Final U.S. tax regulations transform cross-border financing

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On April 7, 2020, the IRS and Treasury Department announced long-awaited final and proposed regulations addressing hybrid financing arrangements. The final regulations generally adhere to the framework established by the December 2018 proposed regulations (the 2018 proposed regulations) but contain a new clarification addressing interest-free loans (IFLs) that will have a major impact on how Canadian businesses finance their U.S. subsidiaries and their cost of capital for financing U.S. operations.

Canadian companies that have been awaiting final guidance in this area have, in many cases, been in the difficult position of trying to assess how the proposed rules would impact current and future financing arrangements — leading some to be stuck in an awkward financing “holding pattern.” Like them or not, the final and proposed regulations provide a form of closure and allow Canadian businesses to turn the page and move forward with financing their U.S. operations.

BACKGROUND

Section 267A was enacted as part of the U.S. tax reform legislation commonly referred to as the Tax Cuts and Jobs Act” at the end of 2017. On its face, Section 267A denies a deduction for certain amounts paid or accrued to related parties pursuant to a “hybrid transaction” or by, or to, a “hybrid entity.” The OECD had previously examined this area in the 2015 Base Erosion and Profit Shifting Project final report on Action 2: “Neutralising the Effects of Hybrid Mismatch Arrangements” (the BEPS Hybrid report). The legislative history of Section 267A, as restated in the 2018 proposed regulations, notes that Section 267A is intended to be “consistent with many of the approaches to the same or similar problems” addressed in, among other sources, the BEPS Hybrid report.

On December 20, 2018, the IRS and Treasury Department released proposed regulations under Section 267A. As noted, the final 267A regulations largely conform to the 2018 proposed regulations. For a summary of the 2018 proposed regulations, please see our previous Osler update New U.S. anti-hybrid rules: A primer.”

THE FINAL 267A REGULATIONS — IN GENERAL

Apart from new language related to IFLs (summarized below) and certain other items, the final 267A regulations adhere very closely to the blueprint established by the 2018 proposed regulations. Perhaps
most importantly, the final regulations continue to abide by the overarching limitation that the scope of the 267A rules is limited to neutralizing deduction/no inclusion (D/NI) outcomes that are attributable to hybrid instruments and/or hybrid entities (and are not designed to neutralize all D/NI outcomes that may arise in cross-border transactions that are attributable to non-hybrid factors).

The final rules contain a number of modifications and clarifications that are, for the most part, highly technical and targeted in nature. For Canadian corporations financing the operations of their U.S. subsidiaries, the most notable of these technical changes are the following:

- **Long-term deferrals**: The final regulations preserve the basic rule that a payment that results in a deferral of more than 36 months between (x) the time the payor’s deduction accrues and (y) the time the payee’s income inclusion occurs is deemed to be a hybrid payment. The IRS has introduced a number of technical modifications in the final regulations, however, that ease the administrability and impact of this 36-month rule, including a “reasonable expectation” rule that requires a payor to assess, at the time of payment, whether it is reasonable to expect that the payee will include the payment in income within the 36-month period.

- **Deemed branch payments do not conflict with treaties**: In the preamble to the final regulations, the IRS and Treasury Department clarified that, in their view, the deemed branch payment rules of Section 1.267A-2(c) do not conflict with U.S. tax treaty obligations.

- **Dual inclusion income clarified**: The 2018 proposed regulations provide that disregarded payments are treated as “hybrid” payments only to the extent that they exceed “dual inclusion income.” Dual inclusion income is essentially income that is subject to tax in the hands of both (a) the entity or branch making the disregarded payment, and (b) the entity or branch receiving that income. The final regulations provided additional clarity on what is included in the important “dual inclusion income” category, including by clarifying that certain items of participation exempt income may be counted as “dual inclusion income.”

- **Controversial “non-inclusion anywhere” rule retained**: Under the 2018 proposed regulations, a single payment can have multiple “specified recipients.” This scenario arises most frequently when a payment is made to a hybrid entity or branch. Furthermore, the U.S. tax deduction associated with such hybrid payment may be subject to disallowance under 267A if it results in a D/NI outcome for any “specified recipient” of the payment, even if another specified recipient has an income inclusion in respect of that payment. Commentators argued that this rule could lead to double taxation and was inconsistent with the BEPS Hybrid report (under which an income inclusion by any recipient turns off the mismatch rule). Despite these concerns, the IRS retained the controversial rule on the basis that dropping the “non-inclusion anywhere” would encourage taxpayers to route hybrid payments through low-rate jurisdictions or engage in similar rate arbitrage manoeuvres.

