THE TAX CLUB

A Field Guide to Applying Treaties to Hybrid Entities

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It is well known that the steady proliferation of hybrid entities and instruments in international tax planning has put a formidable strain on the tax bases of countries around the world. Simply put, the international tax "system" was not built to withstand the highly selective use of hybridity to engineer tax outcomes. The thoughtful deployment of hybridity to thread needles as capital and income cross borders has confounded tax administrators around the globe who are only recently beginning to catch up with the state of the art. Both the domestic laws of OECD countries and bilateral treaty networks have been well behind the curve of taxpayer ingenuity and, while recent legislative and multilateral initiatives have made lurching strides forward to address hybridity in a concerted way, these new policy initiatives have also created important new problems and questions in cross-border tax planning.

The purpose of this paper is to address one facet of this multifaceted problem — the treatment of hybrid entities under U.S. tax treaties. This discussion provides (1) an overview of the evolving framework for the U.S. federal income tax treatment of hybrid entities in the cross-border setting, (2) illustrations of some of the persistent open questions relating to how U.S. tax treaties apply to hybrids, and (3) an attempt to synthesize various perspectives and analyses to try to propose a practical way forward on these open questions.

Level-Setting

The use of hybridity or other forms of tax arbitrage to achieve desired cross-border tax outcomes is a sweeping and diffuse topic that may be conjured up in countless ways. This is one of the defining challenges of making cross-border hybridity so difficult to address. For example, hybridity can come in the form of “regular” or “reverse” hybrid entities, hybrid instruments (e.g. instruments that are treated as equity in one jurisdiction but debt in another) and, more broadly, hybridity can manifest itself as any type of asymmetry that arises as a result of a tax base incongruity between two taxing jurisdictions. Multiplying the problem is the fact that taxpayers can assemble hybrid scenarios through a near limitless number of combinations of different taxing jurisdictions. Clearly, the topic becomes unworkably vast if one casts the net too broadly. Accordingly, this paper will take the narrower approach of focusing on the treatment of hybrid entities under U.S. tax treaties. As will be seen below, even within these narrow confines, there is a multitude of problems, traps and opportunities.1

Before jumping into the deeper end of this pool, it is useful to establish a few baseline conventions that will help streamline this discussion. In particular, for purposes of this discussion, the following meanings will apply to the symbols and acronyms below.

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1 For further reading on this topic, there are two excellent reports that also address questions related to the application of U.S. tax treaties to hybrid entities: (1) New York State Bar Association Tax Section, Report on the Application of Section 894 to Effectively Connected Income of Hybrid Entities (June 13, 2017) (the "NYSBA Hybrid Report"), and (2) Andrew Walker, Proceed with Caution: D(e)riving a Hybrid Down the Tax Treaty On-Ramp, Tax Lawyer Vol. 70, No. 3. Each of these report were immensely helpful in preparing this paper.
= Corporation. This entity is treated as a corporation under the laws of both the United States and the applicable foreign jurisdiction.

= Partnership. This entity is treated as a partnership (i.e., a recognized fiscally transparent entity) under the laws of both the United States and the applicable foreign jurisdiction.

= Hybrid Entity (or “regular hybrid entity”). This entity is treated as (a) fiscally transparent in the United States (i.e. either a disregarded entity if it has a single owner or a partnership if it has 2 or more regarded owners), and (b) fiscally non-transparent under the tax laws of the relevant non-U.S. jurisdiction. E.g., a domestic LLC.

= Reverse Hybrid Entity. This entity is treated as (a) fiscally non-transparent for U.S. tax purposes (i.e. a corporation), and (b) fiscally transparent under the tax laws of the relevant non-U.S. jurisdiction.

"DRH" = “domestic reverse hybrid”. This means a reverse hybrid entity that is organized under the laws of the U.S. For example, this could include a Delaware partnership that makes a check-the-box election to be treated as a corporation for U.S. tax purposes.

"FRH" = “foreign reverse hybrid”. This means a reverse hybrid entity that is organized under the laws of a foreign country. For example, a Cayman Islands partnership that makes a check-the-box election to be treated as a corporation for U.S. tax purposes.

"D/NI" = a tax outcome in which the use of a hybrid entity or hybrid instrument results in (a) a deduction (“D”) in one jurisdiction, and (b) a “non-inclusion” (“NI”) in income in the other jurisdiction.

"D/D" = a tax outcome in which the use of a hybrid entity or hybrid instrument results in (a) a deduction (“D”) in one jurisdiction, and (b) a deduction in the other jurisdiction.

**Part I**

*A Brief History of U.S. Tax Rules Related to Hybrids*

*A Challenging Problem to Tackle*

Over the last 20-25 years, the Code and U.S. tax treaties have been under-developed and slow-moving in addressing the deleterious effects of hybrid arrangements. Throughout this period sophisticated multinational taxpayers have been steadily leaning into hybridity and the opportunities it creates. A root cause of this sluggish advancement of U.S. tax rules to address this state of affairs has been a basic lack of clarity about defining the existence and scope of the
problem. Specifically, one of the confounding aspects of the hybridity problem is that, when viewed from any particular taxing jurisdiction’s perspective, a hybrid arrangement may not be viewed as perpetrating any inappropriate result (and, if anything, it only perpetrates an inappropriate tax result in another country). This has particularly been the case for D/NI arrangements. For example, for years, many were of the view that a “typical” Luxembourg treaty-based financing structure from Canada into the United States (sample illustrated below) was not problematic, from a tax policy perspective, to the U.S. tax base:

*Diagram 1: Lucco Financing Structure*

If each of the taxing jurisdictions involved views their own tax base as “intact” but see a problem as occurring in another jurisdiction’s backyard, none of them are sufficiently motivated to act to address the “problem” of an overall D/NI result. In a way, in order to recognize that an arrangement like this is problematic, one needs to engage in a bit of a paradigm shift and accept the slightly more global premise that any hybrid-based arrangement that produces a D/NI income harms the international tax system as whole and that this is, from a macro perspective, harmful to individual jurisdictions that themselves rely on a cohesive set of international tax norms to ultimately protect their own tax bases. In other words, one may take the view that taxing jurisdictions need to “stick together” in addressing hybridity in order to prevent themselves from being endlessly played one against the other to their collective detriment. As discussed below, this paradigm shift toward a more collective approach to protecting the international tax “system” as a whole is one of the central achievements of the BEPS project.

Another basic problem with formulating a game plan for addressing the inappropriate use of hybridity is deciding which rule making “tools” should be used to tackle the problem. On the one hand, domestic legislation or regulations are in theory easier to enact because they don’t involve negotiations with foreign countries but, on the other hand, these types of remedies are unilateral in nature and don’t do much to establish the comity required to address such a multi-headed phenomenon. Some examples of long-standing domestic provisions to combat hybridity include
the dual-consolidated loss rules (which, broadly speaking, address D/D arrangements by denying domestic deductions) and Section 894 anti-hybrid regulations (which are discussed further below and, by their terms, limited to FDAPI income). Separately, attempts to address hybridity through treaties has proven to be a slow and inconsistent process (as discussed further below). Overall, these attempts by U.S. tax authorities to address the use of hybrid entities in the cross-border space feel relatively ad hoc and inconsistent and, while they move things forward, they don’t really coalesce with any broader-based multinational strategy.

