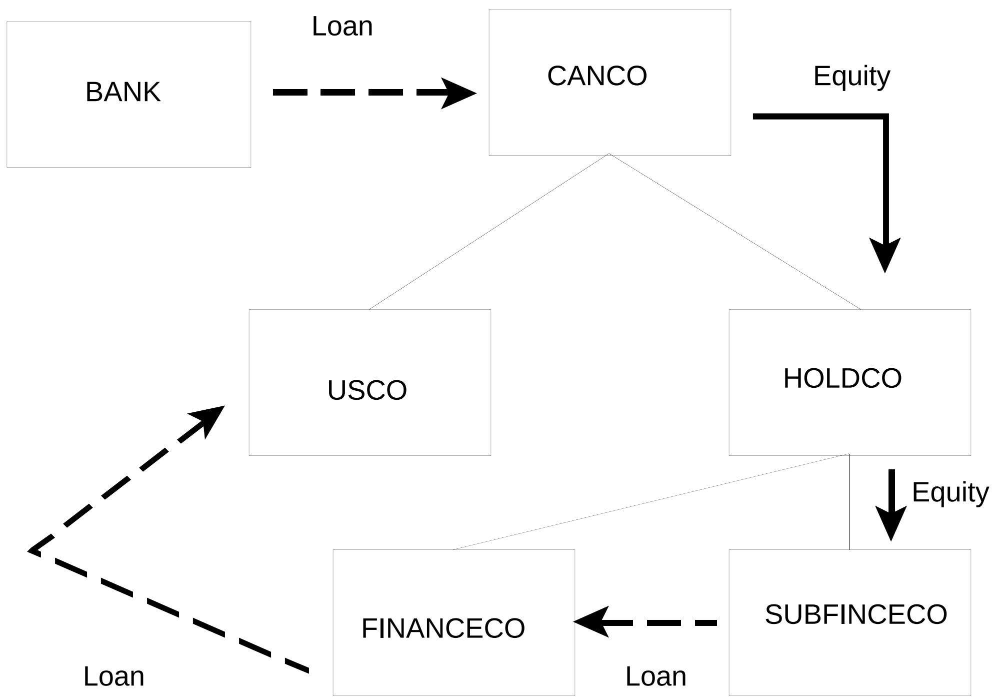
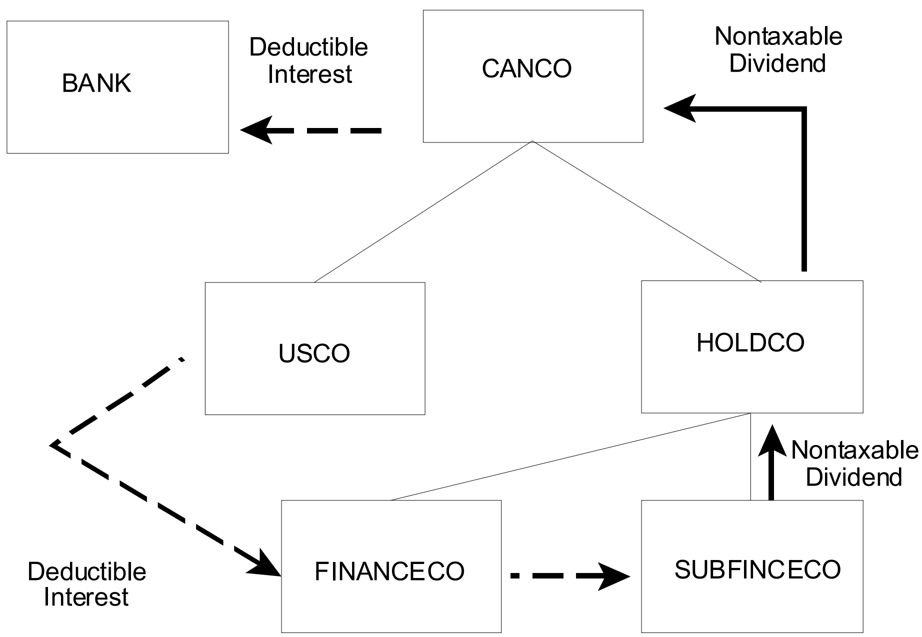
13 This type of structure is embodied in the facts underlying *Laidlaw Transportation Inc. v. Commr.*, Tax Court Memo. 1998-232. In the case, the plan seemed to work in principle, but the taxpayer ignored the plan in practice.

Structure



The return flow of funds from the U.S. affiliate ultimately to the Canadian parent company is illustrated by the following diagram:

Flows of Funds



The global effective tax rate under the foregoing plan was modest. Withholding tax would be eliminated in the U.S., limited income tax would be imposed in the Netherlands (although dividends would be subject to a 10% withholding tax), the dividends received in Canada would be free of corporate tax, and the interest paid to the Canadian bank would reduce other taxable income in Canada.

The foregoing structure was dependent on the application of the 1948 income tax treaty between the U.S. and the Netherlands, as modified by several protocols. When the treaty was replaced, effective as of 1995, the benefits disappeared. Once the replacement treaty applied, Article 26 (Limitation on

Benefits) set forth tests that had to be met by a Dutch company in order to obtain benefits under the replacement treaty. Detailed rules were provided in the treaty and the accompanying Memorandum of Understanding setting forth the application of the limitation on benefits provision. Objective tests were expressly spelled out so as to limit opportunities for maneuvering. Under those tests, the Dutch finance company in the above example likely would no longer be entitled to treaty benefits.

III. Enter the Hybrid

With the Dutch treaty no longer available, an alternative to the back-to-back loan had to be crafted by the Canadian parent company. For several years, the hybrid entity proved to be a valuable successor. To be a hybrid entity for U.S. purposes, (i) the entity must be eligible to choose its character as a flow-thru entity that is transparent for U.S. income tax purposes or an association taxable as a corporation and (ii) the characterization of that entity as a taxpayer or a flow-thru entity must differ for U.S. income tax purposes and foreign tax purposes.[14] Under the U.S. income tax regulations, an eligible entity is any entity that is not on the list of *per se* corporations in the procedure and administration regulations that address the status of various business entities.[15] A typical example of an eligible entity is a limited liability company ("L.L.C.") created under U.S. domestic law, a G.m.b.H. created under German law, and a Society with Restricted Liability ("S.R.L.") created under the laws of Barbados. While other hybrid entities exist, the Barbados S.R.L. was the entity of choice for Canadians.

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[14] See generally Treas. Regs. §1.894-1(d).

[15] See Treas. Regs. §301.7701-2(b) for the list of entities that must be treated as taxpayers in their own right. See Treas. Regs. §301.7701-3 for entities that either default into flow-thru treatment or may elect such treatment.

An S.R.L. is a special company formed in Barbados. An S.R.L. may be taxed under the International Business Corporation ("I.B.C.") regime or the regime for regular corporations. If the S.R.L. elects to be covered by the I.B.C. regime, its maximum tax rate is 2.5% and the rate can be reduced in several tranches to as little as 0.25% as gross income increases. It can also be reduced to 1% by credits.

More importantly, Canada has had an income tax treaty in effect with Barbados for many years, and although the limitations have been imposed on entities eligible for benefits, in broad terms, treaty benefits are extended to S.R.L.'s that are not I.B.C.'s.[16] Dividends paid by this type of S.R.L. can be viewed to arise from exempt surplus. For a Canadian company, the existence of the treaty and its application to an S.R.L. means that no Canadian tax is due on the receipt of dividends paid by a covered S.R.L. out of exempt surplus. For an S.R.L. that is an I.B.C., no withholding tax exists in Barbados.[17] At each step of the way, care must be taken to ensure that the S.R.L. is treated as a resident of Barbados under Canadian tax concepts, that the S.R.L. qualifies for benefits under the treaty between Canada and Barbados, and that dividends paid by the S.R.L. are deemed to come from exempt surplus.

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16 As of the effective date of this paper, paragraph 3 of Article XXX (Miscellaneous Rules) of the Barbados-Canada Income Tax Treaty provides that an entity entitled to I.B.C. benefits is generally not entitled to the benefits of Articles VI to XXIV of that treaty. This provision was adopted as part of a protocol that was concluded in 2011 and entered into force on January 1, 2014. A predecessor provision was in effect from 1980.

17 Under legislation announced in December 2007, no withholding tax exists in Barbados for corporations that are not subject to the I.B.C. regime when the dividend represents the distribution of profits earned outside of Barbados.

Inherent in the foregoing discussion of the taxation of an S.R.L. and its Canadian parent company is the acknowledgment that the S.R.L. is treated as a corporation for tax purposes in Canada and Barbados.

The treatment of the S.R.L. for U.S. tax purposes is somewhat different. In the U.S., an S.R.L. formed under Barbados law is not among the companies listed as *per se* corporations in the procedure and administration regulations. Consequently, if the S.R.L. is wholly owned by a Canadian company and a check-the-box election is made for the S.R.L., the S.R.L. is treated as a branch of the Canadian parent company. (It should be noted that for company law purposes, an S.R.L. must have a minimum of two shareholders; however, if one shareholder is an individual such as a local lawyer who is a nominee/agent of the principal shareholder, and if properly structured, that ownership can be ignored for U.S. income tax purposes.[18])

Thus, the S.R.L. has the characteristics of a hybrid entity for income tax purposes, and that hybrid nature made it an attractive financing tool. Instead of a back-to-back loan to finance a U.S. affiliate, the planning involved the formation of an S.R.L. in Barbados. An equity investment would be made in the S.R.L. by the Canadian parent, and a loan would be made by the S.R.L. to the U.S. affiliate. This may be illustrated in the following diagram.