- **U.S. withholding tax not relevant to application of 267A**: Many commentators argued that the 267A deduction disallowance rule should not apply to hybrid payments that are subject to U.S. withholding tax. Observers argued that the U.S. withholding tax operates as a surrogate income inclusion and, when it applies, it is not proper to find that there has been a D/NI. The IRS declined to follow this suggestion, noting (among other things) that the policy considerations underlying U.S. withholding taxes and treaties, on the one hand, and 267A, on the other, are not the same and it was not appropriate for 267A to be subordinated to the operation of withholding tax rules.

- **Disqualified import mismatch arrangement (DIMMA) rules clarified**: Under the 2018 proposed regulations, a series of complex rules referred to as the DIMMA rules generally prevent the effects of an offshore hybrid arrangement from being imported into the U.S. taxing jurisdiction through the use of a non-hybrid arrangement. In essence, if the DIMMA rules connect a non-hybrid U.S. payment of
interest or royalties with a hybrid payment made by a related party offshore, the U.S. deduction is generally denied. The final regulations retain these rules but provide important clarifications about their operation, including: (a) guidance regarding how to co-ordinate the DIMMA rules with conflicting hybrid mismatch rules in other jurisdictions, and (b) clarification that all parties in the chain of payments reviewed under the DIMMA rules must be related to one another.

- **Anti-abuse rule retained**: Despite receiving comments calling for its removal, the IRS retained the 267A anti-abuse rule included in the 2018 proposed regulations. However, the IRS provided comfort that the anti-abuse rule would be deployed in a disciplined manner, noting in the preamble that it would be focused on, “the terms and structure of an arrangement and would require that the D/NI outcome produced is a result of a hybrid or branch arrangement.”

- **Double-dip “check-the-box” rules retained**: The final regulations do not materially modify the dual consolidated loss (DCL) rules included in the 2018 proposed regulations. Specifically, they retain the rule that requires taxpayers to treat a U.S. partnership as a “dual resident corporation” subject to the DCL rules if the taxpayer (1) wants to elect to treat the partnership as a corporation for U.S. tax purposes under the “check-the-box” regulations, and (2) the partnership has a related foreign owner that treats the partnership as fiscally transparent under foreign law (i.e., the partnership is a “domestic reverse hybrid”). The IRS and Treasury also stated that they continue to study structures involving payments from foreign entities that are regarded for foreign law purposes to their domestic corporate owners where the foreign entity is disregarded for U.S. tax purposes (i.e., a “foreign hybrid”). They noted that they may issue guidance addressing the application of the DCL rules to these structures in the future, but did not provide any further detail regarding the scope of any such rules. Canadians financing U.S. subsidiaries will want to keep a close eye on any further developments in this area.

**THE FATE OF NON-INTEREST-BEARING DEBT UNDER THE FINAL 267A REGULATIONS**

For many Canadian companies, the key open questions in the wake of the 2018 proposed regulations were (1) are IFL structures captured by the 267A regulations, and if so, (2) as of what date will the interest deductions associated with IFL structures be disallowed. Prior to the release of the final regulations, there was genuine debate and uncertainty on the question of whether the 2018 proposed regulations affected IFL arrangements. Some observers believed that, since (a) the OECD anti-hybrid rules explicitly declined to apply to IFL structures, and (b) the 267A rules were intended by Congress to align with the OECD measures against hybrid structures, it was not appropriate for 267A to neutralize IFL imputed deductions (at least not without specific and clear language to that effect). On the other hand, some observers felt that imputed deductions on IFLs were economically equivalent to D/NI outcomes created by “disregarded payments” and, accordingly, it was appropriate for IFLs to be neutralized by the 2018 proposed regulations.

