77th Annual Conference
Scottsdale, AZ

Current & Emerging Issues in Cross-border U.S.–Canada Structures and Transactions

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2:00 pm - 3:00 pm

Moderator

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Agenda

Current & Emerging Issues in Cross-border U.S. - Canada Structures and Transactions

Canadian Financing Related Changes

1. Anti-Hybrid Rules & U.S.-Hungary Tax Treaty Update
2. Eifel (30%) Rule (Earnings Stripping)
3. Changes to Withholding Tax Rules to Partnerships

Canadian Transaction Related Changes

1. New Mandatory Tax Disclosure Rules
2. Potential Changes to GAAR Rules
3. Share Exchanges in Foreign Mergers

U.S. Related Updates

1. Inflation Reduction Act
2. Anti-Hybrid Recent Regulations & Examples
3. Interest Expense Limitation Changes

OECD/G20 Pillar One and Pillar Two

1. Canadian DST
2. U.S. Legislative Process

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Canadian Financing Related Changes

Anti-Hybrid Rules

Hybrid Mismatch Background

- **Canada's version of BEPS Action 2**

- Action 2 recommends countries implement rules to prevent "deduction/non-inclusion" (D/NI) and "double deduction" situations

- First announced in 2021 Budget:
  - To be implemented in two separate legislative packages.
    1. D/NI mismatch arising from a payment in respect of hybrid financial instruments – to be released "later in 2021" and would apply "as of July 1, 2022"
    2. Branch and double deduction scenarios – to be released after 2021, and to apply "no earlier than 2023"

Hybrid Mismatch Package 1

- **April 29, 2022**
  - First of two packages released. To apply to payments on or after July 1, 2022 and deadline for submissions set at June 30, 2022 (i.e., one day before the effective date)
  - Rules go beyond Action 2 recommendations in some respects, including:
    - by deeming an interest payment that is non-deductible under the rules to be a dividend subject to WHT
    - by deeming a debt on which a notional interest deduction is available to be a hybrid mismatch arrangement
- Submissions to Department of Finance identify numerous issues with the proposals, and recommends, inter alia, that the effective date be postponed

Hybrid Mismatch Package 1

- Two main operative provisions:
  - **Primary operative rule**: neutralizes a "D/NI mismatch" arising from a payment under a "hybrid mismatch arrangement" by restricting the deduction
  - **Secondary operative rule**: "defensive" rule that neutralizes a mismatch by including an amount in the income of a recipient

- Various supplemental operative provisions, including:
  - **Anti-avoidance rule**
  - **Limitation on dividends received deduction (DRD)** – restricts DRD for dividends from a foreign affiliate (FA) to the extent that a foreign income tax deduction in respect of the dividend is available to the FA

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Hybrid Mismatch Package 1

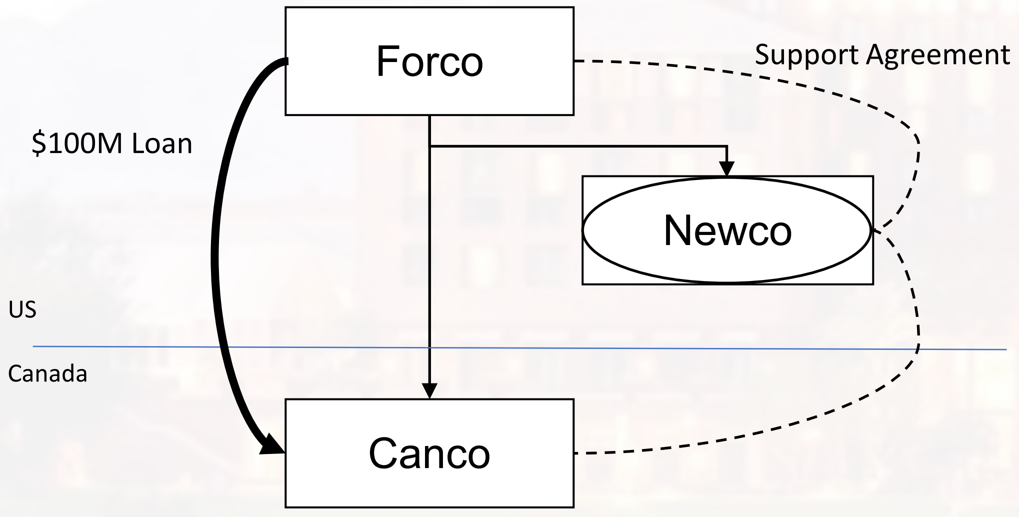
- **Hybrid Mismatch Arrangement** (proposed ITA 18.4(1)):
  - general term that encompasses three categories of arrangements:
    - "hybrid financial instrument arrangement" – simplified, where mismatch arises from differences in the income tax treatment of payments under or in connection with a financial instrument due to the terms or conditions of the instrument
    - "hybrid financial transfer arrangement"– simplified, where mismatch results from different entities being treated as the owner of returns on a transferred instrument
    - "substitute payment arrangement" – generally where a payment under, or in connection with, a transfer of a financial instrument functions as a substitute for certain returns on the instrument
- additional categories to be added in future

Hybrid Mismatch Package 1

- **Hybrid Mismatch Arrangement**:
  - rules generally require there to be some degree of nexus between the parties (i.e., if parties are NAL or if one is a "specified entity" of the other – very generally, 25% votes or value)
    - **exception**: no relationship test if the arrangement is a "structured arrangement" (generally defined to mean an arrangement where the D/NI is priced into the arrangement or the arrangement is designed to produce the mismatch – limited exception in proposed ITA 18.4(5))
- *Interpretive rule* – hybrid mismatch rules are to be interpreted consistently with the BEPS Action 2 Report, unless the context otherwise requires (e.g., where rules depart from recommendations in the report)