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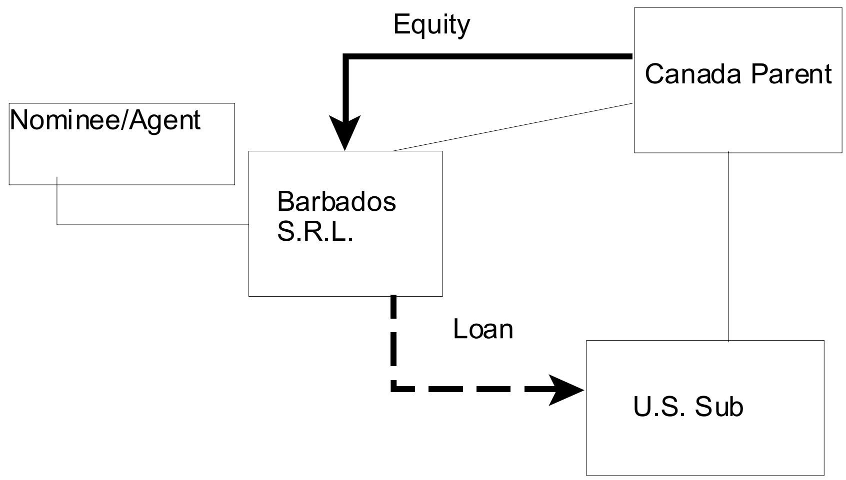
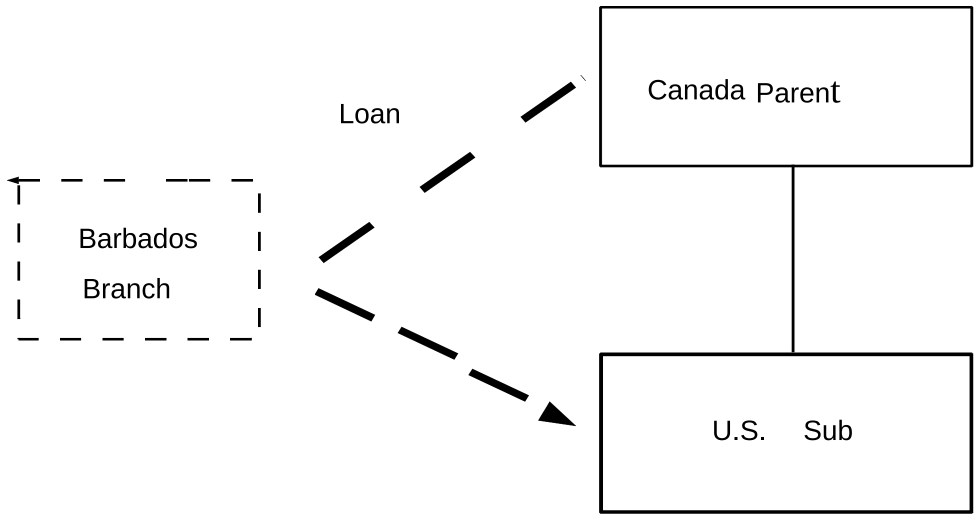
[18] See e.g., P.L.R. 200201024, P.L.R. 199911033, P.L.R. 199914006, and I.L.M. 200501001 for fact patterns in which a second owner of an eligible entity was disregarded by the I.R.S.

Hybrid Structure



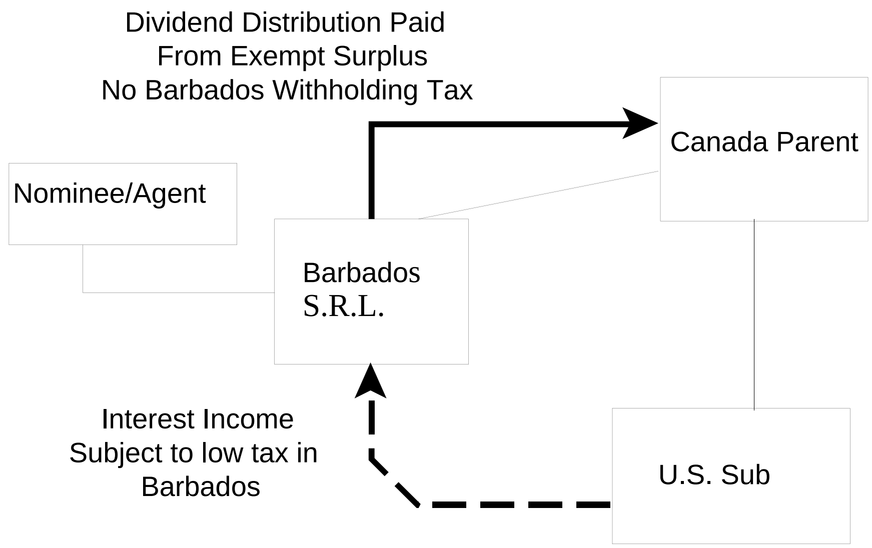
In this scenario, a disjuncture existed between the tax law in the U.S. and the tax laws in Canada and Barbados. In Canada and Barbados, the foregoing structure would be respected. A Canadian company made an equity investment in an S.R.L. and the S.R.L. made a loan to the U.S. affiliate. However, under U.S. tax concepts, the S.R.L. would be ignored. The U.S. affiliate would be considered to have borrowed funds from its Canadian parent company. This is illustrated by the following diagram, which is strikingly similar to the diagram on page 4, above.

U.S. View



Upon payment of interest by the U.S. company, the receipt of the interest income by the S.R.L. would be respected for tax purposes in Barbados and Canada. The S.R.L. would owe tax in Barbados, but with planning, the effective rate would be modest. Thereupon, the S.R.L. would pay a dividend to the Canadian parent company. Provided that the U.S. company was engaged in an active business and the interest expense reduced the taxable profit of that business, the Foreign Accrual Property Income Rules would not apply or cause the Canadian company to be taxed immediately upon the receipt of interest income by the S.R.L. In addition, when the Canadian company received a dividend from the S.R.L., the dividend would be deemed to arise from exempt surplus and corporate tax would not be imposed on the Canadian corporation. The result was that the interest income of the S.R.L. was not taxable to the Canadian parent company either when earned or when the resulting earnings were distributed in the form of a dividend. This is illustrated by the following diagram.

Canadian Treatment of Funds Flow



In comparison, the transaction would be treated in the U.S. as if the Canadian corporation were the recipient of the interest. The interest income would continue be subject to 10% U.S. tax under prior versions of the Canada-U.S. Income Tax Treaty for years beginning in 1996. The S.R.L. would be ignored for U.S. income tax purposes. The simplicity of the structure also prevented application of the anti-conduit rules of U.S. tax law designed to prevent back-to-back financing arrangements.[19]

IV. The Regulatory and Statutory Response

The foregoing treatment was far too attractive to remain unchallenged by the I.R.S. and Congress. Taking separate paths, the I.R.S. and Congress modified U.S. treaty interpretation policy by denying tax treaty benefits to

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19 See Treas. Regs. §1.881-3.

certain income of hybrid entities. The regulations issued by the I.R.S. go beyond the context of Canadian investment in the U.S., and when the statute was revised, Congress intended to eliminate the use of hybrid finance vehicles by Canada-based groups investing in the U.S.

A. Hybrid Regulations

Having roots in an earlier set of proposed withholding tax regulations, the I.R.S. issued final regulations[20] under section 894(c) of the Internal Revenue Code of 1986 as amended from time to time (the "Code"), the provision that integrates U.S. tax law with conflicting provisions of various U.S. income tax treaties. The regulations are designed to prevent taxpayers from using hybrid entities to create synthetic tax havens through which the relevant income is not subject to tax in any jurisdiction or receives the benefit of a reduced withholding tax rate under a treaty.

The regulations reflect the view that an income tax treaty is a negotiated agreement between two jurisdictions in which one side (the state from which the income is sourced) agrees to a reduced rate of withholding and the other side (the state of residence) agrees to provide double tax relief. The relief may take the form of an exemption or a tax credit for withholding taxes paid in the other state. The arrangement is designed to prevent double taxation, not to encourage double no taxation on a global basis. Thus, the regulations adopt the view that treaty benefits should not be extended by the state from which the income is sourced if the state of residence is not going to subject that income to its tax regime.[21]

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[20] Treas. Regs. §1.894-1(d).

[21] This view does not extend to cover reduced withholding taxes on dividends, where the state of residence may permit the taxpayer the benefit of a participation exemption or a dividends-received deduction.

The regulations address the income tax benefits afforded by treaty to a hybrid entity. For this purpose, a hybrid entity is an entity that is treated as fiscally transparent in one country and as a taxpayer in another country. For U.S. income and withholding taxes on the non-effectively connected income of a hybrid entity to be reduced by treaty benefits, one of two conditions must be met. Either (i) the hybrid entity must be treated as a taxable entity in its country of residence and would, in its own right, be entitled to treaty benefits were it not a flow-thru entity for U.S. tax purposes or (ii) the entity must be treated as fiscally transparent in the country of residence of its shareholder, the shareholder must be taxed in that country as if it received the income directly from the U.S., and the shareholder would, in its own right, be entitled to treaty benefits under an applicable treaty.[22]

The regulations define when an entity will be considered to be fiscally transparent. For an entity to be fiscally transparent, its shareholders must take into account separately, and on a current basis, their respective shares of the items of income paid to the entity. Moreover, the items of income in the hands of the shareholders must have the same character for tax purposes that would exist if those items were realized directly from the source.[23] In other words, the entity is given the equivalent of partnership flow-thru treatment – not the equivalent of C.F.C. inclusion treatment.[24]

Consequently, the anti-hybrid regulations provide that the U.S. will reduce its withholding tax only if (i) the hybrid or its shareholders are taxed abroad on

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[22] Treas. Regs. §1.894-1(d)(1).

