HYBRID ENTITIES IN CROSS BORDER TRANSACTIONS: THE CANADIAN EXPERIENCE–THE U.S. RESPONSE

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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

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

2 To be treated as a corporation for income tax purposes, an entity needed to have more corporate characteristics than non-corporate characteristics. The principal corporate characteristics were centralization of management, limited liability, free transferability ownership interest 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.

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 perhaps no other group of foreign based investors has availed itself of the planning opportunity to the extent used by Canadians. 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]

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

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4 The new treaty entered into force on December 31, 1993 and contains a limitation on benefits provision that became the model for several subsequent treaties of the U.S. See Article 26 (Limitation on Benefits). The treaty contained 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.

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]

This article provides an overview of the experience with hybrid entities as a tool to invest in the U.S. It places the use of hybrids in context by explaining: (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, and (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.

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

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,[6] 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.

If the Canadian parent company loaned funds directly to the U.S. affiliate engaged in an active trade or business,[7] a 10% or 15% withholding tax[8] 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.

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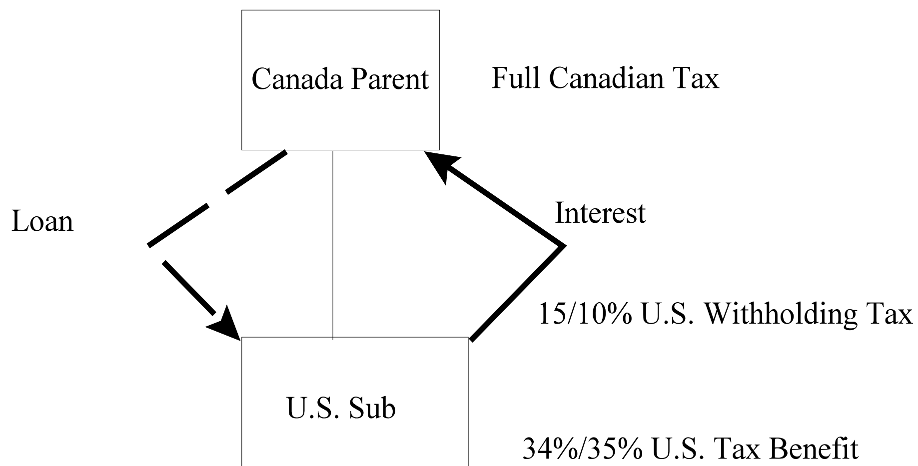
6 See for example Article 26 (Limitation on Benefits) of the treaty between the U.S. and the Netherlands.

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

8 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.

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 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 was zero.[9] 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.[10] 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

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

[10] See Article II (Definitions) of the 1948 treaty.

finance company reported income in the Netherlands in the amount of the 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. If the dividends were paid from exempt surplus for purposes of Canadian corporate tax, there was no further 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 treaty jurisdiction 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. [11]