Hybrid Mismatch Package 1

Example 1: Hybrid Financial Instrument Arrangement



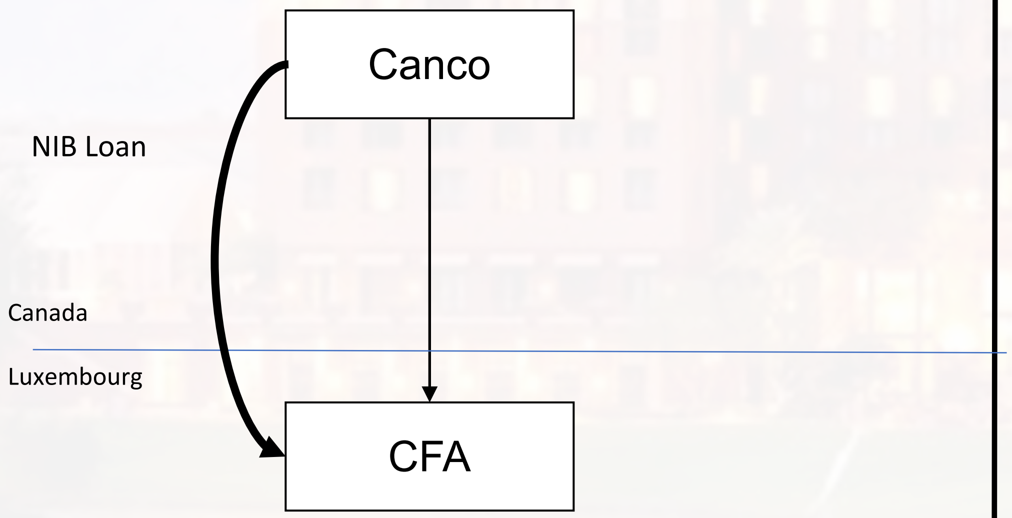
Treatment in US: Economically offsetting Loan and Forward are treated as a single instrument; interest payment on Loan is treated as a stock dividend and, as such, isn't included in Forco's income in the US

Application to interest payment by Canco:

- (i) interest payment gives rise to D/NI; (ii) Loan is a financial instrument and payment arises under the Loan; (iii) Canco and Forco are NAL; (iv) difference in treatment is attributable to the terms and conditions of the Loan and Forward (i.e., causal test is met)
- Canco denied a deduction in respect of interest payments on the Loan
- The denied interest payment is deemed to be a dividend subject to Part XIII withholding tax

Hybrid Mismatch Package 1

Example 2: Hybrid Financial Instrument Arrangement (Notional Interest Expense)



Treatment in Luxembourg: Although the Loan is non-interest bearing, Luxembourg allows CFA to deduct an amount of notional interest expense equal to what would be an arm's length rate

Application:

- (i) notional deduction engages deeming rules; (ii) deduction of notional interest in Luxembourg gives rise to D/NI (deduction in Luxembourg on notional expense; no corresponding inclusion in Canada under deemed interest income provisions since CFA uses funds to earn income from an active business); (iii) Canco and CFA are non-arm's length
- The amount of the notional interest is included in Canco's income

Hybrid Mismatch Package 1

Example 3: Convertible Debt – "Structured Arrangement"?

Facts:

- Canco issues convertible debt to arm's length persons (resident, NR and tax-exempt)
- Payment of interest results in D/NI for certain non-resident holders
- Debentures trade on secondary market
- Interest rate and conversion premium are the same for all holders, and consistent with those offered by other issuers in the Canadian market
- Debentures are not primarily marketed to holders in jurisdictions where D/NI arises, and are not beneficially owned primarily by those holders

Application:

Per Explanatory Notes:

"It is not expected that the payment of interest on the convertible debentures in this example would be considered to arise under, or in connection with, a structured arrangement.

The convertible debentures would not appear to have been designed to result in the [D/NI] mismatch since …

Although this analysis is based on an objective consideration of the limited facts and circumstances outlined for this example, in all cases, all available facts surrounding a particular transaction or series must be considered in their full and proper context"

Hybrid Mismatch Status

- Wait and See
  - Package 1:
    - No revised legislation as of yet
  - Package 2:
    - Not released as of yet, and no update on timing of release or effective date for same

U.S. Anti-Hybrid Rules: Sections 245A(e) & 267A

Recent Regulations Issued – During 2020, final and proposed regulations were issued to address certain hybrid arrangements and hybrid entities. Final regulations provide detailed guidance and special rules:

- Special rules for hybrid dividends *(Reg. §1.245A(e)-1)*
- Disallowance of certain interest and royalty deductions for hybrid and branch arrangements *(Reg. §1.267A-2)*
- Rules for determining income inclusions and amounts not treated as disqualified hybrid amounts *(Reg. §1.267A-3*)
- Disqualified imported mismatch rule - payments offset by a hybrid deduction *(Reg. §1.267A-4)*
- Anti-avoidance rule and other special rules that apply for purposes of 267A *(Reg. §1.267A-5)*

Background

As a response to Article 2 of the Organization for Economic Cooperation ad Development (OECD) Base Erosion and Profit Shifting (BEPS) project that targeted hybrid and branch mismatch arrangements, these new provisions were introduced to neutralize the effects of hybrid arrangements.

The Tax Cuts and Jobs Act introduced two new provisions to the Internal Revenue Code to address hybrid arrangements:

- **Section 245A(e)** denies a dividends received deduction with respect to hybrid dividends; and
- **Section 267A** denies certain interest or royalty deductions from hybrid transactions.

Effects on Cross-border M&A Transactions – Since the enactment of these provisions, we now need to reconsider certain financing structures and hybrid arrangements.

U.S. Treasury Terminates Tax Treaty with Hungary

- The U.S. Treasury Department notified Hungary on **July 8, 2022**, that the United States would terminate its tax treaty with Hungary.
- Treasury's surprise move came on the heels of Hungary's veto of a 15% global minimal corporate income tax, preventing the European Union from proceeding with its efforts to implement OECD Pillar 2.
- **Effects on Cross-border M&A Transactions –** Effects of terminating the treaty will mostly impact structures involving Hungarian holding companies with U.S. subsidiaries. Treaty benefits enjoyed by corporate taxpayers under the U.S.-Hungary Income Tax Treaty will no longer be available once the treaty termination is effective. Consequently, benefits of lower tax rates on certain income (e.g., interest, dividends), as well as relief from double taxation would expire with the termination of the treaty.
- **Effective Dates of Termination:**
  - The treaty termination will be generally effective on January 8, 2023.
  - With respect to taxes withheld at source, the treaty ceases to have effect on January 1, 2024.
  - With respect to other taxes, the treaty ceases to have effect for tax periods beginning on/or after January 1, 2024.