[23] Treas. Regs. §1.894-1(d)(3)(ii).

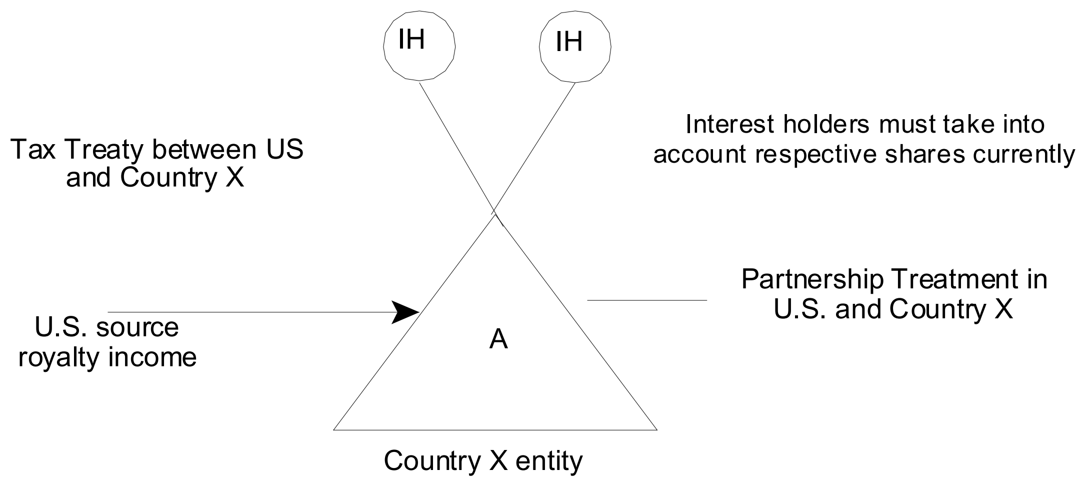
[24] Treas. Regs. §1.894-1(d)(3)(iii).

amounts paid by a U.S. entity and (ii) the party that is taxed qualifies for treaty benefits.

Examples are provided that illustrate how this is achieved in various circumstances.

In Example 1, Company A is a business organization that is formed in Country X, which has an income tax treaty in effect with the U.S. Company A is treated as a partnership for U.S. tax purposes as well as for Country X tax purposes. Country X requires Company A's interest holders to separately and currently take into account their respective shares of Company A's income. The character and source of the income are treated as if they were realized directly by the interest holders from the source. Company A receives royalty income from the U.S. that is not effectively connected income. This is illustrated in the following diagram.

Example 1

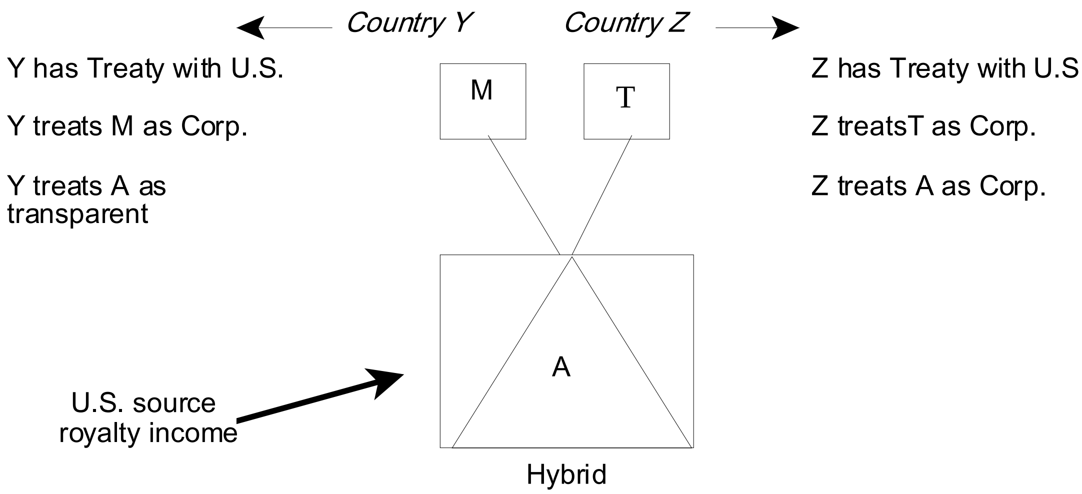


A is fiscally transparent. A's royalty income not covered by treaty

Because Company A is fiscally transparent in its jurisdiction, Company A is not treated as having derived the income for the purposes of the treaty and does not receive a reduction in withholding.

In Example 2, the facts are the same as in Example 1, except that the partners in Company A are Company M, a corporation organized in Country Y, and Company T, a corporation organized in Country Z. Both countries have tax treaties with the U.S. and neither Company M nor Company T is treated as fiscally transparent in its country of residence. Country Y requires Company M to take into account on a current basis its share of the items of income paid to Company A whether or not distributed. Country Z does not require Company T to include its share of Company A's income on a current basis. This is illustrated in the following diagram:

Example 2



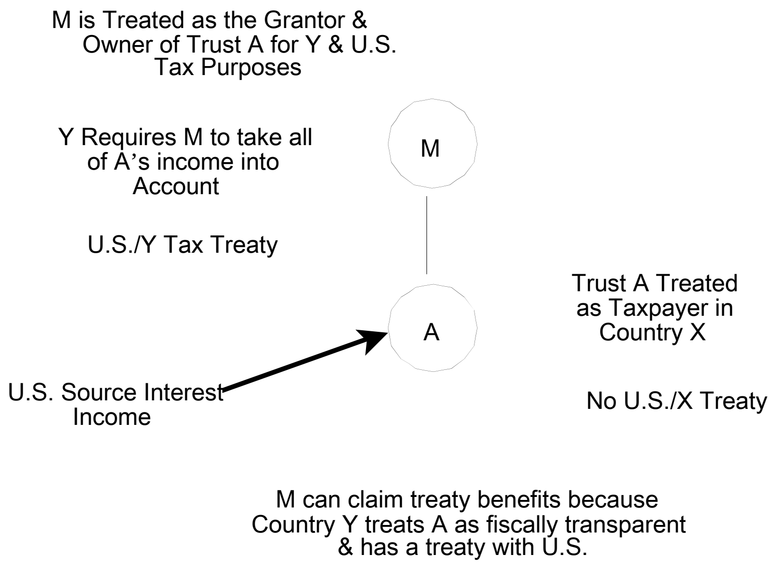
M gets treaty benefits on share of U.S.source income, but T does not because A is not fiscally transparent in Z

Because Country Y treats Company A as fiscally transparent, Company M is treated as having derived its share of the U.S. source royalty income for purposes of the treaty between Country Y and the U.S. Consequently, benefits under that treaty are extended to Company M with regard to its share of the income of Company A. However, Country Z does not treat Company A as fiscally transparent. Therefore, Company T is not treated as deriving its share of the U.S. source royalty income for purposes of the treaty between Country Z and the U.S. Consequently, Company T is not entitled to treaty benefits on its share of the royalty income of Company A.

In Example 3, facts are the same as in Example 2 except that Country X taxes Company A as a corporation. The income tax treaty between the U.S. and Country X reduces withholding to 5 percent. The income tax treaty between the U.S. and Country Y exempts royalty completely. Consequently, U.S. withholding tax is eliminated under the treaty for residents of Country Y. Company A is treated as deriving the U.S.-source royalty income for purposes of the income tax treaty between the U.S. and Country X. It is entitled to a reduced withholding tax of 5 percent. Because Country Y treats Company A as fiscally transparent, Company M is treated as deriving its share of the royalty income paid to Company A for purposes of the income tax treaty between the U.S. and Country Y. It is entitled to a complete exemption from withholding tax on its share of the royalty income. Because Country Z does not treat Company A as transparent, Company T is not treated as deriving the royalty income for purposes of the income tax treaty between the U.S. and Country Z. Consequently, Company T receives no treaty benefits.

In Example 4, Trust A is organized in Country X, which does not have a tax treaty with the U.S. Individual M, a resident of Country Y, is the grantor and owner of the trust for U.S. and Country Y tax purposes. Country Y has a tax treaty with the U.S. Country Y requires Individual M to take into account all of Trust A's income in the taxable year, whether or not distributed. Country X does not treat Individual M as the owner of Trust A. Trust A receives interest from the U.S. that is neither portfolio interest nor effectively connected income. This is illustrated in the following diagram:

Example 4

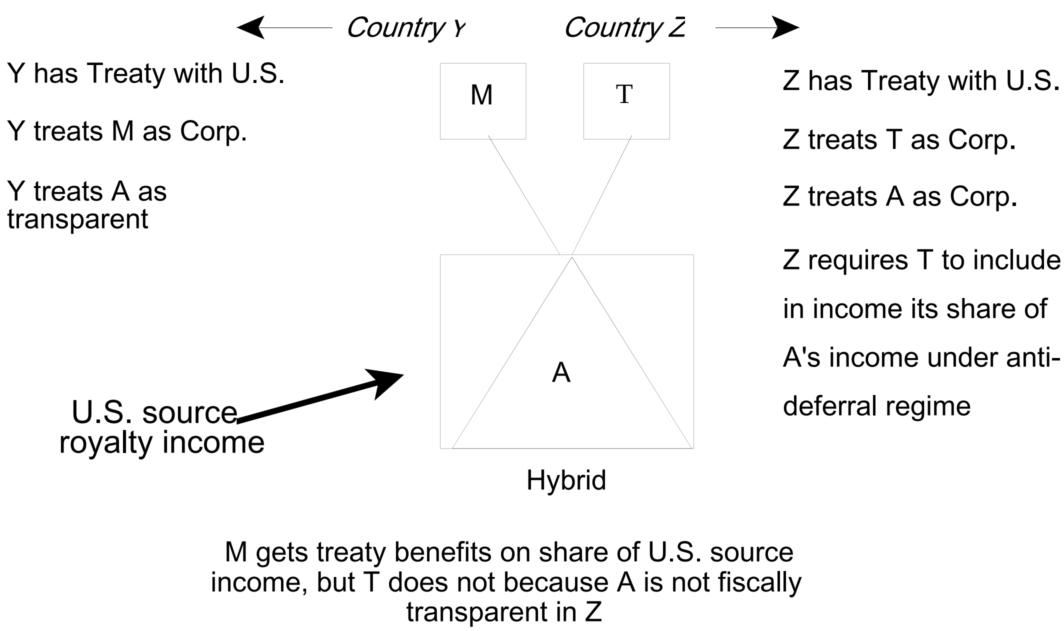


Trust A cannot claim treaty benefits because there is no treaty between the U.S. and Country X, but Individual M can claim treaty benefits because Country Y treats Trust A as fiscally transparent and a tax treaty exists between Country Y and the U.S.