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

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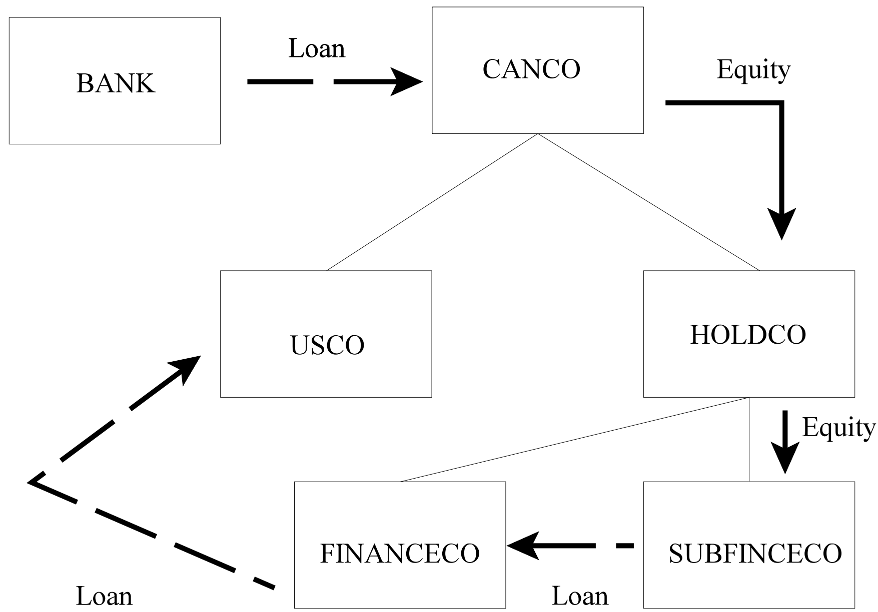
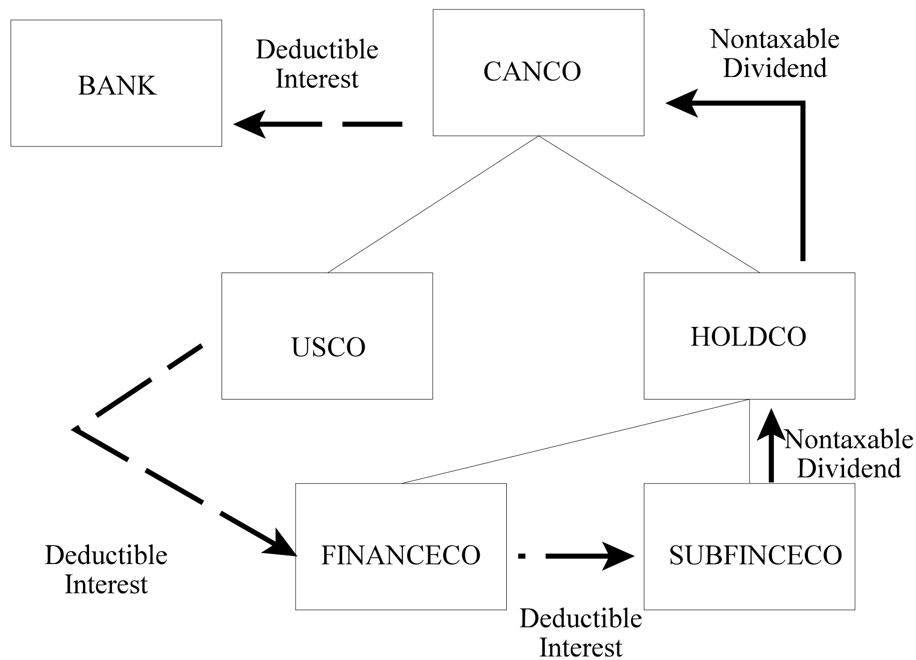
[11] This type of structure is embodied in the facts underlying *Laidlaw Transportation Inc. v. Commr.*, Tax Court Memo. 1998-232. In the case, the plan seemed to work in principle, but the taxpayer ignored the plan in practice.

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 the1948 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 was not 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 found by the Canadian parent company. For several years, the hybrid entity proved to be a valuable successor. A hybrid 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.[12] A typical example of a hybrid 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

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[12] See Treas. Regs. §301.7701-2(b).

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.

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 can be reduced to as little as 1% as gross income increases. It can also be reduced to 1% by credits.

More importantly, Canada has an income tax treaty in effect with Barbados that extends benefits to an S.R.L. 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.[13] 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

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[13] 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.

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.

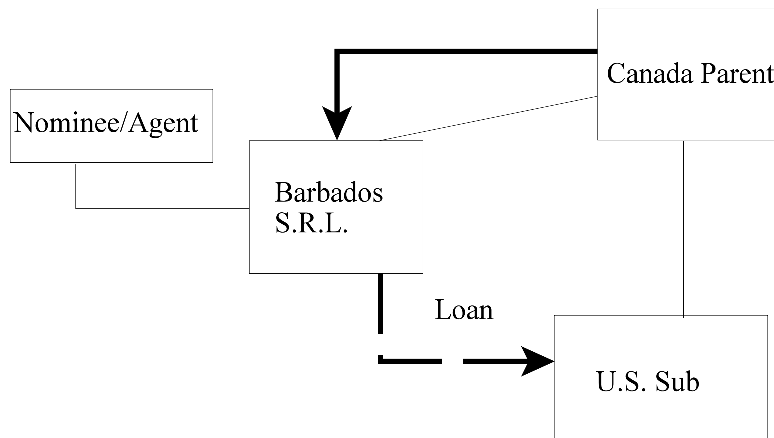
Inherent in the foregoing discussion of the taxation of an S.R.L. and its Canadian parent company is the acknowledgment that the S.R.L. is treated as a corporation for tax purposes in Canada and Barbados.

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.)