Canadian Financing Related Changes

Eifel (30%) Rule (Earnings Stripping)

Eifel Rules (30% Rule) – Background

Canada's version of BEPS Action 4

- Action 4 recommends that the amount of interest that can be deducted be limited to a percentage of EBITDA
- First announced 2021 Budget
  - Draft legislative proposals expected to be released for comment in summer 2021 with measures to apply January 1, 2023

Eifel Rules (30% Rule) – Release of Draft Rules

- Draft legislation released on Feb 4, 2022. Rules still proposed to apply to taxation years beginning on or after January 1, 2023
- Deduction limits apply to “interest and financing expenses” (IFE)
- 30% fixed ratio (40% for 2023) applies to “adjusted taxable income” (ATI)
- Very complex given Canada does not have a consolidated tax regime
- Existing rules still apply: thin capitalization, foreign affiliate dumping and new anti-hybrid rules

Eifel Rules (30% Rule)

- Many submissions identifying numerous issues with the proposals and recommends, inter alia, that the effective date be postponed

- Department of Finance acknowledged issues with the proposals as drafted (including the fact that significant parts of the draft legislation – e.g., as the application of the rules to foreign affiliates – were not completed prior to the release and details on those rules have yet to be released)

- No revised legislation as of yet but expected soon

U.S. Section 163(j) Interest Expense Limitation Changes

For tax years starting after 2021 - §163(j)(8)(A)(v) revises this calculation to reflect earnings before interest and taxes (EBIT) thus, disallowing the addback of depreciation and amortization. This change in calculation (i.e., 30% of EBIT) will restrict the amount of deductible interest expense, likely affecting many entities that had narrowly escaped the limitation in prior years.

Background:
Historically, the U.S. had Old §163(j) rules that targeted certain earnings stripping transactions conducted by U.S. taxpayers with foreign affiliates. The Old §163(j) rules were replaced by New §163(j) business interest expense limitation rules as part of the enactment of the Tax Cuts and Jobs Act.

New §163(j) applies to all businesses, domestic or multinational, with certain exceptions for "small businesses" or certain trades or businesses that are eligible and choose to elect out. New §163(j) caps interest expense to 30% of earnings before interest, taxes, depreciation, and amortization (EBITDA).

- Applies to third-party debt as well as intercompany debt
- Broad application that also limits deductions for payments or accruals that are economically equivalent to interest, such as: OID, repurchase premium, and unstated interest on deferred consideration
- Interest expense limitation is determined at the consolidated group level

Effects on Cross-border M&A Transactions – The more restrictive earnings stripping rule (30% of EBIT) makes the U.S. a less attractive financing option and generally effects the financing considerations in M&A deals.

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Canadian Financing Related Changes: Partnership and Withholding Tax

Partnerships and Withholding Tax

- CURRENT RULE
  - If a partnership pays/credits an amount to a non-resident person, it is deemed to be a person resident in Canada for withholding tax purposes in respect of the portion of the amount that is deductible in computing the partnership's Canadian-source income/loss

- PROPOSED RULE
  - August 9, 2022 proposed amendment to apply to amounts paid/credited no earlier than date of future release of draft legislation, to occur after consultation period for August proposals
  - If a partnership pays/credits a particular amount to a non-resident person, the partnership is deemed to be a person resident in Canada in respect of the total of all amounts each of which is a portion of the particular amount that is deductible in computing partner's Canadian source income/loss

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Canadian Transaction Related Changes

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Overview: Three Categories of Mandatory Disclosure

- Budget 2021 → Draft legislation February 4, 2022 and revised August 9, 2022
  - Most rules will apply to transactions / taxation years that begin, as applicable, after 2022
- Three categories:
  - "Reportable transactions" (expansion of existing rules)
  - "Notifiable transactions" (new)
  - "Reportable uncertain tax treatments" (new)
- Consequences of not filing or late filing
  - Significant penalties
  - Assessment period extended until 4 years (for large corporations) after return is filed (*i.e.,* potentially indefinitely)
  - So long as penalties have not been paid, GAAR can be applied even if no misuse or abuse

Reportable Transactions – The Basics

- A transaction is a "reportable transaction" if:
  - It is an "avoidance transaction" (or is part of a series that includes one), and
  - At least 1 out of 3 hallmarks is present
- Applies to taxpayers, advisors and promoters
  - "Advisor" includes person who provides another person assistance/advice re planning <u>or implementing</u> the transaction or series
    - Some entities may be either taxpayer or advisor, depending on transaction
  - Confidentiality: consider relationships/engagement terms with outside advisors, counterparties and advisors to counterparties

Avoidance Transaction

- "Avoidance Transaction" redefined:
  - Transaction (including an arrangement or event) that has, or is part of a series that has,
  - As one of the main purposes to obtain a tax benefit
- Non-tax motivated transaction is reportable if it is part of relevant series (common law and ITA 248(10))
- Low threshold – examples?
  - Non-resident filing a Part XIII tax refund claim on payment that is part of series that includes a section 85 election by another person
  - RRSP contribution – consider role of FI that assisted in "implementing" this transaction – advisor?

Contractual Protection Hallmark

- Protection (insurance, indemnity, compensation or a guarantee) that
  - Protects against a failure of the transaction or series to achieve tax benefit
  - Pays for/reimburses any expense, fee, tax, interest, penalty etc. as part of a dispute in respect of a tax benefit from the transaction or series
- Could be provided to taxpayer or advisor/promoter
- (Other two hallmarks only to advisor/promoter)

Contractual Protection – Exclusion

- A form of insurance, protection or undertaking that
  1. Applies in a normal commercial or investment context in which parties deal with each other at AL acting prudently, etc., and
  2. Does not extend contractual protection for a tax treatment in respect of an avoidance transaction
- Consider:
  - Indemnities for tax reps and warranties
  - RWI
  - Other forms of insurance

Confidential Protection Hallmark

- Confidential protection: anything that prohibits disclosure to any person or to CRA of the details or structure of the transaction or series
- Hallmark met where advisor/promoter obtains confidential protection
- **Exclusions**
  - If no confidentiality re the tax treatment of the avoidance transaction or series
  - Solicitor-client privilege (client confidentiality?)

Fee Hallmark

- Unchanged
- Applies where an advisor's or promoter's fee is <u>to any extent</u>
  - Contingent on obtaining, or failing to obtain, a tax benefit
  - Based on the amount of a tax benefit, or
  - Attributable to the number of transaction participants provided with access to advice

Who has to report? When?

Who?

a) Taxpayer — Person who obtains or expects tax benefit

b) Accommodation Party

- Could be relevant to an entity that enters into a trade that allows a counterparty to obtain a tax benefit

c) Advisor/ promoter receiving fees described in fee hallmark or in respect of contractual protection

When?

- Within 45 days of entering into the transaction (or, if earlier, becoming contractually obligated to do so)
- Consider early transaction that is part of series

When is this information return due?