In Example 5, the facts are the same as in Example 4 except that Individual M is treated as the owner of the trust under U.S. tax law; the limited application of the grantor trust rules apply in circumstances where the grantor is a foreign person. The trust document governing Trust A does not require current distributions, but some distributions are made currently to Individual M. There is no requirement under Country Y law requiring Individual M to take into account Trust A's income on a current basis whether or not distributed. However, if current distributions are made, Country Y treats the character of the income in the hands of Individual M as if the income were realized directly from the source. The example concludes that Individual M does not derive the U.S.-source interest income. Trust A is not viewed to be fiscally transparent under the laws of Country Y because Individual M is not required to take into account his share of Trust A's interest income on a current basis, whether or not distributed.

In Example 6, the facts are the same as in Example 2, except that Country Z requires Company T, which owns 60 percent of Company A, to take into account its respective share of the royalty income under an anti-deferral regime applicable to certain passive income of controlled foreign corporations. This is illustrated in the following diagram:

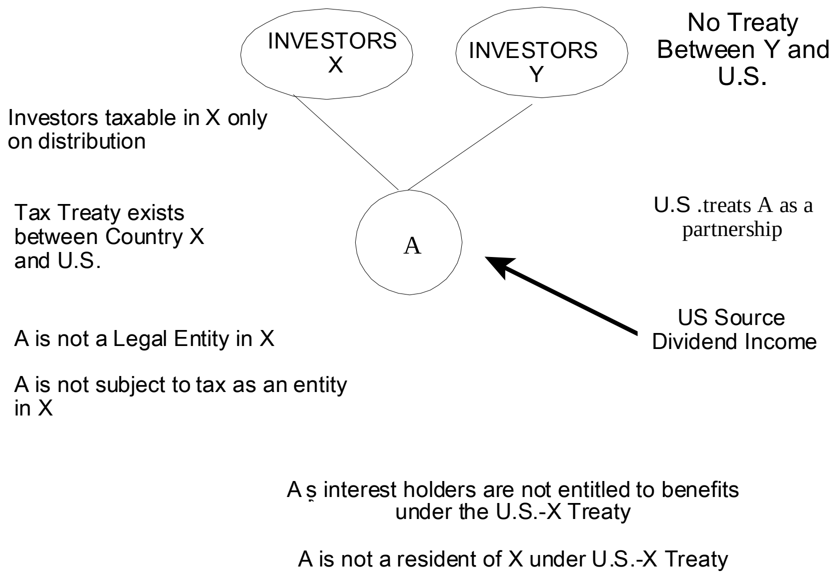
Example 6



The example concludes that Company T cannot claim treaty benefits with respect to the royalty income, because the inclusion in income under an anti-deferral rule does not meet the definition of fiscal transparency. The amounts included in income by the shareholder do not have the same class, kind, and character as the income received by the subsidiary company.

In Example 7, Arrangement A is a collective investment fund, providing for joint ownership of securities. It has no legal personality under the laws of Country X. A tax treaty exists between Country X and the U.S. Arrangement A is considered a common fund under Country X's laws. Because it has no legal personality, it is not subject to tax at the entity level in Country X and is not a resident of Country X under the residence definition of the tax treaty between Country X and the U.S. Arrangement A receives U.S.-source dividend income and is treated as a partnership for U.S. tax purposes. Under Country X's laws, Arrangement A's investors take their respective shares of Arrangement A's income into account only when distributions are received from the common fund. Some of Arrangement A's interest holders are resident in Country X, others in Country Y. Country Y has no treaty with the U.S. This is illustrated in the following diagram:

Example 7



Arrangement A is not fiscally transparent with respect to the U.S.-source dividend income because the interest holders are not required to take their respective shares into account in the taxable year whether or not distributed. Moreover, because Arrangement A is not a resident of Country X for the purposes of the income tax treaty between Country X and the U.S., it is not entitled to treaty benefits in its own right. Finally, because Arrangement A is not fiscally transparent with respect to the U.S.-source dividend income, Arrangement A's interest holders that are Country X residents are not entitled to benefits under the tax treaty between Country X and the U.S.

In Example 8, the facts are the same as in Example 7, except that Arrangement A is organized in Country Z and the income tax treaty between the U.S. and Country Z provides that a common fund organized under the laws of Country Z is treated as a Country Z resident for purposes of the Treaty. The example concludes that the treaty applies to Arrangement A as it is expressly treated as a resident by treaty.

In Example 9, Company A is formed under the laws of Country X, which has an income tax treaty with the U.S. Company A is treated as a partnership for U.S. income tax purposes. However, under the laws of Country X, Company A is an investment company taxable at the entity level. Investment companies are entitled to a deduction for amounts distributed to shareholders on a current basis. Under Country X law, all amounts distributed are treated as dividends from sources within Country X and Country X imposes a withholding tax on all payments by Company A to foreign persons. Company A receives U.S.-source dividend income which is distributed on a current basis to shareholders.

The example concludes that Company A is not fiscally transparent with respect to the U.S.-source dividends. Two facts support this conclusion. First, the shareholders are not required to take into account the U.S.-source dividend income of Company A on a current basis, whether or not distributed. Additionally, when dividends are paid, there is a change in source of the income received by shareholders.

In Example 10, Company A is an investment company formed under the laws of Country X, taxable at the entity level and resident in Country X for the purposes of the income tax treaty between Country X and the U.S. It is also entitled to a distribution deduction for the amounts that it currently distributes to its interest holders. Company A receives U.S.-source interest and dividend income that is neither exempt portfolio interest nor effectively connected income. Country X sources all distributions attributable to dividend income based upon the investment company's residence, but distributions attributable to interest income are treated as arising at the place of residence of the payor of the interest. The character of the distributions to shareholders remains the same as the income of Company A. Under Country X law, however, the shareholders of Company A are taxed only at the time distributions are received. There is no withholding with respect to distributions made to the shareholders of Company A to the extent attributable to U.S.-source interest.

An item by item analysis of the income of Company A is required in order to determine whether it is fiscally transparent. Company A is not fiscally transparent with respect to the U.S.-source dividends because, at the level of the Company A shareholders, the source of the dividends received from Company A is not the same as the source of the dividend income received by Company A, itself. Consequently, as to the dividend income received by Company A, Company A is not fiscally transparent. Company A is entitled to the benefits of the income tax treaty between Country X and the U.S. with regard to dividends from U.S. sources.

Company A is not fiscally transparent with regard to its interest income. Although the dividends paid to the Company A shareholders have the same source as the interest income received by Company A, the shareholders are taxed only when dividends are distributed. Fiscal transparency requires taxation of shareholders even when dividends are not distributed.

Example 11 concludes that charitable organizations, by definition, are not fiscally transparent because no other person is deemed to receive the income of the charitable organization.

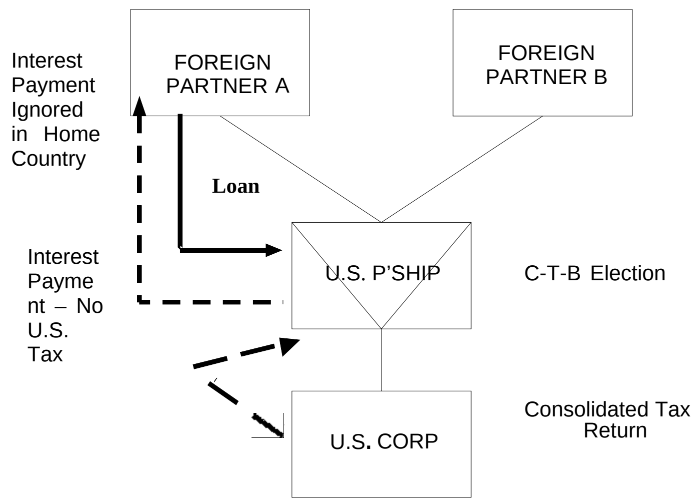
In Example 12, Trust A is organized in Country X to provide pension or other similar benefits to employees, pursuant to a plan. Trust A receives U.S.-source dividend income. Country X law exempts Trust A's income from tax because Trust A is established and operated exclusively to provide pension or other similar benefits to employees. Under Country X laws, the beneficiaries are not required to take into account their respective share of Trust A's income on a current basis, whether distributed or not, and the character and source in the hands of Trust A's beneficiaries are not determined as if realized directly from the source from which it was realized by Trust A.

Because the beneficiaries are not required to take into their respective shares of Trust A's income on a current basis, whether or not distributed, and because the character and source of the income in the hands of Trust A's beneficiaries are not the same as in the hands of Trust A, Trust A is not fiscally transparent with respect to the U.S.-source dividend income. Consequently, Trust A is treated as an entity and is viewed to have derived the U.S.-source dividend income in its own right for purposes of the income tax treaty between U.S. and Country X.