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

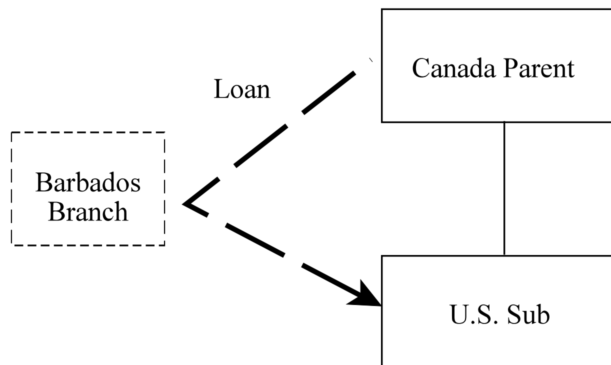
the S.R.L. by the Canadian parent, and a loan would be made by the S.R.L. to the U.S. affiliate. This may be illustrated in the following diagram.

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.

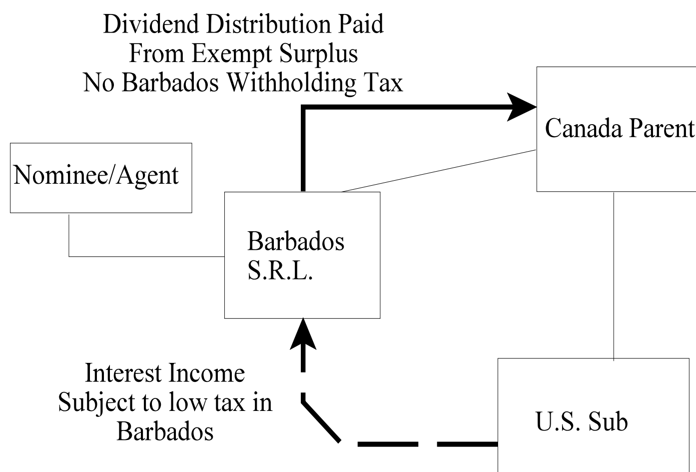
U.S. View



Upon payment of interest by the U.S. company, for tax purposes in Barbados and Canada, the receipt of the interest income by the S.R.L. would be respected. 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 to 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 as provided in the treaty between Canada and the U.S. 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.[14]

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 certain income of hybrid entities. The regulations issued by the I.R.S. go beyond the context of Canadian investment in the U.S.; however, when the statute was revised, Congress intended to eliminate the use of hybrid finance vehicles of Canadian 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[15] under section 894(c) of 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 whereby the relevant income is

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[14] See Tres. Regs. §1.881-3.

[15] Treas. Regs. §1.894-1(d).

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 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 zero 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.[16]

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 tax on the non-effectively connected income of a hybrid entity to be reduced by, one of two conditions must be met. Either (i) the hybrid is treated

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[16] 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.

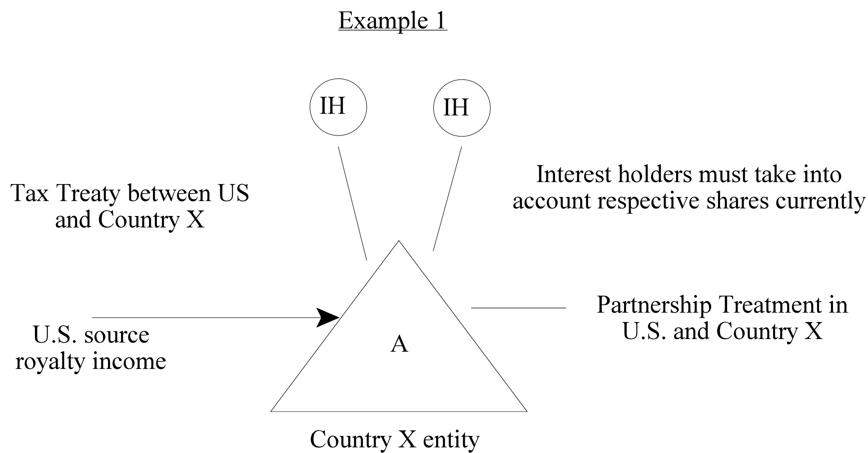
as a taxable entity in its country of residence and would, in its own right, be entitled to treaty benefits, were it not a passthrough entity for U.S. tax purposes or (ii) the entity is treated as fiscally transparent in the country of residence of its shareholder, the shareholder is taxed in that country 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.