A third headwind that has impaired the advance of the U.S. tax system to address the use of hybrids is the logistical difficulties of coordinated international action. For years the absence of international focus, consensus and political urgency has left jurisdictions to their own devices. In this sort of a climate, individual countries not bound together through some sort of concerted policy had grown increasingly vulnerable to being picked off by taxpayers importing mismatch arrangements into their jurisdiction to erode their tax bases.

Section 894(c) of the Code and Related Treasury Regulations

Section 894(c) of the Code, which was enacted under the Taxpayer Relief Act of 1997, appears to be Congress’s first foray into the field of regulating the ability of hybrid entities and their owners to access treaty benefits. While Section 894(c)(1) takes aim at a specific hybrid arrangement that had become known to Congress (a specific arrangement which doesn’t appear to have much continuing relevance), Section 894(c)(2) takes a much more conceptual and proactive tack by directing the Secretary to:

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\text{“prescribe such regulations as may be necessary or appropriate to determine the extent to which a taxpayer to which paragraph (1) does not apply shall not be entitled to benefits under any income tax treaty of the United States with respect to any payment received by, or income attributable to any activities of, an entity organized in any jurisdiction (including the United States) that is treated as a partnership or is otherwise treated as fiscally transparent for purposes of this title (including a common investment trust under section 584, a grantor trust, or an entity that is disregarded for purposes of this title) and is treated as fiscally nontransparent for purposes of the tax laws of the jurisdiction of residence of the taxpayer.”}
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This appears to be the first time the concepts of fiscal “transparency” and “non-transparency”, essential tools for parsing international tax outcomes, were introduced into the Internal Revenue Code. These terms have since become essential building blocks for analyzing international tax outcomes and facilitating cross-systemic discussions about hybridity. It is also notable that the regulatory authority contemplated in Section 894(c) (1) does not appear to be limited only to fixed, determinable, annual or periodic income (“FDAPI”) but also includes trade or business income, and (2) does appear to be limited in scope to just “regular” hybrid entities (not foreign reverse hybrids).

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2 P.L. 105-34, Section 1054(a).
Diagram 2: Prototypical 894(c)(2) Scenario

French resident

Canadian resident

U.K. resident

Cayman Company

U.S. source FDAP

Final Regulations under Section 894(c) were introduced in July 2000 (the “894 Regulations”). The final regulations made two critical design choices (particularly in light of the language of 894(c)(2) itself). First, the regulations apply only to U.S. source FDAP and do not extend to trade or business income (or, in Treaty parlance, business profits). Second, the 894 Regulations apply to both “regular” hybrid and “reverse hybrid” entities.

The basic platform concept underlying the 894 Regulations is that U.S. treaty benefits will not be available with respect to an item of U.S. source FDAP paid to an entity that is regarded, under the U.S. “and/or any other jurisdiction”, as “fiscally transparent” with respect to that FDAP item unless, and to the extent that, (a) the entity itself is a treaty resident and it “derives” the income item in question (in which case it may apply its treaty), or (b) a direct or indirect owner of the entity is a treaty resident and they establish that they “derive” the income in question through the entity (in which case, such owner may apply its treaty). In cases where both the entity and/or one or more owners (in other tax treaty jurisdictions) concurrently derive the income, it appears that the parties are free to select which of the treaties to apply.

Accordingly, the concept of “derivation” plays a central gatekeeping role in determining access to U.S. tax treaty benefits with respect to FDAP. The derived concept is anchored firmly to the idea of fiscal transparency. In particular, the 894 Regulations prescribe that:

“...an item of income may be derived by either the entity receiving the item of income or by the interest holders in the entity or, in certain circumstances, both. An item of income paid to an entity shall be considered to be derived by the entity only if the entity is not

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fiscally transparent under the laws of the entity's jurisdiction...[a]n item of income paid to an entity shall be considered to be derived by the interest holder in the entity only if the interest holder is not fiscally transparent in its jurisdiction with respect to the item of income and the entity is considered to be fiscally transparent under the laws of the interest holder's jurisdiction with respect to the item of income."4 [emphasis added]

Under the 894 Regulations, an entity will be “fiscally transparent” if under the tax laws of the relevant jurisdiction:

- interest holders in the entity, wherever they may be resident, are required to separately take into account on a current basis their respective share of the item of income paid to the entity, whether or not distributed to the interest holder, and5

- the character and source of the item in the hands of the interest holder are determined as if such item were realized directly from the source from which realized by the entity.

Accordingly, fiscal transparency appears to be uniquely focused on consistency of timing, source, and character of income items. If an entity’s presence in a payment stream does not distort the FDAP item’s timing, source or character under the foreign tax laws of the entity’s owner, it will be treated as fiscally transparent under the 894 Regulations and the owner will generally be eligible to claim treaty benefits in respect of income received by the entity so long as the owner (i) is not, themself, fiscally transparent, and (ii) is otherwise eligible for such treaty benefits. By contrast, if there is distortion of timing, source or character of the FDAP income item under the tax laws of the entity’s owner, then only the entity itself will be eligible to claim treaty benefits in respect of such income (assuming the entity is not fiscally transparent under its tax laws, is resident in a treaty jurisdiction and otherwise satisfies treaty eligibility requirements).

Stepping back, another design choice of the 894 Regulations that is perhaps less visible but just as foundational as those listed above is how the regulations frame the idea of “derivation”. Specifically, the preamble to the regulations states that

These final regulations are fully consistent with existing U.S. treaties. They rely on the basic principle that tax treaties are intended to relieve double taxation or excessive taxation. Accordingly, the United States and its treaty partners agree to cede part or all of their taxation rights on income arising from sources within their respective borders on the mutual understanding that the other party is asserting tax jurisdiction over the items of income. This objective is generally achieved through treaty provisions that limit or eliminate the tax that the source state may impose on income arising within its borders to the extent that the income is considered to be derived by a resident of the other jurisdiction. In general, an item of income will be considered derived by a resident for treaty purposes only when the residence country is asserting taxing jurisdiction over the item of...

4 Treasury Regulation 1.894-1(d)(1).

5 The 894 Regulations clarify that an entity that, under the laws of its taxing jurisdiction, is (a) in the first instance required to include an item of U.S. source FDAP in income but (b) in the second instance entitled to a distributions paid deduction for amounts distributed to its owners, is not considered to be fiscally transparent under such laws. In addition, an entity will not be treated as fiscally transparent with respect to an item of income merely because an interest holder in the entity is required, under the law of the interest holder's jurisdiction, to include in gross income a share of all or part of the entity's income on a current basis under any type of anti-deferral or comparable mechanism.
income. However, the source state does not necessarily require, as a condition for ceding its taxing jurisdiction, that the income actually be taxed in the residence state or taxed at a rate commensurate with the rate imposed in the source state. The source state and the residence state may come to different conclusions regarding the appropriate taxation principles that apply to a particular type of taxpayer or a particular type of income. Such differences reflect how each state has decided to assert its taxing jurisdiction over that taxpayer or item of income and may or may not affect the source state's willingness to forego its taxing rights in whole or in part during the treaty negotiation process.

The proposed and temporary regulations further provided that an item of income received by an entity is treated as derived by a resident only to the extent the item of income is subject to tax in the hands of a resident of such jurisdiction. Numerous comments were received stating that this general rule needed clarification. Commentators suggested that the term subject to tax could be interpreted as requiring that an actual tax be paid rather than requiring an exercise of taxing jurisdiction by the applicable treaty jurisdiction, whether or not there is an actual tax paid.