B. Reverse Hybrid Regulations

Provisions have also been adopted addressing reverse hybrids. A reverse hybrid is an entity that is treated as fiscally transparent for foreign tax purposes and as a taxable entity in the U.S. Reverse hybrids have been used to facilitate intragroup financing of U.S. operations. The preferred vehicle is a domestic partnership which checks the box and elects to be treated as a corporation. The partners are foreign entities and the hybrid is the parent of a group of U.S. companies.

The partnership is used to borrow funds from one of its foreign members. In the U.S., the interest paid on the amount borrowed is deductible. In the foreign jurisdiction, the transaction between the partnership and the partner is ignored. The result of the disjuncture is that income is reduced in the U.S. without an offsetting increase in income abroad. It may also be used as a vehicle to flow dividends out of the U.S. without withholding tax and possibly with no income tax abroad. In the foreign jurisdiction, the dividends may be deemed to be attributed to a permanent establishment maintained in the U.S. and exempt from tax at home. Instead of paying dividends, the reverse hybrid pays interest and principal on a partner loan, and claims the tax benefit previously discussed. This is illustrated in the following diagram:



Again, this type of transaction is viewed by the I.R.S. to violate the underlying premise of an income tax treaty – reduction of tax in the source country to avoid double taxation, not the elimination of all taxes. Consequently, the I.R.S. has issued regulations[25] relating to the eligibility for treaty benefits of items of income paid by reverse hybrids.

Initially, the regulations acknowledge that a reverse hybrid is a U.S. corporation for purposes of U.S. income tax and that it cannot rely on a treaty

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25 Treas. Reg. §1.894-1(d)(2).

to reduce the U.S. tax on U.S.-source payments. Moreover, the members of a domestic reverse hybrid entity cannot claim the benefits of an income tax treaty with regard to items of U.S.-source income derived by the entity. Distributions paid by the domestic reverse hybrid entity may qualify for tax treaty benefits. Thus, the rationale for the reverse hybrid provisions is diametrically opposed to the rationale under the general rule. Foreign law does not control the application of a treaty.

The regulations go on to provide that an item of income paid by a domestic reverse hybrid entity to a member has the character mandated under U.S. law; again, foreign law is not controlling. Also, whether a payment results in income is to be determined under U.S. law.

Finally, the regulations provide that payments of interest or other deductible items to a foreign party related to the domestic reverse hybrid entity will be converted to dividend payments for U.S. domestic law purposes and for purposes of the treaty if, and to the extent that, the domestic reverse hybrid received dividends from affiliates. This means that the payments are not deductible and the withholding tax rate for dividends is applicable.

Thus, dividends from operating companies cannot be converted to deductible payments merely by washing the payment through a domestic reverse hybrid. In recognition of that policy, the amount that is recharacterized as a dividend is reduced by dividends actually paid by the domestic reverse hybrid to its members. A person is related to a domestic reverse hybrid if it would be related under the standards that appear in Code Sections 267(b) and 707(b)(1), using an ownership threshold of at least 80% rather than the ownership threshold of more than 50% ordinarily applied. Anti-abuse rules address conduit payments through unrelated parties.

C. Code §894(c)

Separate from the regulatory attack on hybrid entities, Code Section 894(c) adopts provisions designed to prevent the use of hybrid entities in circumstances that were particularly unique to Canadian enterprises prior to the Fifth Protocol to the Canada-U.S. Income Tax Treaty. In part, this reflected complaints directed at a specific Canadian company engaged in the funeral parlor business. Prior to the time Code Section 894(c) was enacted, that business segment went through a significant consolidation in which a Canadian company was out-bidding its U.S. counterparts in the acquisition process. The Canadian company flaunted the financial advantage derived from the use of hybrid vehicles. Congress decided to remove that advantage in order to level the playing field.

Under the provision, a foreign person will not be entitled to the benefit of an income tax treaty with regard to income derived through a fiscally transparent entity such as a partnership or trust if the following three factors exist:

- The income derived by the fiscally transparent entity is not treated as an item of income of the person claiming a treaty benefit for purposes of the applicable foreign tax;

- The income tax treaty does not contain a provision which addresses the application of the treaty when an item of income is derived through a partnership; and

- The country of residence of the investor does not impose a tax on distributions from the hybrid entity to the investor.

At the time of enactment, Canada was generally viewed as the principal target of this provision because the income tax treaty between the U.S. and Canada did not contain a partnership provision under which a partnership is deemed to be a resident of a country to the extent its income is taxed in the hands of partners who are themselves residents of the country. As explained in greater detail below, this was rectified in the Fifth Protocol to the treaty.

V. The Use of Hybrid Entities Today

The actions of Congress and the I.R.S. have limited the use of hybrid entities in cross-border financings. However, for the operating company, there may be continuing opportunities. The regulations and Code Section 894(c) address taxes that are collected by withholding. They are silent about items of effectively connected income. Consequently, until the statute or the regulations are revised, a hybrid entity formed in a third country may be able to provide ongoing benefits for business profits derived by a resident of a treaty country partner. Moreover, if dividends received from the hybrid entity qualify for the participation exemption, the structure may result in little or no tax on business profits. Note, however, that this opportunity is denied to Canadian resident entities under the treaty currently in effect. Note, also, that this type of planning falls squarely into the B.E.P.S. initiative of the O.E.C.D.

The paradigm structure begins with a nonresident business entity other than a Canadian resident. (As will be discussed later, the Fifth Protocol extends the concepts of Treas. Reg. §1.894-1(d) to effectively connected income. As a result, a Canadian resident corporation cannot utilize the plan.) This business entity must qualify for benefits under the terms of the income tax treaty between the U.S. and its country of residence. In the typical case, the business entity may wish to distribute its product in the U.S. market. Rather than establishing a branch in the U.S. or a U.S. subsidiary, it could consider carrying on distribution activities through a hybrid entity, possibly a Barbados

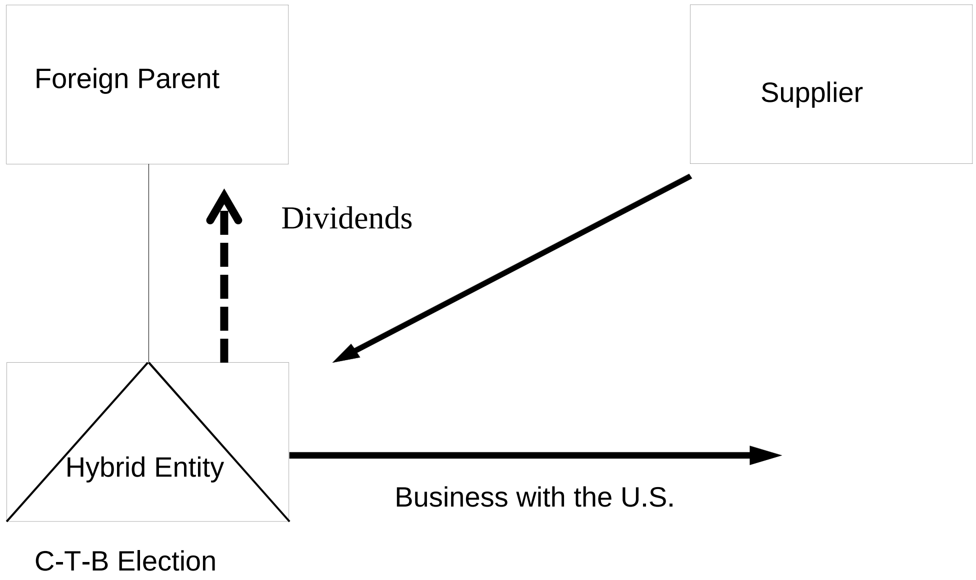
S.R.L. An equity investment is made in an S.R.L. in Barbados and the S.R.L. conducts business with the U.S., taking care to avoid having a permanent establishment in the U.S. within the meaning of the income tax treaty between the U.S. and the country of residence of the foreign business entity. The S.R.L. would make a check-the-box election, and because it is wholly owned beneficially by a qualified resident of a treaty jurisdiction, the foreign resident may claim treaty benefits under the treaty between the U.S. and its country of residence.

Benefits may be derived if:

- Under the terms of the treaty between the U.S. and the country in which the foreign parent is resident, no permanent establishment is maintained in the U.S.; and

- Under the terms of the tax treaty between the country of residence of the hybrid entity and the foreign parent, no permanent establishment exists in the country of residence of the parent.

In those circumstances, the profits of the S.R.L. arguably are not taxed in the U.S. or the foreign parent's country of residence. Moreover, if by treaty or domestic law, dividends paid by the hybrid entity benefit from a participation exemption, it would be possible to bring profits home without any tax in the home jurisdiction. The planning opportunity is illustrated in the following diagram:



In each particular planning situation, the devil is in the details and many hurdles must be overcome before the desired benefit is safely achieved. These include:

- The foreign parent company must be a qualified resident of a treaty partner of the U.S.;

- The hybrid entity must not be viewed to be a resident of the jurisdiction in which the foreign parent resides under a mind and management test;

- The business carried on by the hybrid entity must not result in an inadvertent transfer of a business abroad by the foreign parent (such transfers may be taxable);

- The administrative transfer pricing rules in all jurisdictions must be followed;

- The hybrid entity must not have a permanent establishment in the jurisdiction of residence of the foreign parent;

- The business activity related to the U.S. must actually be conducted from the country of residence of the hybrid entity, perhaps assisted by independent agents in the U.S. that would not rise to the level of a permanent establishment; and

- The planning impediments of the B.E.P.S. initiative must be successfully navigated.