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. In other words, the entity is given the equivalent of partnership flow-through treatment – not the equivalent of C.F.C. inclusion treatment.

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 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.

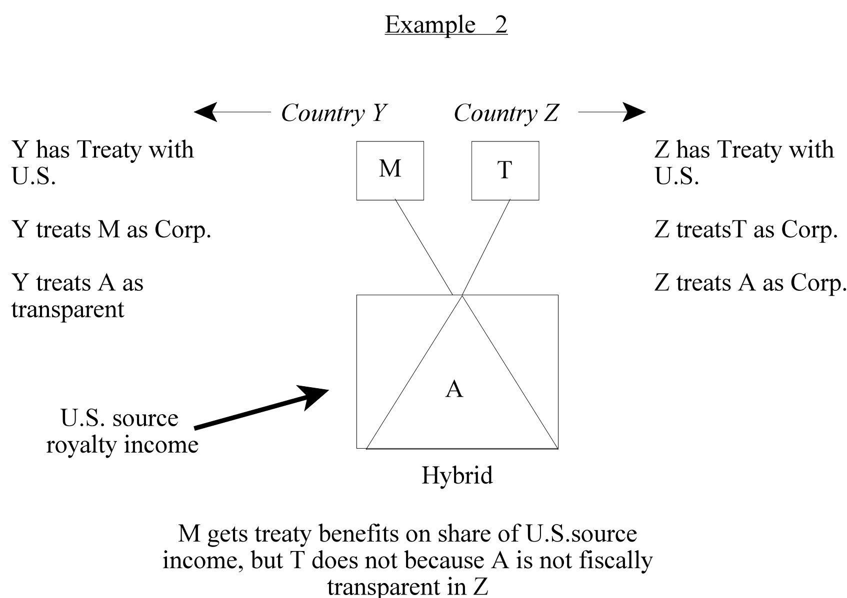
In Example 1, Company A is a business organization is formed in Country X, which has an income tax treaty in effect with the U.S. Company A is treated as a partnership for U.S. tax purposes as well as for Country X tax purposes. Country X requires Company A's interest holders to separately take into account currently their respective shares of 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.



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 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

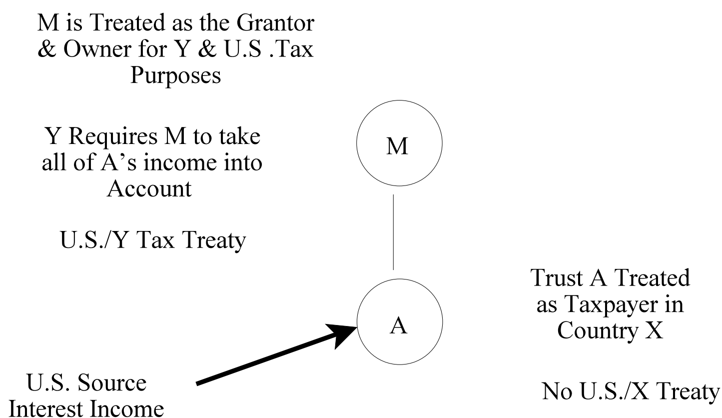
Because Country Y treats Company A as fiscally transparent, Company M is treated as having derived its share of the U.S. source royalty income for purposes of the treaty between Country Y and the U.S. Consequently, benefits under that treaty are extended to Company M with regard to its share of the income of Company A. 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.

<u>Example 4</u>



M can claim treaty benefits because Country Y treats A as fiscally transparent & has a treaty with U.S.

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.