The IRS and Treasury agree that the term subject to tax could cause unintentional confusion and that a more direct and simpler way of ensuring that an item of income is subject to the taxing jurisdiction of the residence country is to determine if the item of income is derived by a resident of a treaty jurisdiction. The concept of derived by a resident is a more useful surrogate for the concept of subject to the taxing jurisdiction of the residence state, the necessary prerequisite for the grant of treaty benefits on an item of income.

Thus, although the premise that the purpose of U.S. tax treaties is to eliminate double taxation or double non-taxation, the 894 Regulations do not actually probe whether there is, in fact, double non-taxation. Rather, the 894 Regulations ask a slightly different question — whether the relevant treaty jurisdiction “recognizes” the income item in question, with high-fidelity in respect of timing, source and character or, alternatively, whether the presence of the hybrid entity obscures the treaty jurisdiction’s ability to recognize that income item. Framed this way, the 894 Regulations don’t determine whether or not there is actually double non-taxation but, instead only spring into action if there is no “recognition” of the income item in the treaty jurisdiction (with timing, source and character intact), which is not the same question. In other words, the 894 Regulations will permit double non-taxation so long as the treaty partner recognizes the underlying income but just chooses not to tax it. This construct has the benefit of according deference to the manner in which the treaty partner chooses to tax income within its purview but carries the detriment of falling short of actually pre-empting cases of double non-taxation.

Properly framed, however, this result makes sense because the job of Section 894 and the Hybrid Rule is to "turn off" treaty benefits when the presence of a hybrid entity in the payment chain changes the tax treatment in the residence jurisdiction of an item of income relative to the treatment of that item in the residence jurisdiction if it had been earned without the intermediation of the hybrid entity. In other words, the Hybrid Rule is not focused on the actual presence or absence of "double nontaxation" outcomes but rather on whether the presence of the hybrid entity causes the income item in question not to be includible in the residence country's tax base in the same way it would be had it been earned directly by the resident.

While the 894 Regulations have established a reasonably sturdy and objective framework for determining the tax treaty treatment of hybrid entity arrangements with respect to U.S. source

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6 Notably, U.S. treaty designers circled back to address the issue of actual double non-taxation with respect to cross-border related party payments of interest, royalties and guarantee fees through introduction of a new treaty device, the "special tax regime" rules contained in the 2016 Model Tax Treaty.
FDAPI, their choice to stop-short of addressing business income has allowed that sphere of cross-border, hybrid-entity treaty tax planning and practice to fall into a state of disarray.

An Aside on Fiscal Transparency

As noted above, the concept of fiscal transparency is integral to determining whether a treaty resident derives income under the Hybrid Provision. While the concept of fiscal transparency has become fairly broadly adopted and consistently applied, there are some components and limits to this concept that are not clearly understood. For example, some commentators take the view that the regular operation of the "derived by" rule is not required in cases where certain tax-exempt entities invest through hybrid entities. Consider, for example, the following scenario:

Diagram 3: Inbound investment by Tax-Exempt through LLC

In the above scenario, the hybridity of the LLC has been characterized as a matter of "indifference" from a tax policy perspective since, as compared to the baseline scenario where the pension fund earns the dividend directly, the interposition of the LLC does not create a tax advantage to the pension fund nor any tax disadvantage to the U.S. tax net. Some commentators argue that the

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Hybrid Provision should be relaxed in these circumstances. This principle has been endorsed by the U.S. competent authority in a 2003 agreement with the Netherlands competent authority.

Once this door is opened, however, it raises the question of how far this relaxation may be extended. Consider the following scenario:

**Diagram 4: Inbound investment by Tax-Exempt through Cayman Trust**

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8 See, Willard B. Taylor, *Fiscally Transparent Entities and U.S. Tax Treaties*, Bloomberg Law International Journal (December 14, 2007) (“The §894(c)(2) regulations provide that, if treaty benefits for an item of income (say, U.S.-source dividends) are sought because the owner of an interest in the fiscally transparent entity is a resident of the other country, the item of income must either be included in income by the owner currently and with the same source and character as if received directly or, if the foreign tax treatment would be the same even though the source or character changed, the item must still be included in income currently, whether or not distributed. Does this make sense? Why should a treaty-eligible tax-exempt entity that invests through a fiscally transparent entity be denied treaty benefits if the tax treatment of income from the U.S. investment would be the same whether or not the item was currently included in its income? Why shouldn't U.S. tax treaties, as a matter of course, provide for treaty benefits in such a case, bearing in mind that any denial of treaty benefits will most likely be reciprocal and thus affect foreign investments by U.S. tax exempts”).

9 See, "U.S. AND NETHERLANDS REACH AGREEMENT ON PENSION FUNDS" (IR 2003-37) (3/21/2003) ("It has come to the attention of the Competent Authorities that pension funds of one Contracting State, that are otherwise entitled to benefits under Article 35 (Exempt Pension Trusts) of the Convention, may invest in the other Contracting State through an entity that is organized and treated as fiscally transparent in the other Contracting State, but treated as taxable by the first Contracting State. In order to ensure the application of Article 35, and pursuant to the authority of Article 29 (Mutual Agreement Procedure) of the Convention, the Competent Authorities agree that interest and dividends paid to and through such an entity for the benefit of a pension fund entitled to the benefits of Article 35 of the Convention shall be considered to be derived by a resident of the first Contracting State to the extent of the share the pension fund has in the interest and dividends described in Article 35 and paid to the entity. Further, this agreement is effective only for interest and dividends that would have been exempt from tax had they been derived directly by the pension fund").
Assume further that, (a) the Canadian pension fund is non-taxable under Canadian law, and (b) under the terms of the declaration of trust of the Cayman Trust, the trust is required to distribute all of its income annually to its owners in proportion to their ownership.

There are some who take the position that the pension fund in this scenario can claim the 0% rate under Article XXI of the Canada-U.S. tax treaty, notwithstanding that the trust is not a fiscally transparent entity under Canadian law (and, accordingly, that the pension fund does not “derive” the U.S. source dividend income in the ordinary sense). The theory underlying this position is that the interposition of the trust doesn’t result in a fundamental alteration of the tax treatment that would have prevailed under the laws of Canada had the pension fund received the dividend directly. More particularly, the taxpayer would argue that since a direct receipt of the dividend would not have been subject to tax in Canada, the indirect receipt of this dividend through the trust should not change that treatment since (a) the income item (or its proxy, the trust distribution) is recognized currently by the pension fund, and (b) although the source and character may be altered by virtue of the trust’s interposition, this is (again) a matter of “indifference” given that the underlying item isn’t taxable to the pension regardless of its source and character. This position may arguably be textually grounded in the language of 1.894-1(d)(3)(iii) (definition of “fiscally transparent under the law of an interest holder’s jurisdiction”) which, after stating the general rule of fiscal transparency, provides that:

“However, an entity will be fiscally transparent with respect to the item of income even if the item of income is not separately taken into account by the interest holder, provided the item of income, if separately taken into account by the interest holder, would not result in an income tax liability for the interest holder different from that which would result in the interest holder did not take the item into account separately”.

While it may be meritorious to relax the derived by requirement in certain circumstances, such as Diagram 3 above, it is not clear that the definitional limits of fiscal transparency can be stretched to the extent required to support the position in Diagram 4.