VI. The Fifth Protocol to the Canada-U.S. Income Tax Treaty

In September 2007, the Fifth Protocol to the Canada-U.S. Income Tax Treaty was signed. The Fifth Protocol entered into force on December 15, 2008. The protocol is intended to regulate the use of hybrid entities in cross-border transactions between the two countries.[26] It does this by allowing treaty benefits to be derived by U.S. taxpayers that invest in Canada through U.S. L.L.C.'s, but generally denying treaty benefits when other hybrid entities are used to invest in Canada. This reflects the general approaches of the tax authorities in the two countries – the I.R.S. views the L.L.C. as a partnership in the absence of a check-the-box election and C.R.A. views the L.L.C. as a corporation that is not a treaty resident of the U.S. under domestic Canadian

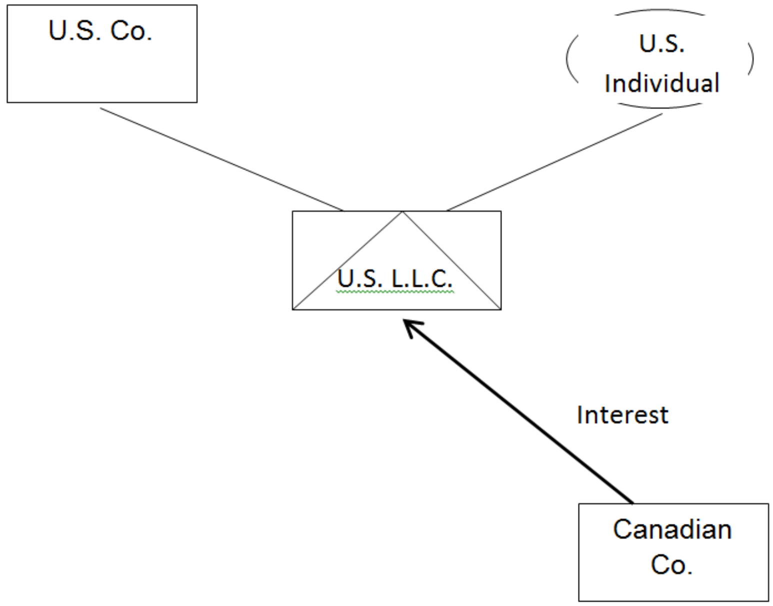
[26] For a more detailed discussion than that set forth above, see M. Milet and P. Repetto, *Canada-U.S Tax Treaty Issues: Anti-Hybrid Rules, The GAAR, and the U.S. Dual Consolidated Loss Rules*, Tax Notes International (Sept. 19, 2011).

principles of treaty application because it is not subject to U.S. tax on its profits.[27]

Paragraph 6 of Article IV (Residence) extends treaty benefits in Canada to a U.S. L.L.C. that is owned by U.S. residents. It does this by providing that an amount of income, profit, or gain is considered to be derived by a person who is a resident of the U.S. where two tests are met. First, the person receiving the income is considered under the taxation law of the U.S. to have derived the amount through an entity, other than an entity that is a resident of Canada. Second, by reason of the entity being treated as fiscally transparent under the laws of the U.S., the U.S. tax treatment of the income is the same as it would have been if the income were derived directly by the U.S. person. This means that if a group of U.S. persons invests in Canada through an L.L.C., treaty benefits can be claimed by the L.L.C. because the income is treated as income of U.S. residents.

This is illustrated by the following diagram:

27 See, e.g., n. 1 of C.R.A.'s *Guidelines for Treaty-Based Waivers Involving Regulation 105 Withholding*.



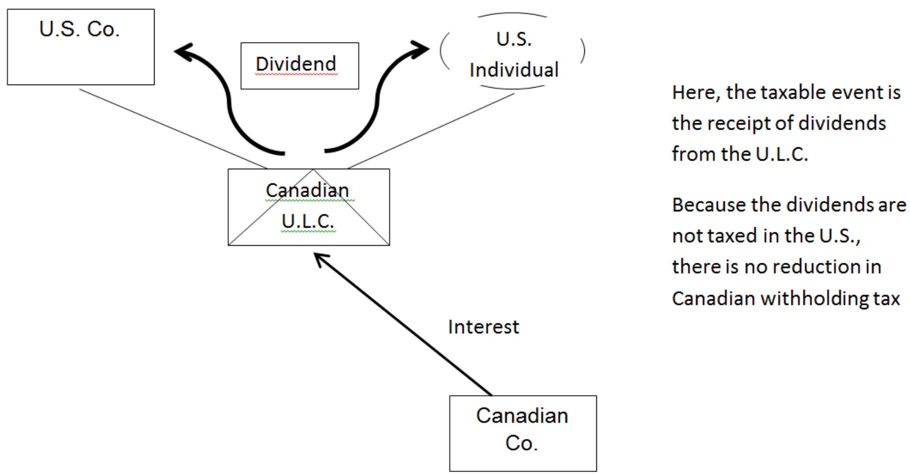
However, the Fifth Protocol unexpectedly provides adverse tax consequences in Canada under the treaty if another type of entity is used for making the investment in Canada. New paragraph 7(b) of Article IV (Residence), which took effect on January 1, 2010,[28] denies treaty benefits in Canada for U.S. residents receiving income through a Canadian unlimited liability company or from that entity.

Paragraph 7(b) provides that an amount of income, profit or gain is considered not to be paid to or derived by a person who is a resident of the U.S where (a) the U.S. person is considered under the taxation law of Canada to have derived the amount through an entity that is a resident of Canada, (b) the Canadian entity is not fiscally transparent under the laws of Canada but is fiscally transparent under U.S. tax rules, and (c) as a result, the treatment of

28 Fifth Protocol, Art. 27(3)(b).

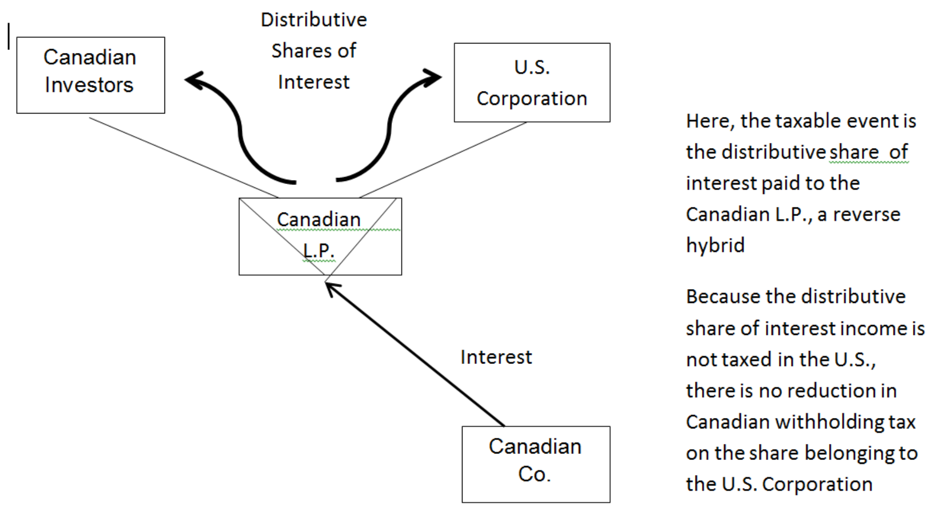
the amount under the taxation law of U.S. is not the same as the treatment that would apply if the entity were not fiscally transparent in the U.S. It follows from this standard that income derived by a U.S. resident through an unlimited liability company does not qualify for treaty benefits. The U.L.C. is (a) a resident of Canada, (b) not fiscally transparent for Canadian tax purposes, (c) fiscally transparent for U.S. tax purposes. As a result, the U.S. tax treatment of dividends from the U.L.C. in the U.S. is different from the U.S. tax that would be imposed if the U.L.C. were treated as an association taxable as a corporation in the U.S. In the former case, no additional tax is imposed on cash distribution, whereas in the latter case dividends would be taxable upon receipt.

This is illustrated by the following diagram:



In addition, Paragraph 7(a) provides a rule that disallows treaty benefits to reverse hybrids based in Canada. Under this provision, an amount of income, profit, or gain is considered not to be paid to, or derived by, a U.S. resident if (a) Canada views the person as deriving the amount through an entity that is not a resident of the U.S., and (b) by reason of the entity not being treated as fiscally transparent under the laws of the U.S., the treatment of the item of income or gain is not the same as the treatment that would exist if it had been derived directly by the U.S. person. The principal example is a U.S. investor in a Canadian limited partnership that receives non-business interest income. The L.P. defaults into fiscal transparency under U.S. tax regulations and Canada views the L.P. as fiscally transparent, too. Assume that a check-the-box election is made causing the Canadian L.P. to be treated as a corporation for U.S. purposes. Because no U.S. tax is imposed when and as interest, royalties, or dividends are received by the L.P. as a result of the election, Canada will not reduce or eliminate its withholding tax imposed under domestic law.

This is illustrated by the following diagram:



Both such provisions will be effective as of the first day of the third calendar year ending after Protocol enters into force. Whether these provisions have lasting effect is open to question. One would suppose that a Luxembourg Sarl could be imposed between the U.S. shareholder group and the Canadian L.L.C. and the results could approximate the existing situation before the effective date of new paragraph 7, assuming the Luxembourg withholding tax on dividends can be reduced through planning.