- 45 days of the earlier of:
  - The day the taxpayer becomes contractually obligated to enter into the “transaction”; and
  - The day the taxpayer enters into the “transaction”
- Application to a series of transactions

Consequences of Failing to Report

- For taxpayer or accommodation party: $2,000 x number of weeks of non-reporting, capped by 25% of tax benefit – for ex. 4 years delay reporting of tax benefit of $100M → $4.16M (capped by $25M)
- For advisor:
    - $110,000, plus the advisor's fee in respect of the RT (not limited to fees for tax advice/assistance)

Notifiable Transactions

- Consistent with BEPS MDRs, new 237.4 allows CRA to designate specific types of transactions/series to be “notifiable”
- Taxpayers must report all transactions that are “substantially similar” (interpreted broadly) to designated transactions
  - i.e., expected to obtain the same or similar types of tax consequences and either factually similar or based on the same or a similar tax strategy
- Same reporting deadline as reportable transactions (45 days), and same requirement that multiple people must report
- Separate Quebec notifiable transaction regime

Notifiable Transactions

- Six sample types provided (not clearly “designated” yet):
  1. Manipulation of CCPC status to avoid anti-deferral rules applicable to investment income
  2. Straddle loss creation transactions using a partnership
  3. Avoidance of deemed disposition of trust property
  4. Manipulation of bankrupt status to reduce a forgiven amount in respect of a commercial obligation
  5. Reliance on purpose tests in the loss restriction rules (section 256.1 of the ITA) to avoid a deemed acquisition of control
  6. Back-to-back arrangements intended to circumvent the thin capitalization rules and Part XIII withholding tax

Notifiable Transactions

- Information return must describe/identify:
  1. Expected/claimed/purported tax treatment and all potential benefits
  2. Any contractual protection
  3. Any contingent fees
  4. The transaction in sufficient detail for the Minister to be able to understand the tax structure of the transaction
  5. Provisions relied upon for the tax treatment (ITA, Regulations, ITAR, tax treaty, other relevant enactments)
  6. To the best knowledge of the person who is filing the return, every person required to file an information return in respect of the transaction
  7. Other information required by the information return

Reportable Uncertain Tax Treatments

- Response to *BP Canada Energy Company*, 2017 FCA 61
- Note *Atlas Tube*, 2018 FC 1086, and *BMO Nesbitt Burns*, 2022 FC 157
- Certain corporations must provide their "reportable uncertain tax treatments"
  - Treatment in respect of a transaction/series that the corporation uses/plans to use in an income tax return/information return, in respect of which uncertainty is reflected in the audited financial statements of the corporation/consolidated group <u>for the year</u>
- Due with regular income tax return
- Does not constitute an admission that the tax treatment is not in accordance with the ITA or that any transaction is part of a series of transactions

Reportable Uncertain Tax Treatments

- Applies to a "reporting corporation":
  - Corporation/consolidated group has audited financial statements for a period that ends in the taxation year prepared in accordance with IFRS or (if listed on a non-Canadian stock exchange) country-specific GAAP
  - Carrying value of corporation's assets (per rules for defunct large corporations tax) is at least $50 million at the end of the taxation year; <u>and</u>
  - Corporation is required to file a Canadian income tax return for the year (i.e., Canadian resident or a non-resident with taxable income earned in Canada)

Reportable Uncertain Tax Treatments

- Required information expected to include:
  - Taxation year
  - Relevant facts
  - Provisions relied upon
  - Differences between the tax payable (or refund/other amount) under the ITA determined in accordance with the financial statements and the tax treatment of the corporation
  - Whether those differences represent a permanent or temporary difference, involve a determination of the value of any property, and involve a computation of basis
  - Other information as required by the CRA

Reassessment Period & Penalty

- CRA has 3 or 4 years after return is filed to reassess in respect of the UTP in the return
  - Originally 3 years for all taxpayers; now changed to align with normal 3 or 4 year normal assessment period based on the type of taxpayer
- Failure to file penalty: $2,000 per week the corporation fails to file (maximum of $100,000)

Coming Into Force

- Uncertain tax treatment reporting and extended reassessment periods: taxation years beginning after 2022
  - Originally 2021; pushed back 1 year in August 9 amendments
- Failure to file penalties: taxation years beginning after royal assent

GAAR Consultation Process

- GAAR consultation first proposed in 2020 Fall Economic Statement
  - Budgets 2021 and 2022 reaffirmed government’s intention to proceed
- Consultation Paper released August 9, 2022; submissions were due September 30
- Listed 24 cases the government lost as justification for potential amendments
  - Admitted that the GAAR has applied by the Minister as the primary or alternative reassessing position over 1,300 times

GAAR Consultation Paper

- Five sections, each with a statement of issue, background, and potential methods of addressing the issue
- Tax Benefit: concern about unrealized tax attributes, which has already been addressed by previously released draft legislation – no additional proposed changes
- Avoidance Transaction:
  - Discussion of a limited number of cases where the courts concluded there was no avoidance transaction (*Loblaw*, *Swirsky*, *McClarty Family Trust*, *Spruce Credit*, *Canadian Pacific*)
  - Potential amendments: interpretive rule regarding what does not constitute a *bona fide* purpose (e.g. foreign tax savings/avoidance); defining “transaction” as including a choice; lower the threshold from ‘primary purpose’ to ‘one of the purposes’ or ‘one of the main purposes’

GAAR Consultation Paper

- Misuse/Abuse:
  - Reversing the burden
  - Preamble/purpose statements
  - Extrinsic aids
  - Abuse of the Act read as a whole
  - Interpretive rules, e.g. fairness to the tax system as a whole, application to both foreseen and unforeseen tax planning (*Alta Energy*)

GAAR Consultation Paper

- Economic Substance:
  - In Minister’s mandate letter
  - Limited specifics, discussion of the limitations (including lack of definition); many potential ways discussed of how to define and incorporate
    - Sole/dominant purpose test; potential for pre-tax profit; impact on economic positions of parties to transaction; legal form vs accounting treatment
    - Deeming transaction to be abusive; reversing the misuse/abuse burden; more stringent misuse/abuse test; different ‘reasonable consequences’ rule