**Hybrid Entity Language in U.S. Tax Treaties**

After the arrival of the 894 Regulations, the U.S. expanded these concepts to address the issue of hybrid entities in the language of the tax treaties themselves. While no treaties are exactly the same as a whole, the typical hybrid entity language found in U.S. tax treaties is similar to that used in the 2006 U.S. Model Tax Treaty:

An item of income, profit or gain derived through an entity that is fiscally transparent under the laws of either Contracting State shall be considered to be derived by a resident of a State to the extent that the item is treated for purposes of
The taxation law of such Contracting State as the income, profit or gain of a resident.\textsuperscript{10}

The above provision (together with its variants in other U.S. tax treaties) is referred to as the "Hybrid Provision".

With respect to U.S. source FDAPI, this treaty language has substantially the same functional effect as the 894 Regulations. In particular, like Section 894, it focuses on whether the treaty partner jurisdiction "recognizes" the income item in question as an income item of a resident of that jurisdiction, notwithstanding the intermediation of a hybrid entity. Only when that correlation is present will treaty entitlements be afforded (again, regardless of whether or not that treaty partner jurisdiction actually asserts taxing jurisdiction over that income item).

Importantly, the Treaty language does not limit itself to FDAPI and, correspondingly, is interpreted by many as also applying to business profits and branch profits taxes (as well as any other non-FDAPI treaty provisions). While this does seem to be a fair interpretation of the plain language of the treaty and the Technical Explanations that accompany these provisions, there is some uncertainty as a technical matter. Specifically, the treaty language itself technically only prescribes when an income item is derived through a fiscally transparent entity. Not all operative treaty provisions contain a derivation requirement as a precondition to their application and, to that extent, it's not clear what specific relevance the Hybrid Provision has to operation of such a section.

For example, Article V (Permanent Establishment) of the 2006 Model U.S. Tax Treaty does not contain a "derivation" requirement and it's not clear how Article 1(6) modifies a treaty claimant’s ability to assert the substantive benefits of Article V. Specifically, Article V(1) of the 2006 U.S. Model Treaty provides:

\textit{For the purposes of this Convention, the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on.}

The reading in of a "derivation" requirement into this language is, however, assisted by the definition "enterprise" in Article III(1)(c), which states that the term “enterprise of a Contracting State” means:

\textit{“an enterprise carried on by a resident of a Contracting State, and an enterprise carried on by a resident of the other Contracting State; the terms also include an enterprise carried on by a resident of a Contracting State through an entity that is treated as fiscally transparent in that Contracting State...”}.

\textsuperscript{10} The corresponding language of the 2016 Model U.S. Tax Treaty is substantially similar to that of the 2006 model: "[f]or the purposes of this Convention, an item of income, profit or gain derived by or through an entity that is treated as wholly or partly fiscally transparent under the taxation laws of either Contracting State shall be considered to be derived by a resident of a Contracting State, but only to the extent that the item is treated for purposes of the taxation laws of such Contracting State as the income, profit or gain of a resident". Several other current U.S. tax treaties contain hybrid entity language that is substantially similar to the 2006 Model Tax Treaty, including the treaties with: Iceland, Sweden, the U.K., Germany, France and Finland.
Similarly, Article 11(1) (Interest) of the 2006 U.S. Model Treaty does not contain a derivation requirement and instead pivots to a requirement of beneficial ownership. Specifically, Article 11(1) requires that, “[i]nterest arising in a Contracting State and beneficially owned by a resident of the other Contracting State may be taxed only in that other State”. The concept of beneficial ownership (which is determined under U.S. federal income tax principles) doesn’t do the same thing as a derivation requirement and it’s not clear that a derivation requirement can be cleanly read into Article 11.

Going further, the LOB provisions of the 2006 U.S. Model Treaty handle the “derivation” concept in a somewhat inconsistent manner. Specifically, Article 22(1), which provides that treaty benefits otherwise accorded under the Treaty to residents are only available if the resident is a “qualified person” as defined in Article 22(2). Neither Article 22(1) nor (2) superimpose a derivation requirement. By contrast, Article 22(3) (the so-called “active trade or business” rule) specifically requires that, “[a] resident of a Contracting State will be entitled to benefits of the Convention with respect to an item of income derived from the other State, regardless of whether the resident is a qualified person, if…..”. Given the explicit invocation of the derivation concept in Art 22(3), it would seem difficult to argue that a tacit derivation requirement is intended in Article 22(1) and (2).

In negotiating the hybrid provisions of the 2007 Fifth Protocol to Canada—U.S. Tax Treaty (the “Canadian Protocol”), the U.S. and Canadian treaty negotiators moved away from the more conventional construct that is similar to Article 1(6) of the U.S. Model Treaty, and instead adopted a more prescriptive and detailed framework for addressing how hybrid entities would be treated under that treaty. Specifically, the hybrid provisions of the Canadian Protocol are structured into the following subcomponents:

**Article 4(6)**

An amount of income, profit or gain shall be considered to be derived by a person who is a resident of a Contracting State where:

(a) the person is considered under the taxation law of that State to have derived the amount through an entity (other than an entity that is a resident of the other Contracting State); and

(b) by reason of the entity being treated as fiscally transparent under the laws of the first-mentioned State, the treatment of the amount under the taxation law of that State is the same as its treatment would be if that amount had been derived directly by that person.

**Article 4(7)**

An amount of income, profit or gain shall be considered not to be paid to or derived by a person who is a resident of a Contracting State where:

(a) the person is considered under the taxation law of the other Contracting State to have derived the amount through an entity that is not a resident of the first-mentioned State, but by reason of the entity not being treated as fiscally transparent under the laws of that State, the treatment of the

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11 Article 12 (Royalties) has similar construction. Specifically, Article 12(1) provides that “[r]oyalties arising in a Contracting State and beneficially owned by a resident of the other Contracting State may be taxed only in that other State”.

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amount under the taxation law of that State is not the same as its treatment would be if that amount had been derived directly by that person; or

(b) the person is considered under the taxation law of the other Contracting State to have received the amount from an entity that is a resident of that other State, but by reason of the entity being treated as fiscally transparent under the laws of the first-mentioned State, the treatment of the amount under the taxation law of that State is not the same as its treatment would be if that entity were not treated as fiscally transparent under the laws of that State.

Together, Article IV(6) and (7)(a) achieve substantially the same end result as the 894 Regulations but articulate a slightly different framework for testing for fiscal transparency. More specifically, the Canadian protocol requires taxpayers to compare the “actual” tax treatment of the income item in question against the “hypothetical” tax treatment the treaty resident would have received had it earned the income item directly. If there is a variance in the tax treatment of the item between these scenarios and that variance is causally connected to the hybridity of the entity, then the treaty resident will not be able to claim treaty benefits in respect of that item. The Technical Explanation to the Canadian protocol asserts that the “same treatment” concept embedded in Article IV(6) and (7) is intended to be consistent with the 894 Regulations.

Importantly, however, the Technical Explanation explicitly provides that Article IV(6) applies to business income, gains and other income (and is not strictly limited to FDAP).

In summary, given the bilateral nature of tax treaties and peculiarities of treaty negotiations, the extant U.S. tax treaty network is a patchwork of methods for addressing hybrid entities in cross-border structures that is not smooth and consistent across treaties.