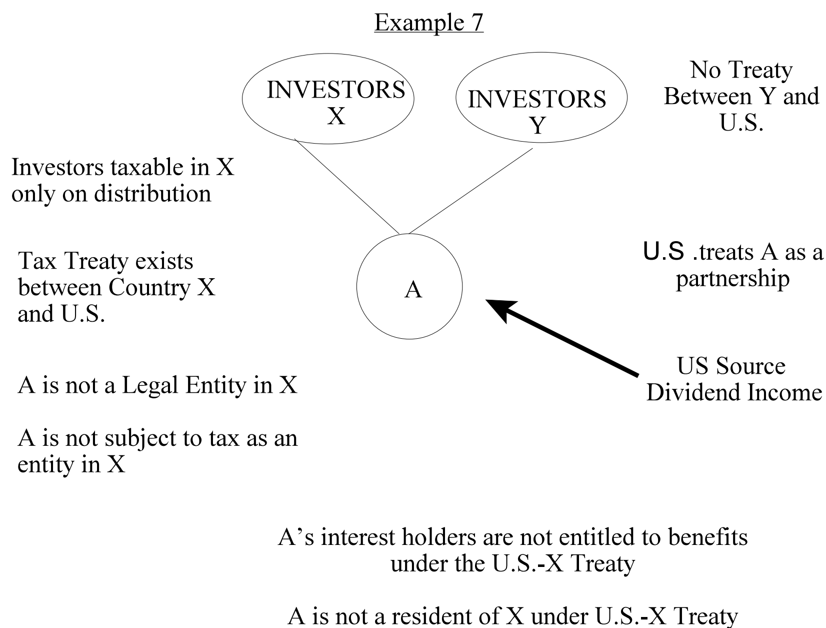
In Example 5, the facts are the same as in Example 4 except that Individual M is treated as the owner of the trust under U.S. tax law; the limited application of the grantor trust rules apply in circumstances where the grantor is a foreign person. The trust document governing Trust A does not require 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. Although, if current distributions are made, Country A 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.

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.



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. 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 reasons 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 for purposes of Country X tax as the source of the dividend income received by Company A. 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.

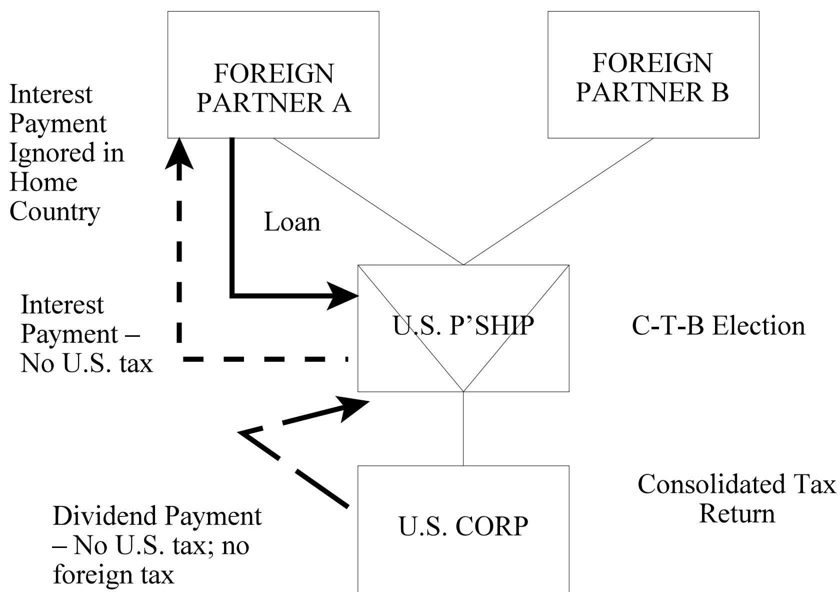
B. Reverse Hybrid Regulations

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 investor is more likely European than Canadian, because the planning relies on an income tax treaty that eliminates withholding tax on

interest payments. The withholding tax rate on interest payments is 10% under the income tax treaty between Canada and the U.S.

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 possible 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.

Reverse Hybrid Transaction



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[17] relating to the eligibility for treaty benefits of items of income paid by reverse hybrids.

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17 Treas. Reg. §1.894-1(d)(2).

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 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 particularly unique to Canadian enterprises. 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 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.

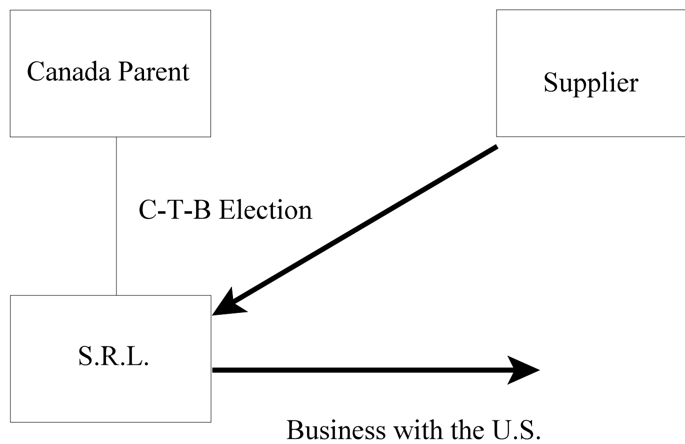
Canada is generally viewed as the principal target of this provision because the income tax treaty between the U.S. and Canada does not contain a partnership provision under which a partnership is deemed to be a resident of a country to the extent its income is taxed in the hands of partners who are themselves residents of the country.