GAAR Consultation Paper

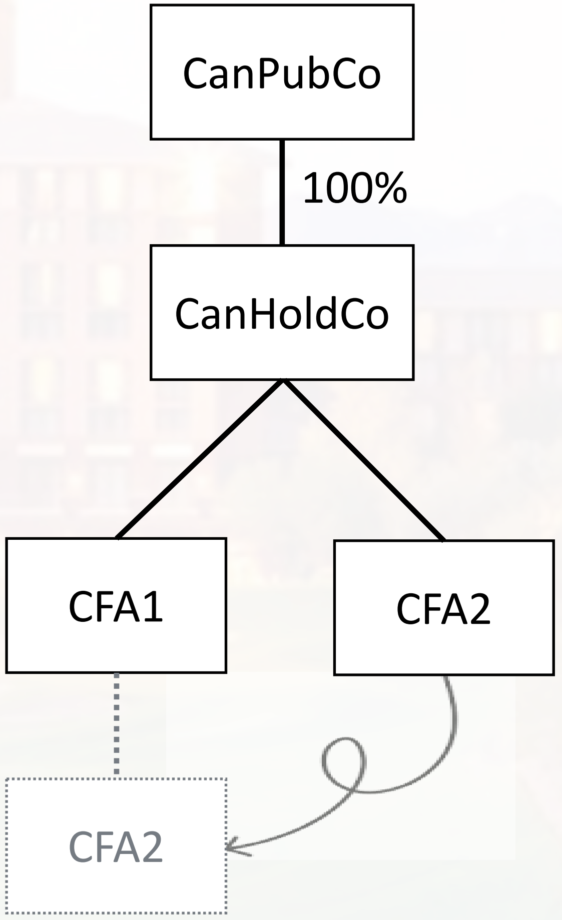
- <u>Penalties/Reassessment Period</u>:
  - Concern of insufficient deterrence
    - No discussion of impact of MDR, though notes close relationship
  - Penalty: automatic vs conditional (or both), potential defence – discretionary penalty is not an option
  - Higher interest rate
  - Extended reassessment period

Anti-Avoidance Rollover Proposal

- Proposed expansion of anti-avoidance rule in ITA 85.1(4) (intended to prevent the deferral of capital gains on a sale of foreign affiliate shares through a prior transfer under ITA 85.1(3)):
  - Subsequent disposition of substituted property or <u>a property any of the FMV of which is derived from the share or substituted property</u> (“Derivative Property”) can trigger the anti-avoidance rule
  - Subsequent purchaser could be an arm’s length person or a non-resident non-arm’s length person (other than a controlled foreign affiliate for purposes of section 17)
  - Excluded property condition can be satisfied by either all or substantially all of the property of the transferred affiliate, *or* the property that is subsequently disposed of, being excluded property
- Similar amendments proposed for ITA 87(8.3)

Anti-Avoidance Rollover Proposal: Example

- Shares of CanPubCo, CanHoldCo, and post-transfer CFA1 derive some value (however minimal) from CFA2 – Derivative Property
- Concern where the disposition of shares may be part of a series with the transfer of CFA2 (heightened by broadness of ITA 248(10))
  - E.g. public market sales of CanPubCo shares; sale of any shares of CFA1 to AL party, even if sale is fully taxable / CFA1 continues to be CFA of CanHoldCo
- Potential fix: threshold for value derived; require Derivative Property to be excluded property *and* sold by another foreign affiliate



U.S. Related Changes:

The Inflation Reduction Act of 2022

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IRA: Corporate Alternative (Book) Minimum Tax

- The IRA attempts to raise revenue from certain corporations (that meet the "average annual adjusted financial statement income test" (excess of $1 billion for prior 3 tax years preceding current tax year) without raising the corporate tax rate via a 15% alternative minimum tax on book income of such corporations for tax years beginning after December 31, 2022.

Formulaic Expression: **CAMT = Excess of [Tentative Minimum Tax] – [Regular Federal Tax Liability + BEAT Liability]**

Drivers of Book Minimum Tax – When a corporation has significant permanent or temporary book-tax differences that cause the financial statement income to exceed the taxable income, in a given year, it may trigger the 15% Book Minimum Tax. Other drivers:

1) Differences between U.S. GAAP and U.S. tax characterization of goodwill & intangible property leading to step ups for one/other
2) Pre-2020 NOLs may reduce taxable income and increase corporate AMT
3) Accelerated tax depreciation as compared to book depreciation
4) Low-taxed GILTI income and taking GILTI from 10.5% to 15% may be a driver of CAMT
5) Foreign-derived intangible income ("FDII") deduction
6) Excess tax benefits related to stock-based compensation
7) Accounting method changes - §481(a) adjustments
8) Mandatory §174 capitalization resulting in a large temporary difference between book income and taxable income
9) Split-Off Transactions

Effects on Cross-border M&A Transactions – Significant book-tax permanent or temporary differences can result in adverse consequences (e.g., subjecting a transferor to Corporate AMT on a split-off transaction).

IRA: Excise Tax on Stock Buybacks

Overview

- A 1% Excise Tax is imposed on the FMV of repurchased stock of a "Covered Corporation" during a tax year.
- Applies to repurchases (direct / indirect) by a "Covered Corporation" (domestic or foreign) that is publicly traded on an established securities market (e.g., NYSE, NASDAQ, LSE, Euronext, TSE; and regional and local exchanges).
- Effective for stock repurchases after 12/31/22. No "grandfathering rule" for pre-authorized repurchases, Rule 10b5-1 plan.
- Only applies to repurchases that exceed issuances during the year and will not be deductible in computing U.S. Federal Income Tax.

Excise tax is levied on stock of a "covered corporation" that is repurchased by a "specified affiliate"

- U.S. Corporation – Direct or indirect purchase by controlled subsidiary or controlled partnership
- Foreign Corporation – Indirect purchase by: (i) controlled U.S. subsidiary; (ii) controlled U.S. partnership; or (iii) controlled foreign partnership which has a direct or indirect U.S. partner
- Recently Inverted Corporations – (i) Surrogate Foreign Corporations executed after September 20, 2021) or (ii) Repurchases within the 10-year applicable period after inversion (levied on the expatriated entity)

Effects on Cross-border M&A Transactions – Questions remain regarding the scope of the transactions to which the Excise Tax would apply, such as: (i) certain divisive transactions under IRC §355; (ii) acquisitive reorganizations under IRC §368 with boot; (iii) liquidating or de-SPAC transactions; (iv) IRC §304 cross-border transactions; and (v) other redemptions.

U.S. Related Updates:

Anti-Hybrid Rules:

Sections 245A(e) and 267A

U.S. Anti-Hybrid Rules: Sections 245A(e) & 267A

The Tax Cuts and Jobs Act introduced two new provisions to the Internal Revenue Code to address hybrid arrangements:

- **Section 245A(e)** denies a dividends received deduction with respect to hybrid dividends; and
- **Section 267A** denies certain interest or royalty deductions from hybrid transactions.