**Recent Developments Related to Hybrid Mismatch Arrangements**

In recent years, there has been a groundswell in coordinated international thought action against the use of “hybrid mismatch arrangements” to achieve inappropriate outcomes. Propelled by the OECD’s multi-pronged work on the base erosion profit shifting (“BEPS”) project, there has been an enormous step forward in terms of creating a cohesive framework for thinking about the regulation of hybrid arrangements in the international setting. Specifically, the OECD’s work on

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12 Article IV(7)(b), however, is directed at an entirely different type of mischief and is uniquely focused on imposing full withholding tax on cross-border payments by “reverse” hybrid entities.

13 Specifically, the Technical Explanation to the Canadian Protocol indicates that “whether the treatment of an amount derived by a person through an entity under the tax law of the residence State is the same as its treatment would be if that amount had been derived directly by that person shall be determined in accordance with the principles set forth in Code section 894 and the regulations under that section concerning whether an entity will be treated as fiscally transparent with respect to an item of income received by the entity.

14 The Canadian Protocol provides that “[n]ew paragraph 6 applies not only in respect of amounts of dividends, interest and royalties, but also profit (business income), gains and other income. It may thus be relevant in cases where a resident of one Contracting State carries on business in the other State through an entity that has a different characterization in each of the two Contracting States.
Action item 2 (Neutralising the Effects of Hybrid Mismatch Arrangements)\textsuperscript{15} establishes a much-needed common conceptual baseline for having a consistent, organized discussion about the impact of hybrid arrangements across multiple taxing jurisdictions.

The BEPS Hybrid Report moves the ball forward by establishing a common lexicon for thinking about hybrid mismatch arrangements and the outcomes they can generate. For example, the BEPS Hybrid Report carefully distinguishes between “double deduction” (DD) and “deduction/non-inclusion” (D/NI) outcomes and establishes a taxonomy of hybrid “arrangements”\textsuperscript{16} which may be used to synthesize D/NI and DD results. This framework establishes common parameters and facilitates coordinated thinking about how different jurisdictions should agree to address this arrangement. Importantly, the BEPS Hybrid Report also establishes remedial norms for addressing inappropriate hybrid mismatch outcomes. Specifically, the Report recommends (1) a “primary” response in which the jurisdiction in which the payer entity is resident would deny a deduction with respect to a hybrid payment, and, failing that, (2) a “secondary” or “defensive” response in which the payee jurisdiction would require income inclusion of the hybrid payment in question. This framework helps establishes a sense of coordination and is designed to preempt the asymmetry that could prevail if different jurisdictions pursued their own, uncoordinated remedies.

Since its finalization in 2015, the BEPS Hybrid Report has served as a foundational template for individual countries to implement their own domestic provisions for addressing hybrid mismatch arrangements. In the United States, Section 267A of the Code (enacted as part of the Tax Cuts and Jobs Act of 2017) and, more particularly, Treasury Regulations under Section 267A which were finalized in 2020, stand firmly on the shoulders of the OECD work. Specifically, the Section 267A regulations are directed at disallowing U.S. deductions for any “disqualified related party amount” paid or accrued pursuant to a hybrid transaction or by, or to, a hybrid entity. For this purpose, a “disqualified related party amount” is any interest or royalty paid or accrued to a related party to the extent that (A) such amount is not included in the income of such related party under the tax law of the country in which the related party is a resident for tax purposes, or (B) the related party is allowed a deduction with respect to such amount under the tax law of such country. The Final 267A Regulations clarify that the deduction is denied only to the extent that the NI in the payee’s jurisdiction is causally connected to a hybrid element. Specifically, the regulations (like the BEPS Hybrid Report) enumerate specific hybrid arrangements which are targeted:

- Hybrid Transactions
- Disregarded Payments
- Deemed Branch Payments
- Reverse Hybrid Arrangements

\textsuperscript{15} OECD/G20 Base Erosion and Profit Shifting Project, Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2: 2015 Final Report (the “BEPS Hybrid Report”).

\textsuperscript{16} For example, the BEPS Report itemizes the following different “types” of hybrid arrangements on which it is focused: hybrid financial instruments, disregarded hybrid payments, payments to reverse hybrids, deductible hybrid payments, dual-resident taxpayers and “imported mismatch” arrangements.
• Branch Mismatch Payments

• Disqualified Imported Mismatch Amounts

Against this backdrop of significant advancement in the tax treatment of hybrid arrangements, it's legitimate to ask what, if any, impact has the BEPS Hybrid Report and/or Section 267A had (or should have) on the treaty of hybrid entities under U.S. tax treaties. To begin with, there is less conceptual overlap between Section 894 and Section 267A than may at first be apparent in that, where Section 894 is focused exclusively on hybrid entities, both the BEPS Hybrid Report and the 267A rules are predominantly focused on other types of hybridity. Specifically, the 267A regulations primarily address hybrid instruments or hybrid arrangements involving branches or disregarded payments, as opposed to hybrid entities. In fact, the only type of “hybrid entity” arrangement that the 267A regulations explicitly address are payments to “reverse hybrids” in which there is a “mismatch” in classification of a payee entity as between the tax jurisdiction in which the entity is formed and the tax jurisdiction in which the investor is resident (as illustrated below). Secondly, the 267A regime (like the hybrid entity mismatch proposals) is limited, by its nature, to payments that would in the first instance be deductible for U.S. tax purposes – with the corollary being that the 267A rules do not apply to dividends, whereas 894 does.

More fundamentally, there is no overt policy-linkage between the anti-hybrid mandates of 267A and Section 894 (or its treaty-based variants) and the two provisions appear to operate independent of one another despite their conceptual overlap. More broadly, the preamble to the Final 267A Regulations addressed the question of whether the operation of Section 267A should be modified to take into account the presence or absence of U.S. withholding taxes on the underlying U.S. source payment:

“The Treasury Department and the IRS have determined that it would not be appropriate for withholding taxes to be taken into account for purposes of section 267A. The purpose of withholding taxes is generally not to address mismatches in tax outcomes but, rather, to allow the source jurisdiction to retain its right to tax a payment. In addition, and as explained in the preamble to the proposed regulations, taking withholding taxes into account could create issues regarding how section 267A interacts with foreign hybrid mismatch rules—for example, a foreign country with hybrid mismatch rules may not treat the imposition of U.S. withholding taxes on a specified payment as neutralizing a D/ NI outcome and may therefore apply a secondary or defensive rule requiring the payee to include the payment in income. Moreover, had Congress intended for withholding taxes to be taken into account

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17 Viewed simply, 267A applies when a hybrid element causes the payee jurisdiction not to assert its taxing jurisdiction over the income item in situations where it would have asserted taxing jurisdiction on such income item but for the hybrid element. Similarly, Section 894 (and its treaty-based variants) applies when the presence of a hybrid entity causes the treaty partner jurisdiction not to recognize the income item in question and the treaty partner would have taxed such income, but for the presence of the hybrid entity. Given the conceptual commonality of the underlying triggers of both 267A and Section 894, one might have anticipated greater operational coordination between the two provisions.
for purposes of section 267A, it could have added a rule similar to the one in section 59A(c)(2)(B), which was enacted at the same time as section 267A.”