The final regulations break this logjam by coming down squarely on the side of neutralizing interest deductions associated with most IFL structures. In particular, the final regulations add new Section 1.276A-2(a)(4) which provides that, in the case of IFLs and “similar arrangements,” imputed interest that gives rise to a deduction for the issuer but no corresponding interest income inclusion for the holder of the IFL (because the holder’s tax jurisdiction does not impute interest income to the holder) is treated as a “hybrid transaction” under the regulations. This rule is likely to have the effect of neutralizing U.S. interest deductions for many U.S. corporations paying interest to a Luxembourg affiliate pursuant to prototypical Luxembourg financing structures that are common in the Canada-U.S. space. Importantly,
in order to be caught by the new rule, the “non-inclusion” of interest income needs to be as a result of the IFL holder’s tax jurisdiction not imputing income — if the IFL holder is resident (or a taxable branch) in a tax jurisdiction that doesn’t tax foreign-source interest income in the first place, then the “no-inclusion” is not attributable to the hybridity and ought not to be caught by the new rule.

Given the blunt clarity offered by the new rule addressing IFLs, the next question many Canadian corporations will turn to is determining the effective date of this new rule. The portion of the final regulations addressing effective dates includes a “special” rule indicating that the new IFL provision applies to taxable years beginning on or after December 20, 2018 (the date the 2018 proposed regulations were released). For calendar year taxpayers, this means that the IFL rule applies beginning with their 2019 tax year.

Interestingly, taxpayers are allowed to elect to apply the 2018 proposed regulations in their entirety (in lieu of the final regulations) for all taxable periods ending on or before April 8, 2020. This ability to stretch the life of the 2018 proposed regulations may lead taxpayers to examine the question of whether those regulations (unlike the final regulations) adequately address IFLs. However, taxpayers considering the position that IFLs were not addressed in the 2018 proposed regulations must contend with the IRS assertion in the preamble that the new IFL rule (Section 1.267A-2(a)(4)) is essentially a clarification. In particular, in addressing IFL arrangements, the preamble notes that, “[b]ecause the imputed interest deduction is not regarded under the tax law of the holder of the instrument, the disregarded payment rule of the proposed regulations treats the imputed interest as a disregarded payment and, accordingly, a disqualified hybrid amount to the extent it exceeds dual inclusion income.”

THE PROPOSED REGULATIONS

In addition to the final regulations, the Treasury Department announced new proposed regulations on April 7, 2020. Most notably for Canadian businesses, the new proposed regulations expand the application of the anti-conduit rules. Generally speaking, the U.S. anti-conduit rules allow the IRS to collapse certain back-to-back financing arrangements involving U.S. borrowers by disregarding “intermediate” lenders and recharacterize the financing as if it occurred between the U.S. borrower and the “ultimate” lender. If (a) this recharacterized financing relationship results in greater U.S. withholding tax than the actual financing arrangement does, and (b) there is a tax avoidance purpose, then the anti-conduit rules may apply to require the higher U.S. withholding tax to be paid. Prior to this proposed regulation, a financing between related parties that was in the form of equity was typically not considered an intermediate financing transaction that could be collapsed under the anti-conduit rules unless it had certain debt-like features. The new proposed regulations expand the reach of the anti-conduit rules to apply to equity financings that deliver a notional interest deduction (or similar tax benefit) under the issuer’s tax law.

These expanded anti-conduit rules should result in U.S. withholding tax applying to a broader range of inter-company financing arrangements of Canadian businesses through third countries that feature a hybrid component. Importantly, the new proposed anti-conduit rules will operate in parallel with the 267A regulations (i.e., they don’t displace or override the final 267A regulations discussed above). The new proposed regulations, as they relate to conduit transactions, will apply to payments made on or after the date these regulations are finalized (i.e., they are not currently operative).

CONCLUSION
While the final regulations largely maintain the general organization and operative framework of the 2018 proposed regulations, their impact on U.S.-Canadian financing norms should not be underestimated. For the many Canadian businesses that had been deferring action until greater clarity emerged, these regulations mark an end to that period of suspense. While the final regulations may not bring the closure that Canadians were hoping for, it is a form of closure nonetheless. Well-advised Canadian companies with U.S. operations can now take stock of the new landscape that the final and proposed regulations create and move forward with making thoughtful choices about how to finance their U.S. operations in the future.
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