As a response to Article 2 of the Organization for Economic Cooperation ad Development (OECD) Base Erosion and Profit Shifting (BEPS) project that targeted hybrid and branch mismatch arrangements, these new provisions were introduced to neutralize the effects of hybrid arrangements.

Effects on Cross-border M&A Transactions – Since the enactment of these provisions, we now need to reconsider certain financing structures and hybrid arrangements.

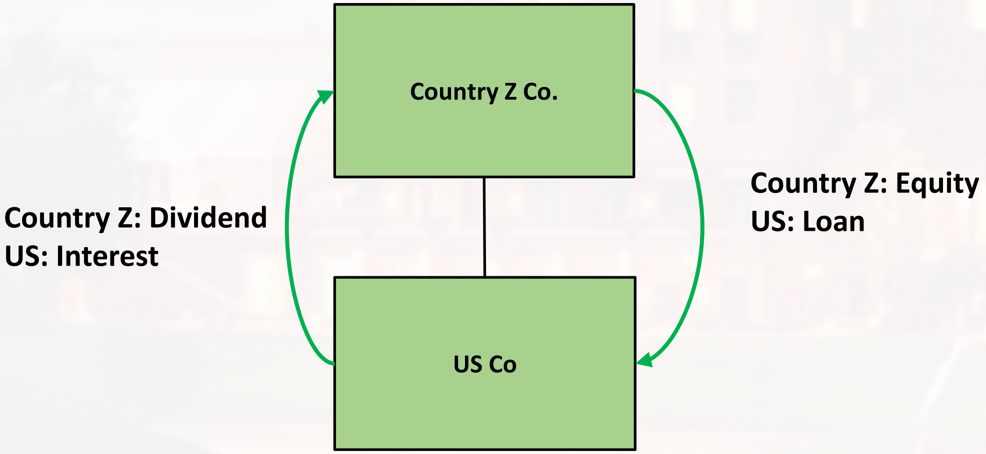
During 2020, final and proposed regulations were issued to address certain hybrid arrangements and hybrid entities. Final regulations provide detailed guidance and special rules:

- Special rules for hybrid dividends *(Reg. §1.245A(e)-1)*
- Disallowance of certain interest and royalty deductions for hybrid and branch arrangements *(Reg. §1.267A-2)*
- Rules for determining income inclusions and amounts not treated as disqualified hybrid amounts *(Reg. §1.267A-3*)
- Disqualified imported mismatch rule - payments offset by a hybrid deduction *(Reg. §1.267A-4)*
- Anti-avoidance rule and other special rules that apply for purposes of 267A *(Reg. §1.267A-5)*

U.S. Anti-Hybrid Rules: Section 267A

Example: Hybrid Debt / Equity Instrument

Country Z treats interest payments as an excludable dividend (not included in Country Z Cos's taxable income)



Under §267A, the U.S. treats interest payment as non-deductible DHA

Overview:

- Section 267A disallows a deduction for "interest" or "royalties" paid or accrued in certain transactions involving a hybrid instrument.
- Section 267A was designed to address cases in which a taxpayer is permitted a deduction under U.S. federal tax law, but the taxpayer does not have a corresponding income inclusion under foreign tax law, commonly referred to as a deduction / no-inclusion ("DNI") outcome.

Facts & Application of Rule:

- Country Z. Co. wholly owns US Co.
- Country Z. Co. enters into a hybrid loan arrangement with US Co.
- Interest payments from U.S. Co. to Country Z are characterized as a dividends (under Country Z law), which are not taxable in Country Z. Thus, the interest payments are treated as excludable income from a Country Z perspective.
- Before Section 267A was enacted, the dividends were not taxable in Country Z. and U.S. Co. could deduct the payments. Thus, the taxpayer would have received a deduction under U.S. federal tax law with no corresponding income inclusion under foreign tax law.
- Under Section 267A, U.S. Co. treats the interest payment as a disqualified hybrid amount ("DHA") for U.S. tax purposes, and the interest payment is non-deductible.

Scope of Section 267A

Section 267A applies only to “specified payments” made by a “specified party.”

- A “specified party” includes a U.S. person, a CFC, or a U.S. taxable branch
- “Specified payments” include payments of “interest” as well as “structured payments”

The §267A disallowance rules apply to a specified payment only if such payment constitutes:

- a “disqualified hybrid amount” (i.e., deduction/non-inclusion resulting from a hybrid or branch arrangement);
- a “disqualified imported mismatch” (i.e., importation of an offshore hybrid or branch arrangement); or
- an “avoidance transaction” (i.e., a specified payment for which the requirements of the anti-avoidance rule of Treas. Reg. §1.267A-5(b)(6) are satisfied).

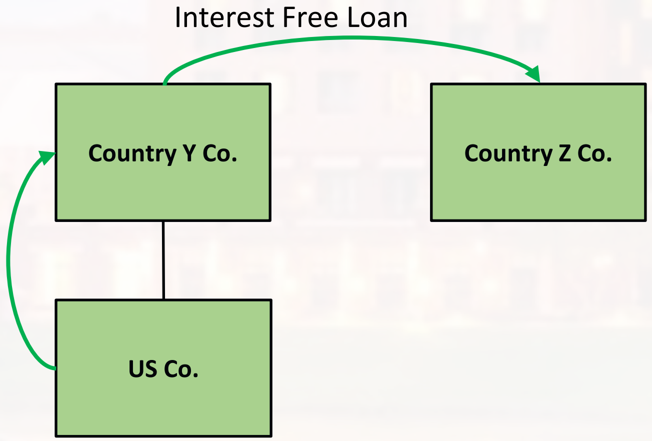
A specified payment that would otherwise be subject to disallowance under Section 267A because it falls within one of these categories is excepted, if the aggregate amount of the specified payments from the payor and related parties is less than $50,000.

Disqualified Hybrid Amounts – Interest Free Loans

Example: Interest Free Loans

Country Y Co.: permitted to take imputed interest deduction

Country Z Co.: not required to impute interest income



Interest is treated as a disqualified hybrid mismatch amount for US Co.

Overview:

Under the Final Regulations, payments under interest free loans and similar arrangements are deemed to be made under a hybrid transaction to the extent that:

1) a payment is imputed (under Sections 482 or 7872); and
2) the tax resident or taxable branch to which the payment is made does not take the payment into account under its tax law as that tax law does not impute interest.