This rationale for the lack of recognition given to U.S. withholding taxes when applying Section 267A is somewhat opaque and unsatisfying. The absence of linkage between 267A and withholding taxes is particularly lacking when one considers scenarios where the reason for the application of withholding taxes is the operation of Section 894 (or similar provision contained within a treaty). In those scenarios, it would seem that the imposition of withholding taxes under Section 894 and the denial of deduction of under Section 267A have the same root cause and the application of both remedies may possibly be regarded as overkill. Consider, for example, the following scenario:

Diagram 5: Reverse Hybrid Arrangement

While the above scenario would arguably not be addressed by Article 1(6) of the 2006 U.S. Model Treaty (which is keyed off of different tax treatment as between the source and residence countries – here there is no such inconsistency between the U.S. and Country X), it would be addressed by Section 894 (which applies if the payee entity is treated as fiscally transparent in any jurisdiction). Accordingly, a payment of U.S. source interest or royalty in the scenario depicted above should be both (1) non-deductible to the U.S. payor under Section 267A, and (2) subject to 30% withholding tax under Section 894 (and/or pursuant to an applicable treaty-based hybrid provision).

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BEPS Hybrid Mismatch Report at para 407. A country will continue to levy withholding taxes on payments that are subject to adjustment under the hybrid mismatch rules in accordance with its domestic law and consistent with its treaty obligations. The function of withholding taxes under the laws of the payer jurisdiction is generally not to address mismatches in tax outcomes and a payment should not be treated as included in ordinary income simply because it has been subject to withholding at source. The primary rule denying the deduction may apply in cases in which the payer jurisdiction also imposes a withholding tax on the payment as it is still important to neutralize the hybrid mismatch in those cases. Withholding taxes alone do not neutralize the hybrid mismatch as withholding taxes, where applicable, often are imposed with respect to equity instruments.
One way to rationalize the operation of Section 267A and the Hybrid Rule with one another is to simply conceptualize each of these rules as policing a separate “level” of taxation. More particularly, in the classical system of U.S. corporate income taxation there are two levels of taxation — one layer of taxation at the corporate level and a second layer of tax at the shareholder level. Broadly speaking, one can view 267A as policing the integrity of the first layer of taxation (e.g. entity level taxation) by denying deductions in cross-border scenarios where, by virtue of specifically proscribed hybrid elements, there is no corresponding income “inclusion” by the direct or indirect payee (i.e., there is a D/NI outcome). By contrast, the decision of whether or not to assert withholding tax on a cross-border payment is, fundamentally, a choice about whether to cede some of the source jurisdiction’s ability to assert taxation on the second level (i.e., the shareholder level) of taxation. Viewed, from the source country’s perspective, base erosion may occur at either (or both) levels of taxation and there does not appear to be any reason why the source jurisdiction should be limited to addressing base erosion at only one level. Stated differently, it’s not clear why the operation of 267A should be modified by the fact that withholding taxes apply to the underlying payment (i.e., base erosion at the entity level should not necessarily be excused because there is no base erosion at the shareholder/withholding-tax level). The opposite should also be true.

In summary, while the BEPS Hybrid Report has advanced the state-of-the-art for tax administrations in addressing hybrid arrangements by establishing a coherent and coordinated framework, it addresses the problems of cross-border hybridity in a manner that is significantly different from the Hybrid Rule. To begin with, the 267A rules adopt a different “remedy” by addressing address hybrid problems through a denial of deductions in the payor jurisdiction. Additionally, the primarily focus of the hybrid mismatch rules is to combat mismatches created through “other” (i.e., non-hybrid entity) forms of hybridity whereas the Hybrid Rule is focused exclusively on hybrid entities. While the 267A rules and the Hybrid Rules will apply in many of the same scenarios and share some common root elements, they should not be conflated into substitutes for one another since they each appear to have separate “jobs” from a U.S. international tax policy perspective.

**Part II**

*Practical Issues involving Hybrid Entities and Treaties*

While the Hybrid Provisions have provided a reasonably sturdy framework for addressing the application of U.S. tax treaties to FDAP, taxpayers and their advisors have largely been left to their own devices when it comes to applying these provisions and principles to adjacent tax issues, such as the tax treatment of business profits earned by hybrid entities. Key (but by no means the only) conceptual issues related to the application of treaties to hybrids earning U.S. trade or business income are:

1. Who has standing to assert the benefits of Article V (Permanent Establishment) or VII (Business Profits)?
2. Who is required to file a U.S. tax return to report the ECI or “business profits”?\(^{19}\)

3. How does the branch profits tax work in connection with business profits earned by or through hybrid entities?

**Hybrid Entities and Business Profits**

This author believes that the Hybrid Rule contained in treaties should not be constrained to FDAP and should be applied to Article V (permanent establishment) and Article VII (business profits) matters and, in fact, any element of U.S. tax treaties in which hybrid entity status has the potential to affect a tax outcome under a treaty. This position flows from the simple observation that all treaty provisions should be applied on a common conceptual footing. While it is clear that there are greater practical challenges to applying the Hybrid Rule to business income, the compelling need for parity should outweigh any reluctance to address those challenges. The discussion below provides examples of how this rule should be (and, practically speaking, frequently is) implemented in particular factual scenarios.

**Domestic Hybrids**

*Diagram 6: U.S. Business conducted through LLC:*

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\(^{19}\) As a brief refresher on the U.S. tax return filing obligations of non-U.S. persons: (a) Treas. Reg. 1.6012-1(b) generally requires every non-resident alien individual who is engaged in a U.S. trade or business ("USTB") at any time during the taxable year to file a 1040NR, and (b) Treas. Reg. 1.6012-2(g) generally requires a non-U.S. corporation that is engaged in a USTB to file a 1120-F, in each case regardless of whether (i) the non-resident individual or foreign corporation has any ECI, or (ii) such income is exempt for U.S. taxation under an applicable U.S. tax treaty. Importantly, for this purpose Section 875(1) provides that a nonresident alien individual or foreign corporation is considered as being engaged in a USTB if the partnership in which individual or corporation is a member is so engaged.

Moreover, under Section 6114(a) of the Code, any taxpayer that takes the position that a U.S. tax treaty modifies the tax treatment of such taxpayer under the Code is required to file IRS Form 1120-F (U.S. Income Tax Return of a Foreign Corporation) and IRS Form 8833 (Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b)). So, for example, a non-U.S. corporation that is engaged in a USTB that generates ECI but that asserts that they do not have a United States permanent establishment and, therefore are not subject to U.S. tax on the ECI is required to make these filings (see Treas. Reg. §§ 301.6114-1(b)(5)(i)).

Importantly, the rules described above are applied from a U.S. tax "perspective" in the sense that the characterization of entities is determined under U.S. federal income tax principles and there is no overt guidance on how these return filing provisions are to be modified (if at all) in the context of hybrid entities. As discussed, certain common practices, which are aligned with the concepts of the Hybrid Rules appear to have developed.
In this scenario, the Section 894 principles applicable to FDAP should be applied directly to the non-U.S. investors. Specifically, if the Canadian and Country X investor do not derive the income earned by LLC (because neither Canada nor Country X treat the LLC as fiscally transparent), neither investor should be able to assert the benefit of Article V to claim an exemption from U.S. taxation on the ECI. Since the treaty is intended to respond to instances of double taxation or double non-taxation, there does not appear to be any legitimate application of the treaty in scenarios (such as this) where there is no possibility of either such event owing to the simple fact that the treaty resident is not treated as recognizing the ECI in the first instance. This is an appropriate result notwithstanding the fact that (a) the United States views the LLC as fiscally transparent, and (b) the Canadian and Country X investor are the persons required to file U.S. tax returns under Section 6012 of the Code.