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. Until the statute or the regulations are revised, a hybrid entity such as an S.R.L. in Barbados should continue to provide tax benefits in connection with business profits.

The paradigm structure begins with a Canadian resident that qualifies for benefits under the terms of the income tax treaty between the U.S. and Canada. The Canadian entity wishes to distribute its product in the U.S. market. Rather than establishing a branch in the U.S. or a U.S. subsidiary, it should be possible to carry on distribution activities through 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 Canada. The S.R.L. makes a check the box election, and because it is wholly owned beneficially by a qualified resident of Canada, the Canadian resident claims treaty benefits under the treaty between the U.S. and Canada. If, (i) under the terms of the U.S.-Canada treaty, no permanent establishment is maintained in the U.S. and (ii) under the terms of the tax treaty between

Barbados and Canada, no permanent establishment exists in Canada, the profits of the S.R.L. should be taxed neither in the U.S. nor Canada. The planning opportunity is illustrated in the following diagram:



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

- The Canadian parent company must be a qualified resident of Canada under the income tax treaty between the U.S. and Canada.

- The S.R.L. must not be viewed to be a resident of Canada under the "central mind and management" test applied under Canadian tax law regarding the tax residence of companies.

- The business carried on by the S.R.L. must not result in an inadvertent transfer of a business abroad by a Canadian resident. Such transfers are taxable. Of course, if a Canadian company has net operating loss carryovers, no tax may be due on the recognized gain.

- The administrative transfer pricing rules in Canada must be followed. Barbados does not have transfer pricing rules at this time.

- The company in Barbados must not have a permanent establishment in Canada.

- The actual business with the U.S. can be conducted from Barbados, perhaps assisted by independent agents in the U.S. who would not rise to the level of a permanent establishment under the Canada-U.S. Income Tax Treaty.

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

In September 2007, a fifth protocol to the Canada-U.S. Income Tax Treaty was signed. The protocol is intended to regulate the use of hybrid entities in cross-border transactions between the two countries. It does this by allowing treaty benefits to be derived by U.S. taxpayers that invest in Canada through a U.S. L.L.C., 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. because it is not subject to U.S. tax on its profits.[18]

Proposed 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 test 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

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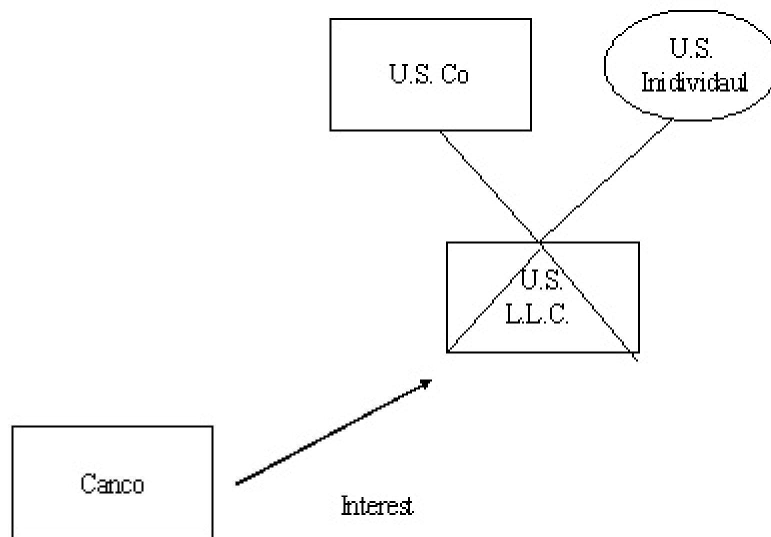
18 See e.g., n. 1 of C.R.A.'s Guidelines for Treaty-Based Waivers Involving Regulation 105 Withholding.

transparent under the laws of the U.S., the treatment of the amount under the taxation law of the U.S. is the same as its treatment would be if that amount had been derived directly by the U.S. person involved. 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 a resident. This is illustrated by the following example.