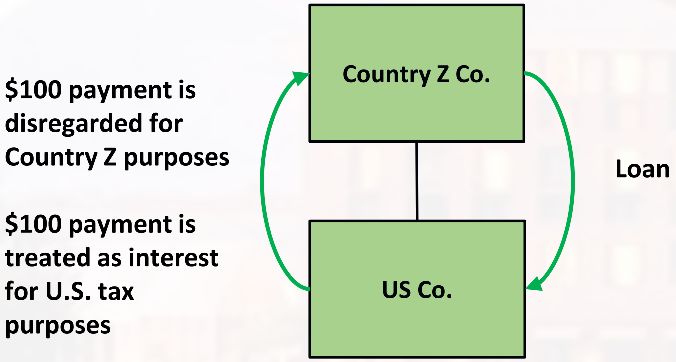
An interest free loan includes an instrument that is treated as debt under both U.S. tax law and the holder’s tax law but provides no stated interest. Instrument would give rise to a deduction and no inclusion to the extent the issuer is allowed an imputed deduction, but the holder is not required to impute interest income.

Facts & Application of Rule:

- U.S. Co. borrows from Country Y Co. under a normal loan, treated as debt both in the United States and in Country Y.
- Country Y Co. borrows from Country Z Co.
- This loan is also debt in both Country Y and County Z, but the loan is interest-free. Country Y is allowed an imputed interest deduction under Country Y tax laws.
- However, Country Z is not required to impute interest income under Country Z’s tax laws. In this case, the interest free loans would be treated as a hybrid transactions under Treas. Reg. §1.267A-2(a)(4) and the interest paid by U.S. Co. to Country Y Co. is treated as a disqualified hybrid amount.

Disqualified Hybrid Amounts – Disregarded Payments

Example: Disregarded Payments



US Co. is disregarded for Country Z tax purposes

- US Co.'s gross income included in Country Z Co.'s gross income ($125) - amount of US Co.'s deductible expenses, other than deductions for disregarded payments, that are available for Country Z tax purposes ($60) = dual inclusion income ($65)
- US Co.'s disregarded payments ($100) – dual inclusion income ($65) = disqualified hybrid amount ($35)

Overview:

- The excess (if any) of the sum of a specified party's disregarded payments for a tax year over its dual inclusion income for the tax year is a disqualified hybrid amount. Treas. Reg. §1.267A-2(b).
- Payments that give rise to a deduction/no-inclusion outcome because they are regarded deductible items of interest in the payor's jurisdiction but do not give rise to income inclusions in the recipient's jurisdiction because they are disregarded would be subject to Section 267A under this rule.
- The exception for dual inclusion income is intended to reduce the amount of the disregarded payment that would otherwise be treated as a disqualified hybrid amount by the amount of income (dual inclusion income) that is taxable to both the specified person for U.S. tax purposes and the foreign recipient for foreign tax purposes.

Facts & Application of Rule:

- Country Z Co. holds all the interests of US1. For Country Z tax purposes, US1 is a disregarded entity of Country Z Co.
- During tax year 1, US1 pays $100 to Country Z Co. pursuant to a debt instrument.
- The amount is treated as interest for U.S. tax purposes but is disregarded for Country Z tax purposes as a transaction involving a single taxpayer.
- During tax year 1, US1's only other items of income, gain, deduction, or loss are $125 of gross income (the entire amount of which is included in US1's income) and a $60 item of deductible expense. The $125 item of gross income is included in Country Z Co's income, and the $60x item of deductible expense is allowable for Country Z tax purposes.
- The excess (if any) of US1's disregarded payments for tax year 1 ($100) over its dual inclusion income for the tax year is a disqualified hybrid amount. US1's dual inclusion income for tax year 1 is $65, calculated as $125 (the amount of US1's gross income that is included in Country Z's income) less $60 (the amount of US1's deductible expenses, other than deductions for disregarded payments, that are allowable for Country Z tax purposes). Therefore, $35 is a disqualified hybrid amount ($100x less $65).

Other Disqualified Hybrid Amount Scenarios

Deemed Branch Payment

A deemed branch payment is a disqualified hybrid amount if the tax law of the home office provides an exclusion or exemption for income attributable to the branch.

Treas. Reg. §1.267A-2(c)(1).

Payments to Reverse Hybrids

A reverse hybrid entity for purposes of Section 267A is defined as an entity that is fiscally transparent under the tax law of the country in which it is established and is not fiscally transparent under the tax law of an investor.

Treas. Reg. §1.267A-2(d)(2).

Branch Mismatch Payment

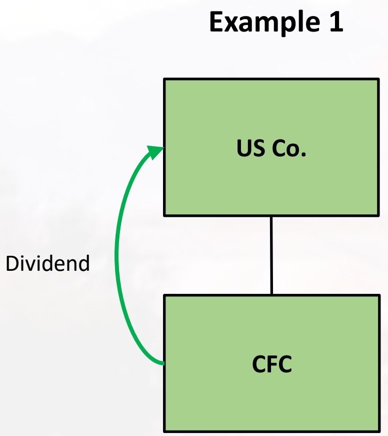
A branch mismatch payment is a disqualified hybrid amount to the extent that a home office, the tax law of which treats the payment as income attributable to a branch of the home office, does not include the payment in income, and the home office's no-inclusion is a result of the payment being a branch mismatch payment.

Treas. Reg. §1.267A-2(e)(1).

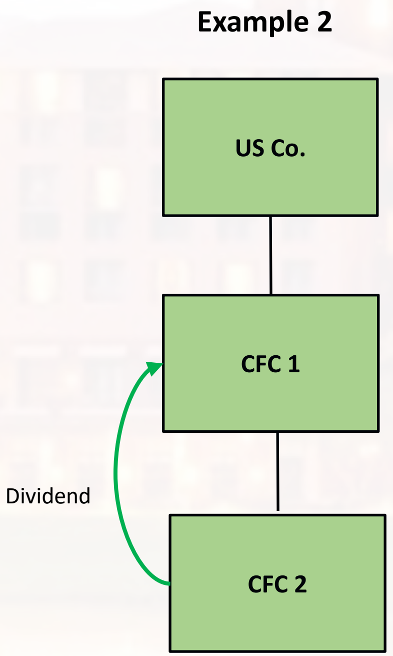
Effects on Cross-border M&A Transactions – Historically, certain holding and operating structures would include hybrid entities that now need to be reconsidered.

Section 245A(e) – Hybrid Dividends

Example: Hybrid Dividends



§245A DRD not permitted if:
- CFC receives deduction or
- other tax benefit for dividend.



Hybrid dividend treated as subpart F income of CFC 1.

Overview:

- Section 245A provides a dividends received deduction ("DRD") for the foreign-source portion of dividends received from certain foreign corporations.