VII. C.R.A. and Dividends paid by a U.L.C. without Full Canadian Withholding Tax

In 2012-0467721R3 (released October 16, 2013), C.R.A. ruled that a deemed dividend paid by a Canadian U.L.C. to a U.S. parent company would qualify for the 5% withholding tax rate under the Canada-U.S. Income Tax Treaty if certain corporate steps are taken by the U.L.C. The steps are as follows:

- The U.L.C. must adopt a corporate resolution to increase its paid-up capital by the amount of retained earnings to be distributed; and

- The U.L.C. subsequently adopts a second corporate resolution, this time to reduce its paid-up capital by the specified amount which will be paid to the U.S. parent in connection with this reduction.

C.R.A. ruled that, for Canadian tax purposes, a deemed dividend arises as a result of the increase in paid-up capital and Paragraph 7(b) of Article IV does not apply to prevent the U.S. parent from accessing the 5% withholding tax rate on the deemed dividend.

VIII. G.A.A.R. Case & Favorable Use of Luxembourg Company to Obtain Tax Treaty Benefits

Canadian Tax Law contains a very broad anti-abuse rule called the General Anti-Avoidance Rule ("G.A.A.R.") set forth in §245(2) of the Income Tax Act, which provides that:

> Where a transaction is an avoidance transaction, the tax consequences to a person shall be determined as is reasonable in the circumstances in order to deny a tax benefit that, but for this section, would result, directly or indirectly, from that transaction or from a series of transactions that includes that transaction.

Section 245(3) provides that an avoidance transaction means any transaction that fits the following description:

> (a) * * * but for this section, [the transaction] would result, directly or indirectly, in a tax benefit, unless the transaction may reasonably be considered to have been undertaken or arranged primarily for bona fide purposes other than to obtain the tax benefit; or
>
> (b) that is part of a series of transactions, which series, but for this section, would result, directly or indirectly, in a tax benefit, unless the transaction may reasonably be considered to have been undertaken or arranged primarily for bona fide purposes other than to obtain the tax benefit.

Section 245(1) provides that a tax benefit means:

> a reduction, avoidance or deferral of tax or other amount payable under this Act or an increase in a refund of tax or other amount under this Act, and includes a reduction, avoidance or deferral of tax or other amount that would be payable under this Act, but for a tax treaty or an increase in a refund of tax or other amount under this Act as a result of a tax treaty.

Most importantly, possible tax treaty abuse is contemplated by G.A.A.R. due to a 2005 Amendment under which §245(4) was amended to provide that the G.A.A.R. will apply:

> * * * only if it may reasonably be considered that the transaction (a) would, if this Act were read without reference to this section, result directly or indirectly in a misuse of the provisions of any one or more of … (iv) a tax treaty."

A major case in seeking to apply G.A.A.R. to tax treaties is *MIL (Investments) S.A. v. The Queen*, 2006 TCC 460, affirmed, 2007 FCA 236 (Federal Court of Appeal). The case involved a Luxembourg company that sold shares of a Canadian company and was seeking the benefits of the Canada-Luxembourg Income Tax Treaty. The Tax Court of Canada held for the taxpayer, stating at paragraph 72:

> There is nothing inherently proper or improper with selecting one foreign regime over another. Respondent's counsel was correct in arguing that the selection of a low tax jurisdiction may speak persuasively as evidence of a tax purpose for an alleged avoidance transaction, but the shopping or selection of a treaty to minimize tax on its own cannot be viewed as

> being abusive. It is the use of the selected treaty that must be examined.

The Federal Court of Appeal dismissed the Crown's appeal indicating in its reasoning that legislative direction is sorely needed on the issue.

IX. OECD B.E.P.S. Report: Attack on Hybrid Entities and Instruments

Base erosion and profit shifting ("B.E.P.S.") refers to tax planning strategies that exploit gaps and mismatches in tax rules to make profits "disappear" for tax purposes or to shift profits to locations where there is little or no real activity, but the taxes are low resulting in little or no overall corporate tax being paid.

Many B.E.P.S. strategies take advantage of the interaction between the tax rules of different countries, making it difficult for any single country acting alone to fully address the issue. There is thus a need to provide an internationally coordinated approach which will facilitate and reinforce domestic actions to protect tax bases and provide comprehensive international solutions to respond to the issue. Unilateral and uncoordinated actions by governments responding in isolation could result in double – and possibly multiple – taxation for business. This would have a negative impact on investment, growth, and employment globally. The Organization for Economic Cooperation and Development ("O.E.C.D.") B.E.P.S. Action Plan provides a consensus-based plan to address these issues and is part of the O.E.C.D.'s on-going efforts to ensure that the global tax architecture is equitable and fair.

In July 2013, the B.E.P.S. Action Plan[29] was announced, which sets forth 15 actions to address B.E.P.S. in a comprehensive and coordinated way. One of the action items relates to "establishing international coherence of corporate income taxation," which includes four main issues and one issue deals with hybrid entities and instruments.

The Action Plan calls for the development of "instruments to put an end to or neutralize the effects of hybrid mismatch arrangements and arbitrage." The report explains the problem:

> Hybrid mismatch arrangements can be used to achieve unintended double non-taxation or long-term tax deferral by, for instance, creating two deductions for one borrowing, generating deductions without corresponding income inclusions, or misusing foreign tax credit and participation exemption regimes. Country rules that allow taxpayers to choose the tax treatment of certain domestic and foreign entities could facilitate hybrid mismatches. While it may be difficult to determine which country has in fact lost tax revenue, because the laws of each country involved have been followed, there is a reduction of the overall tax paid by all parties involved as a whole, which harms competition, economic efficiency, transparency and fairness.

The B.E.P.S. Plan then recommends taking Action 2, entitled, "Neutralize the effects of hybrid mismatch arrangements," which aims to accomplish the following:

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29 http://www.oecd.org/ctp/BEPSActionPlan.pdf

> Develop model treaty provisions and recommendations regarding the design of domestic rules to neutralize the effect (e.g. double non-taxation, double deduction, long-term deferral) of hybrid instruments and entities. This may include: (i) changes to the O.E.C.D. Model Tax Convention to ensure that hybrid instruments and entities (as well as dual resident entities) are not used to obtain the benefits of treaties unduly; (ii) domestic law provisions that prevent exemption or non-recognition for payments that are deductible by the payor; (iii) domestic law provisions that deny a deduction for a payment that is not includible in income by the recipient (and is not subject to taxation under controlled foreign company (C.F.C.) or similar rules; (iv) domestic law provisions that deny a deduction for a payment that is also deductible in another jurisdiction; and (v) where necessary, guidance on co-ordination or tie-breaker rules if more than one country seeks to apply such rules to a transaction or structure. Special attention should be given to the interaction between possible changes to domestic law and the provisions of the O.E.C.D. Model Tax Convention. This work will be coordinated with the work on interest expense deduction limitations, the work on C.F.C. rules, and the work on treaty shopping.

On March 19, 2014, the O.E.C.D. issued two discussion drafts proposing steps to neutralize abusive tax planning through hybrid mismatch arrangements. One report proposed changes in domestic law; the second proposed changes to the O.E.C.D. Model Tax Convention.

The discussion drafts reflect the O.E.C.D.'s attempt to bring "zero-sum game" concepts to global tax planning. In a zero-sum game, transactions between two or more parties must always equal zero (i.e., if one party to a transaction recognizes positive income of "X" and pays tax on that amount, the other party or parties generally must recognize negative income of the same amount, thereby reducing tax to the extent permitted under law). Seen from the viewpoint of the government, tax revenue is neither increased nor decreased on a macro basis if timing differences are disregarded.

If all transactions are conducted within one jurisdiction, the government is the ultimate decision maker as to the exceptions to the zero-sum analysis. For policy reasons, a government may decide to make an exception to a zero-sum game result by allowing the party reporting positive income to be taxed at preferential rates or not at all, while allowing the party reporting negative income to fully deduct its payment. But, when transactions cross borders and involve related parties, taxpayers have a say in what is taxed and what is not taxed.

The experience with hybrid entities discussed above illustrates that from a global tax revenue perspective, transactions involving hybrid entities can move from a zero-sum to a double negative sum in a way that is fully compliant with the laws of each country. The O.E.C.D. views this as abusive and proposes changes in domestic law and income tax treaties to end the practice.

A. Hybrid Entity Payments

One item on which the O.E.C.D. focused is “Hybrid Entity Payments.” These are transactions where differences in the characterization of the hybrid payor result in either (a) a deductible payment being disregarded in the country of residence of the recipient, or (b) the allowance of a deduction in another jurisdiction so that the payment is deducted twice, each time offsetting income taxed separately in one, but not both, jurisdictions. The most common double deduction hybrid technique involves the use of a hybrid subsidiary that is treated as transparent under the laws of the investor's tax jurisdiction and opaque under the laws of the jurisdiction where it is established or operates. An opaque entity is treated as an entity, but is entitled to benefits under an income tax treaty. This hybrid treatment can result in the same item of expenditure incurred by the hybrid being deductible under the laws of both the investor and subsidiary jurisdictions.

According to the discussion draft, the double deduction opportunity gives rise to tax policy concerns from the perspective of the investor jurisdiction for the following reasons:

- The hybrid entity is usually structured so that it never generates a net profit; this ensures that there is never sufficient dual inclusion income to eliminate the mismatch generated by the duplicate deduction.

- In the event the hybrid entity does begin to generate surplus dual inclusion income, the investor can simply restructure its holdings in the hybrid entity to prevent the surplus income from being included under the laws of the investor jurisdiction.

- The loss surrender mechanism in the subsidiary jurisdiction can be used to make the mismatch in tax outcomes permanent. The surrendering of surplus deductions to non-hybrid entities means that the deduction will no longer be available to reduce any dual inclusion income that may be derived by the hybrid entity in the current or any subsequent period. Thus, any dual inclusion income derived by the hybrid in a subsequent period will be subject to tax under the laws of the subsidiary jurisdiction at the full rate, and such tax will be fully creditable under the laws of the investor jurisdiction. The effect of the loss surrender mechanism under the consolidation regime therefore allows for each deduction to be set-off permanently against "other income," permanently eroding the tax base of the investor jurisdiction.