By contrast, if Country X treated LLC as fiscally transparent, then it would be appropriate to allow X to assert the benefit of Article V and, accordingly, to be relieved of U.S. tax liability on its allocable share of LLC’s ECI (assuming, of course, that Country X has a tax treaty with the U.S. and X meets the LOB requirement of that Treaty).

**Foreign Hybrids**

Now consider a modified version of the scenario illustrated in Diagram 1 in which a Nova Scotia unlimited liability company (treated as a disregarded entity for U.S. federal income tax purposes) is substituted into the place of the LLC:

*Diagram 7: U.S. business conducted through a Foreign Hybrid*
In this scenario, entirely different considerations take hold. Specifically, ULC (like the LLC in Scenario 1) is fiscally non-transparent under Canadian law and, accordingly, Canco and X (assuming Country X also treats ULC as fiscally opaque) do not derive the ECI earned by ULC under the Hybrid Rule. However, ULC (unlike the LLC in Scenario 1) is a resident of Canada in its own right and, as such, is entitled (assuming it meets the LOB requirements to the treaty) to assert the benefits of the U.S.-Canada tax treaty even though it is viewed as a partnership for U.S. tax purposes.

In this scenario, there appears to be a range of views about how to best approach this situation practically. For example, although there does not appear to be any explicit regulatory authority to support the practice, some taxpayers may take the position that the ULC (as the treaty benefit claimant and the entity that would deliver a Form W-8BEN-E establishing treaty benefits) should file a protective 1120-F with an accompanying IRS Form 8833 notwithstanding the fact that the domestic U.S. rules view the ULC as a partnership. In such a case, the theory would go, the investors should be relieved of the U.S. tax return filing obligations that they would otherwise have had if a purely domestic view of the arrangement prevailed. In this case, the domestic return filing rules would effectively “yield” to the treaty-modified conceptualization of the structure.\(^\text{20}\) While this result is consonant with the principles underlying the Hybrid Rule, many advisors in this case would at least recommend that Canco and X file protective 1120-Fs reporting no ECI by virtue of ULC's treaty-based position.

Alternatively, other taxpayers take the position that ULC is required to file a partnership return reporting allocations of income to Canco and X and that Canco and X would, in turn, file 1120-F’s along with IRS Form 8833 indirectly asserting treaty benefits that are actually attributable to ULC.

\(^\text{20}\) The 1441 regulations allow for a comparable result in the context of FDAPFI withholding. In particular, Treasury Regulation 1.1441-6(b)(2) allows a hybrid entity that is treated as non-fiscally transparent under the laws of its jurisdiction may claim treaty benefits on U.S. source FDAPFI by furnishing the U.S. withholding agent with a IRS Form W-8BEN-E.
Clearly, it would be helpful if the compliance expectations of the IRS in this scenario were clarified through administrative guidance.

An Aside on Foreign Hybrids

To illustrate a scenario where the treatment of hybrid entities may lead to difficult choices, consider a situation where Country X is a non-treaty jurisdiction that also treats ULC as a fiscally transparent entity. Is it appropriate for Investor X in this scenario to indirectly benefit from the Canada-U.S. treaty when X wouldn’t have been able to assert the benefits of any treaty had it earned the underlying ECI directly? While the conclusion that Investor X is able to ride the coattails of the Canada-U.S. treaty in this scenario may be questionable, if there’s any mischief here it would seem more appropriate to place the blame with the LOB rules rather than the Hybrid Rule.

Domestic Reverse Hybrids

Turning now to reverse hybrid entities, it is important to note that the Hybrid Rules provide for special treatment of DRHs. In particular, under Treasury Regulation 1.894-1(d)(2)(i) and the savings clause of U.S. tax treaties, the Hybrid Rule yields to the more dominant principle that the U.S. will not concede the ability to tax its own domestic taxpayers (even if those taxpayers are viewed as fiscally transparent in the jurisdictions of the owners of such taxpayer). Consider, for example, the following scenario:

Diagram 8: U.S. business conducted through a Domestic Reverse Hybrid

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21 Treas. Reg. 1.894-1(d)(2) provides that, "[a]n income tax treaty may not apply to reduce the amount of federal income tax on U.S. source payments received by a domestic reverse hybrid entity. Further...the foreign interest holders of a domestic reverse hybrid entity are not entitled to the benefits of a reduction of U.S. income tax under an income tax treaty on items of income received from a U.S. sources by such entity."

22 See, for example, Article 1(4) of the 2006 Model Tax Treaty: "...this Convention shall not affect the taxation by a Contracting State of its residents...."
In this scenario, X and Canco as owners of Delaware LP may not assert the benefits of Art X with respect to U.S. source FDAPI paid to USP, notwithstanding that each of X and Y are treated as deriving such income under Country X and Canadian law respectively. Similarly, neither X nor Y are able to assert the benefits of Article 5 to claim an exemption from taxation on their allocable share of ECI earned by USP.

An Aside on Domestic Reverse Hybrids

While not directly relevant to the operation of the Hybrid Rule (as typically understood), it should be noted here that special considerations apply in this scenario under Article IV(7)(b) of the Canada-U.S. Tax Treaty. Specifically, Article IV(7)(b) would effectively "turn off" the ability of Canco to claim treaty benefits in respect to payment of amounts made by the Delaware LP to Canco to the extent that the treatment of such amounts under Canadian law is different from the treatment that would have prevailed if Delaware LP had been treated as non-fiscally transparent under Canadian tax law.

Foreign Reverse Hybrids

By contrast to the scenario in Diagram 8, when non-U.S. investors hold equity in a FRH (as opposed to a DRH), the “derivation” concept underlying the Hybrid Provision is no longer in conflict with the more foundational concept that the U.S. will not relinquish its ability to assert its taxing jurisdiction over U.S. taxpayers and, accordingly, is allowed reassert itself. In particular, consider the same scenario as Scenario 3 but with a FRH substituted in for the DRH:

Diagram 9: U.S. Business conducted through Foreign Reverse Hybrid
In this scenario, both X and Canco would be able to assert the benefits of their respective treaties in respect of U.S. source FDAPF so long as (a) both Country X and Canada treat the Ontario LP as fiscally transparent, and (b) they each satisfy the LOB requirements of their treaties. However, since the domestic U.S. tax rules do not view X and Canco as beneficial owners of the income (since Ontario LP is viewed as a corporation for domestic tax purposes), it is Ontario LP that must "interact" with the U.S. tax system as the recognized taxpayer. In particular, it is Ontario LP that will file an 1120-F and IRS Form 8833 asserting the benefit of the applicable tax treaty(ies) on behalf of its Treaty resident owners.

Hybrid Entities and Limitation on Benefits

The impact of hybrid entities on the interpretation of LOB provisions is a subject that has not attracted significant attention. Nevertheless, through somewhat inconsistent use of the term "derive" (or other permutations of that verb), there are potentially material discontinuities across U.S. tax treaties regarding the impact that hybrid entities may have on a taxpayer's interpretation of the LOB provisions.