Special rules for hybrid dividends:

- Section 245A(e) provides that a DRD is not available if a CFC distributes a "hybrid dividend" to a corporate shareholder. A hybrid dividend is an amount received from a CFC that would otherwise be eligible for the Section 245A DRD, and for which the CFC received a foreign tax benefit or deduction.
- Further, if a CFC with respect to which a domestic corporation is a U.S. shareholder receives a hybrid dividend from another CFC that has the same domestic corporation as a U.S. shareholder, then the hybrid dividend is treated as subpart F income of the recipient CFC for the taxable year in which the dividend was received.

Examples:

- Example 1: **CFC to US Shareholder**: §245A DRD not permitted if CFC receives deduction or other tax benefit for dividend.
- Example 2: **CFC to CFC where both have same U.S. shareholder**: Hybrid dividend treated as subpart F income of CFC 1.

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U.S. Related Updates:

Section 163(j) Interest Expense Limitation Changes

Section 163(j) Interest Expense Limitation Changes

Background

The Tax Cuts and Jobs Act introduced New §163(j) business interest expense limitation, replacing the Old §163(j) rules that targeted certain earnings stripping transactions conducted by U.S. taxpayers with foreign affiliates.

New §163(j) applies to all businesses, domestic or multinational, with certain exceptions for "small businesses" or certain trades or businesses that are eligible and choose to elect out.

New §163(j) caps interest expense to 30% of earnings before interest, taxes, depreciation, and amortization (EBITDA).

- Applies to third-party debt as well as intercompany debt
- Broad application that also limits deductions for payments or accruals that are economically equivalent to interest, such as: OID, repurchase premium, and unstated interest on deferred consideration
- Interest expense limitation is determined at the consolidated group level

For tax years starting after 2021 - §163(j)(8)(A)(v) revises this calculation to reflect earnings before interest and taxes (EBIT) thus, disallowing the addback of depreciation and amortization. This change in calculation (i.e., 30% of EBIT) will restrict the amount of deductible interest expense, likely affecting many entities that had narrowly escaped the limitation in prior years.

Post-election "lame duck" session - Possible delay of EBITDA to EBIT change with the §163(j) interest deduction limitation?

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OECD Pillar One and Pillar Two

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OECD Pillar One & Pillar Two - Timeline

October 08, 2021

OECD/G20 Inclusive Framework members reach agreement on a Two-Pillar solution to Address the Tax Challenges arising from the Digitalization of the Economy

December 20, 2021

OECD published Pillar Two Model Rules for domestic implementation of 15% Global Minimum Tax

February 2022

- Draft rules on 2 building blocks of Pillar One, Amount A, released for public consultation, (1) Nexus and Revenue Sourcing and (2) Tax Base Determinations
- Public comments received on the 2 building blocks of Pillar One, Amount A and published by OECD

March - October 2022

- OECD published Commentary and Examples on Pillar Two Model Rules
- Public inputs requested on putting in place mechanisms that will ensure tax administrations and MNEs can implement and apply the GloBE Rules in a consistent and coordinated manner while minimizing compliance costs
- Public Consultation documents on other building blocks of Pillar One, Amount A, released, including Progress Reports on Amount A and Administration and Tax Certainty Aspects of Amount A
- Report on considerations for emerging & developing countries in preparation for Pillar Two.

October - Year-End 2002

- Pillar Two - Implementation Framework to be released year-end 2022 & introduction thereafter in domestic law of jurisdictions
- Consultation on other building blocks of Pillar One, Amount A to be released on a rolling basis
- Public consultation on Pillar One, Amount B

2023

- Finalize Multilateral Convention for implementation of Pillar One - By Mid-2023
- Completion of work on Pillar One, Amount B

2024

Entry into force of Multilateral Convention for Pillar One

Pillar Two – Likely effective in 2024

- EU Directive including IIR and STTR to be implemented in 2023 but applicable for fiscal years starting after 12/31/2023, UTPR delayed to 2025
- Hungary continuing to oppose EU Pillar 2 Directive
- Although unanimity is hard to archive EU officials might work with soft law in order to implement
- Joint statement by France, Germany, Italy, Netherlands and Spain that they'll move forward even without EU Directive

Pillar One – Canadian DST

- Canadian 2021 Federal Budget proposed a Digital Services Tax (DST) of 3% on certain Canadian revenues effective January 1, 2022.
- If the OECD Pillar One is implemented by December 31, 2023, Canada's DST legislation will not be declared in force.
- Otherwise, the DST will apply back to January 1, 2022, but first payment/returns will not be due until 2024.
- The DST applies to large businesses, both foreign and domestic, that meet both of two revenue thresholds (determined on a consolidated group basis).
    - Total Revenue Threshold – revenue from all sources of €750,000,000 or more in a fiscal year of the taxpayer or group that ends in prior calendar year. Additionally, if a taxpayer joins a group that meets the €750,000,000 threshold, the taxpayer would meet this threshold as of the date of joining the group.
    - Canadian In-Scope Revenue Threshold - the taxpayer (or the taxpayer's consolidated group, if applicable) earns greater than $20,000,000 of Canadian in-scope revenue in the calendar year.
- Four Categories of in-scope revenue are proposed:
    - Online marketplace services revenue;
    - Online advertising services revenue;
    - Social media services revenue; and
    - User data revenue.

Pillar Two - Latest Developments & Timeline

- **U.S. Legislative Update**
  - **GILTI non-compliant with Income Inclusion Rule (IIR)**
    - The Administration set out legislation to change GILTI and make it compliant with the IIR, replace BEAT with Undertaxed Payment Rules (UTPR) and adopt a QDMTT, but failed to get it passed in the Senate (BBBA and Green Book provisions)
  - **GILTI might be treated as a qualifying CFC Covered Tax**
    - GILTI, in its current version is not a qualifying CFC tax because it is a tax on blended income of a U.S. shareholder's CFCs
    - Under Article 4.3 of the Model Rules, Covered CFC Taxes are formulaically allocated to constituent CFCs
    - The OECD and U.S. Treasury are expected to develop an additional layer of rules to assist with the allocation of the GILTI to CFCs so that the United States remains part of the Pillar 2 framework.

As GILTI is non-compliant with IIR and currently not a qualifying CFC Covered Tax, this may lead to a higher overall ETR for U.S. MNCs.
- U.S. MNCs may need to model Pillar Two impacts and assess existing structures.
- From an M&A perspective, when acquiring companies cross-border, consider the impact of Pillar Two.

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THANK YOU!