The discussion draft proposes to address the hybrid payment issue through a linking rule that focuses only on whether the payment gives rise to a deduction in the subsidiary jurisdiction that could be offset against dual inclusion income. The rule would also have a primary/secondary structure so as to require application in one jurisdiction rather than both.

The double deduction rule isolates the hybrid element in the structure by identifying a deductible payment made by a hybrid in the subsidiary jurisdiction. This is referred to as the "hybrid payment." It also identifies the corresponding "duplicate deduction" generated in the jurisdiction of the investor. The primary recommendation is that the duplicate deduction cannot be claimed in the investor jurisdiction to the extent it exceeds the claimant's dual inclusion income, which is income that is brought into account for tax purposes under the laws of both jurisdictions. A secondary recommendation applies to the hybrid in the subsidiary jurisdiction to prevent the hybrid claiming the benefit of a hybrid payment against non-dual inclusion income if the primary rule does not apply.

For both rules, excess deductions can be carried forward by a taxpayer and offset against future dual inclusion income.

In order to prevent stranded losses, the discussion draft recommends that excess duplicate deductions should be allowed to the extent that the taxpayer can establish, to the satisfaction of the tax administration, that the deduction cannot be set-off against the income of any person under the laws of the other jurisdiction.

The deduction/non-inclusion rule defines a disregarded payment as one that is made cross-border to a related party where the tax treatment of the payor results in the payment being disregarded under the laws of the jurisdiction in which the recipient is resident. The deduction that is generated by a disregarded hybrid payment cannot exceed the taxpayer's dual inclusion income. As a secondary rule, the recipient would be required to include the excess deductions in income.

B. Reverse Hybrid and Imported Mismatches

Two arrangements are targeted by these rules. The first is an arrangement where differences in the characterization of the intermediary result in the payment being disregarded in both the intermediary jurisdiction and the investor's jurisdiction (reverse hybrids). The second is an arrangement where the intermediary is party to a separate hybrid mismatch arrangement, and the payment is set-off against a deduction arising under that arrangement (imported mismatches).

In the reverse hybrid arrangement, the hybrid is treated as opaque by its foreign owner and transparent under the jurisdiction where it is established. The mechanics of reverse hybrid structures also make it difficult for any party to the arrangement to know the nature and extent of the mismatch unless the arrangement is implemented within the confines of a controlled group. Reverse hybrid mismatches can arise in the context of widely-held investment vehicles that admit offshore investors.

In the imported mismatch system, a hybrid instrument is used to reduce or eliminate the income in the intermediary jurisdiction. The intermediary company then lends funds raised with the hybrid instrument in return for a note from a borrower in a third country.

The discussion drafts propose the following rules to address the foregoing perceived abuses. In respect to imported mismatch arrangements other than reverse hybrids, comprehensive hybrid mismatch rules in the investor or the intermediary jurisdiction should be adopted that would be sufficient to prevent imported mismatches being structured through those jurisdictions. It proposes that all countries adopt the same set of hybrid mismatch rules. This approach ensures that the arrangement is neutralized in the jurisdiction where the hybrid technique is deployed, and there would be no resulting mismatch that could be exported into a third jurisdiction. A comprehensive solution where all countries establish the same set of hybrid mismatch rules will also generate compliance and administration efficiencies and certainty of outcomes for taxpayers.

To address reverse hybrid structures and provide measures designed to protect the payor jurisdiction from imported mismatches, the discussion draft makes two recommendations. The first is the adoption of rules that require income of, or payments to, a reverse hybrid to be included in income under the laws of the investor jurisdiction. It would be supported by the adoption of rules requiring income of, or payments to, a reverse hybrid to be included under the laws of the intermediary jurisdiction, if not included under the laws of the investor jurisdiction. The second recommendation is the adoption of rules that would allow the payor jurisdiction to deny the deduction for payments made to an offshore structure, including an imported mismatch structure or reverse hybrid where the parties to the mismatch are members of the same controlled group or the payor has incurred the expense as part of an avoidance arrangement.

C. Treaty Modifications

To supplement the detailed discussion draft of proposed changes to domestic law, a discussion draft was also published regarding changes in the O.E.C.D. Model Tax Convention.

The discussion draft proposes to change the Article 4 (Resident) paragraph (3) of the O.E.C.D. Model Tax Convention to address some of the B.E.P.S. concerns related to dual-resident entities. It will provide a revised method of allocating tax residence by adopting a case-by-case method, instead of the current place of effective management. In essence, it will likely prevent any single rule or approach from being controlling in all circumstances. Certainty of result is given second position to prevention of abuse.

Paragraph 3 of Article 4 would be modified to read as follows:

> Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, *the competent authorities of the Contracting States shall endeavour to determine by mutual agreement the Contracting State of which such person shall be deemed to be a resident* for the purposes of the Convention, having regard to its place of effective management, the place where it is incorporated or otherwise constituted and any other relevant factors. *In the absence of such agreement, such person shall not be entitled to any relief or exemption from tax provided by this Convention except to the extent and in such manner as may be agreed upon by the competent authorities of the Contracting States.* [Emphasis supplied.]

The discussion draft acknowledges that the revision will not address all B.E.P.S. concerns related to dual-resident entities. Thus, an entity could be a resident of a given State under that State's domestic law while, at the same time, being a resident of another State under a tax treaty concluded by the first State. This would allow that entity to benefit from the advantages applicable to residents under domestic law (e.g., being able to shift its foreign losses to another resident company under a group relief system) without being subject to reciprocal obligations regarding global taxation (it could claim treaty protection against taxation of its foreign profits). The draft suggests that countries adopt domestic legislation providing that an entity considered to be a resident of another State under a tax treaty will be deemed not to be a resident under domestic law.

The 1999 O.E.C.D. report on *The Application of the OECD Model Tax Convention to Partnerships* (the "Partnership Report") contains an extensive analysis of the application of treaty provisions to partnerships, including situations where there is a mismatch in the tax treatment of the partnership.[30] The discussion draft proposes to expand the scope of the Partnership Report to other transparent entities. Thus, it proposes to modify Article 1 (Persons Covered) by inserting a new paragraph 2, providing as follows:

> For the purposes of this Convention, income derived by or through an entity or arrangement that is treated as wholly or partly fiscally transparent under the tax law of either Contracting State shall be considered to be income of a resident of a Contracting State but only to the extent that the income is treated, for purposes of taxation by that State, as the income of a resident of that State.

The new text would be supported by the adoption of additional commentary. An example in the proposed commentary explains how the provision would be applied:

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[30] OECD (1999), *The Application of the OECD Model Tax Convention to Partnerships*, Issues in International Taxation, No. 6, OECD Publishing. doi: 10.1787/9789264173316-en.

> State A and State B have concluded a treaty identical to the Model Tax Convention. State A considers that an entity established in State B is a company and taxes that entity on interest that it receives from a debtor resident in State A. Under the domestic law of State B, however, the entity is treated as a partnership and the two members in that entity, who share equally all its income, are each taxed on half of the interest. One of the members is a resident of State B and the other one is a resident of a country with which States A and B do not have a treaty. The paragraph provides that in such case, half of the interest shall be considered, for the purposes of Article 11, to be income of a resident of State B.

The proposed commentary explains that the reference to "income derived by or through an entity or arrangement" is to be given a broad meaning. It is intended to cover any income that is earned by or through an entity or arrangement, regardless of (a) the view taken by each Contracting State as to who derives that income for domestic tax purposes and (b) whether or not that entity or arrangement has legal personality or constitutes a person. It would cover income of any partnership or trust that one or both of the Contracting States treats as wholly or partly fiscally transparent. It does not matter where the entity or arrangement is established. The paragraph applies to an entity established in a third State to the extent that, under the domestic tax law of one of the Contracting States, the entity is treated as wholly or partly fiscally transparent and income of that entity is attributed to a resident of that State.

In the case of an entity or arrangement which is treated as partly fiscally transparent under the domestic law of one of the Contracting States, only part of the income of the entity or arrangement might be taxed at the level of the persons who have an interest in that entity or arrangement, as described in the preceding paragraph, whilst the rest would remain taxable at the level of the entity or arrangement. This provision is intended to apply to (a) trusts that are fiscally transparent when distributions are made from current income and (b) a separate taxpayer for accumulated income. To the extent that the trust qualifies as a resident of a Contracting State, the provision will ensure that the benefits of the treaty will also apply to the share of the income that is taxed at the trust level by the jurisdiction of residence.

The proposed paragraph does not prejudge whether the transparent entity or its members are the beneficial owners of the income. Thus, for example, a fiscally transparent partnership that receives dividends as an agent or nominee for a person who is not a partner does not preclude the State of source from considering that neither the partnership nor the partners are the beneficial owners of the dividend. The fact that the dividend may be considered as income of a resident of a Contracting State under the domestic law of that State is not controlling on the tax treatment of the source State.

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The experience in the context of Canadian investment in the U.S. illustrates that for certain structures, use of hybrid entities may continue to provide planning opportunities in cross-border transactions. For persons wishing to operate a business that sells into the U.S. market, the possibility of achieving a significant tax benefit in the U.S. and in the taxpayer's country of residence may remain available using the planning mechanism developed in the Canada-U.S. context. Of course, for more aggressive planning intended to generate deductions in more than one country or imported mismatches of income and deductions, the O.E.C.D. B.E.P.S. discussion drafts establish a series of hurdles that preclude double non-taxation from the use of hybrids.