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 of Article IV (Residence) denies Treaty benefits in Canada for U.S. residents receiving income through an unlimited liability company or from that entity. It does this by providing 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. in two circumstances. The first is that (a) the U.S. person is considered under the taxation law of Canada to have derived the amount through an entity that is not a resident of the U.S., (b) the non-U.S. entity is treated as not being fiscally transparent under the laws of Canada, and (c) as a result, the treatment of the amount under the taxation law of Canada is not the same as its treatment would be if that amount had been derived directly by the U.S. person.[19] It follows from this standard that income derived by a U.S. resident through an unlimited liability company does not qualify for treaty benefits because the U.L.C. is a resident of Canada that is not fiscally transparent for Canadian tax purposes and as a result, the tax in Canada is different from the tax that would be imposed if the income were received by the U.S. person. This is illustrated by the following diagram:

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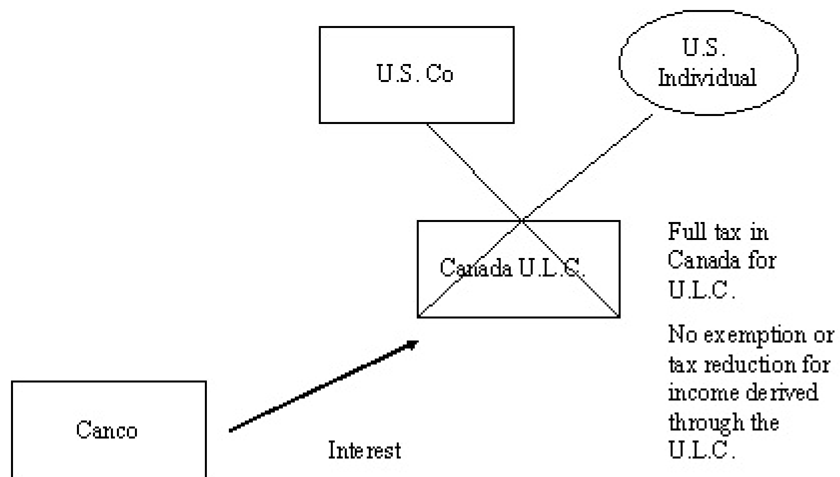
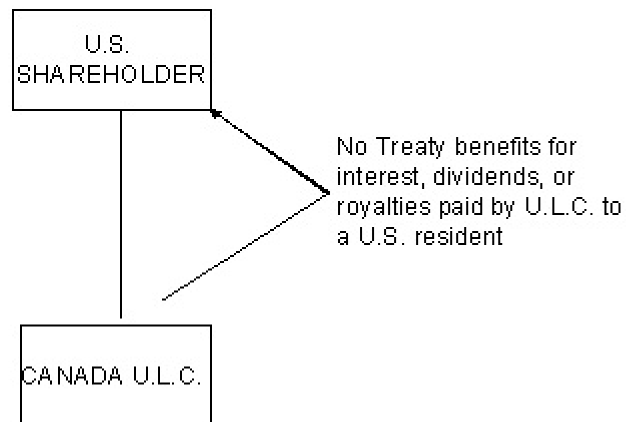
[19] Paragraph 7(a) of the Canada-U.S. Income Tax Treaty as modified by Article 2, paragraph 2 of the Fifth Protocol thereto.



The second set of facts is that (a) the U.S. person is considered under the taxation law of the U.S. to have received the amount from an entity that is a resident of Canada, (b) the entity is treated as being fiscally transparent under the laws of the U.S., and (c) as a result, the treatment of the amount under the taxation law of the U.S. is not the same as its treatment would be if that entity were not treated as fiscally transparent under the laws of the U.S.[20] It follows

20 Paragraph 7(b) of the Canada-U.S. Income Tax Treaty as modified by Article 2, paragraph 2 of the Fifth Protocol thereto.

that a distribution from a Canadian U.L.C. will be caught by this provision because it generally is not taxable in the U.S. unless a check-the-box election is made on its behalf. If the U.L.C. were a taxable entity, tax would be imposed in the U.S. on the recipient. Consequently, dividends paid by a



U.L.C. will become subject to full Canadian withholding tax, currently imposed at the rate of 25%. 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 S.A.R.L. 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.

The Fifth Protocol does not seem to address the circumstance of a Canadian business exporting to the U.S. through a Barbados S.R.L. that makes a check the box election.

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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 operated 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.