LOB and "Derivation"

The LOB provisions play a "gatekeeper" role in U.S. tax treaties in the sense that any claim for treaty benefits under a particular Article of a U.S. tax treaty cannot be perfected unless and until the claimant establishes that they satisfy the LOB requirements of that Treaty. Accordingly, since all treaty roads must pass through LOB hurdle, any substantive requirements of the LOB test effectively modify all other components of the Treaty. This premise is particularly interesting when one examines how different LOB provisions wield the concept of "derivation".

Consider, for example, the introductory provision of Article 23(1) of the U.K.-U.S. Tax Treaty:

"Except as otherwise provided in this Article, a resident of a Contracting State that derives income, profits or gains from the other Contracting State shall be entitled to all the benefits of this Convention otherwise accorded to residents of a contracting State only if such resident is a "qualified person" as
defining in paragraph 2 of this Article and satisfies any other specified conditions for the obtaining of such benefits."

Contrast this language with the comparable language from the 2006 Model U.S. Tax Treaty:

"Except as otherwise provided in this Article, a resident of a Contracting State shall not be entitled to the benefits of this Convention otherwise accorded to residents of a Contracting State unless such resident is a "qualified person" as defined in paragraph 2." 23

Juxtaposed in this way, it seems credible to interpret the U.K.- U.S. Tax as super-imposing a "derivation" requirement on any claim of treaty benefits under that treaty even though the operative Article of the Treaty may not specifically contain a derivation element. By contrast, the absence of a parallel derivation requirement in the LOB language to the 2006 U.S. Model Treaty (and many other U.S. Tax Treaties24) would seem to support the opposite inference. Any attempt to "read in" a parallel LOB derivation requirement into the 2006 U.S. Model Treaty on a principled basis would need to reckon with the fact that the very same LOB Article specifically invokes a derivation requirement in the "active trade or business" prong of the LOB test,25 suggesting that the Treaty parties decided to use the derivation concept specifically and deliberately in their negotiated language. Ordinary principles of Treaty interpretation would suggest that it's not appropriate to impose a derivation requirement in places where the parties could have, but evidently chose not to, employed explicit language to do so (as they have in several other parts of the Treaty).

Hybrids and LOB qualification

Hybrid Entities may also cause Treaty headaches in scenarios where the LOB provision in question looks at direct and indirect ownership through tiers of shareholders. Consider the following scenario:

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23 Similarly, the comparable language in the 2016 Model U.S. Tax Treaty reads: "Except as otherwise provided in this Article.... a resident of a Contracting State shall not be entitled to the benefits of this Convention otherwise accorded to residents of a Contracting State unless such resident is a "qualified person" as defined in paragraph 2 of this Article at the time when the benefit would be accorded."

24 See, for example, Article XXIXA(1) of the Canada-U.S. Tax Treaty.

25 Article 22(3)(a) of the 2006 Model Tax Treaty provides: "A resident of a Contracting State will be entitled to benefits of the Convention with respect to an item of income derived from the other State....". [emphasis added] For a similar construct of the Active Trade or Business prong of an LOB provision, see Article XXIXA(3) of the Canada-U.S. Tax Treaty.
Diagram 10: LOB and Hybrids

In this example, in order to establish that the U.S. Parent is entitled to a 5% rate of withholding on dividends, the U.S. Parent will need to establish that it satisfies the LOB requirements of Article XXIXA of the Canada-U.S. Tax Treaty. Assuming, for sake of discussion, that U.S Parent is not able to satisfy the Active Trade or Business provision of Article XXIXA(3), its only hope for LOB qualification (short of Competent Authority agreement) may be Article XXIXA(2)(e). In general, this provision applies to a resident corporation (i.e., U.S. Parent) so long as (1) 50% or more of the corporation's stock (by vote and value) is not owned, directly or indirectly, by persons other than qualifying persons, and (2) a base erosion requirement is met. In the current case, it would appear that U.S. Parent has a problem under this provision in that one of its direct or indirect owners (e.g. Ont LP) is not a "qualifying person".26

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26 A similar problem would arise under Article 22(2)(e) of the U.S. Model Tax Treaty which houses a substantially similar provision but specifically requires that a corporation may meet the LOB requirement if certain qualified
From a broader perspective, it seems conceptually inconsistent for the Canadian resident investors of Ont LP to be able to assert treaty benefits in respect of U.S. source dividends paid by U.S. Parent notwithstanding the hybrid entity status of Ont LP (by reason of Article IV(6) and, more generally, the Hybrid Rule) but, at the same time, barring U.S. Parent from claiming treaty benefits in respect of Canadian source dividends received by it because of the hybrid entity status of Ont LP. However, this somewhat asymmetric result seems to be required based on a plain reading of the Treaty.

**Hybrid Entities and Branch Profits Taxes**

The application of treaty branch profits tax (“BPT”) provisions to hybrid entities has proven to be fertile ground for uncertainty and debate about appropriate tax outcomes. We will look at some of these issues below but, before engaging in this discussion it is helpful to briefly review the background and purpose of the BPT rules.

The BPT was introduced into Section 884 of the Code in 1986. Congress enacted the BPT in order to address a perceived asymmetry between the manner in which the U.S. tax system taxes (a) non-U.S. corporations that conduct a business in the United States through a domestic subsidiary, and (b) non-U.S. corporations that conduct the same business in the United States through a U.S. branch. In particular, where the non-U.S. corporations contemplated in (a) would be subject to U.S. taxation at two levels (i.e., once in the form of corporate level income taxes paid by the U.S. corporation and again, in the form of U.S. withholding taxes, when profits were distributed by the U.S. corporation to its shareholders), the non-U.S. corporations contemplated in scenario (b) were only subject to one level of U.S. tax (i.e., corporate level tax on their ECI or business profits attributable to a U.S. PE). The BPT was designed to “achieve greater parity between the remittance of branch profits and the distribution of subsidiary earnings” by imposing a tax that was, roughly speaking, a proxy for the dividend withholding that occurs when U.S. profits are repatriated.

More specifically, the BPT regime creates mechanical rules for determining whether a U.S. branch has effected a repatriation of value to its home office in a way that economically corresponds to a 301 distribution by a corporation (with such repatriated amounts being referred to under Section 884 as a “dividend equivalent amount”). In general a dividend equivalent amount will be deemed to arise when the branch’s (1) current “effectively connected earnings and profits” are not reinvested in the branch, or (2) prior year effectively connected earnings and profits that were reinvested in the branch are subsequently remitted to the home office through a reduction in the branch’s net equity. Section 884(a) imposes a 30% tax on dividend equivalent amounts, which parallels the 30% withholding tax that would have applied to a dividend paid by a U.S. subsidiary. Moreover, like dividends paid by a U.S. corporation, the dividend equivalent amount recognized by a foreign corporation may also be reduced under an applicable U.S. tax treaty.

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Residents of a Contracting State own shares representing at least 50% (by vote and value) of such corporation, "provided, that, in the case of indirect ownership, each intermediate owner is a resident of that Contracting State."

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The following language, taken from Article X(6) of the Canada-U.S. tax treaty, is an example of how U.S. tax treaties address the BPT:

Nothing in this Convention shall be construed as preventing a Contracting State from imposing a tax on the earnings of a company attributable to permanent establishments in that State, in addition to the tax which would be chargeable on the earnings of a company which is a resident of that State, provided that any additional tax so imposed shall not exceed 5 per cent of the amount of such earnings which have not been subjected to such additional tax in previous taxation years.

The core questions addressed below is whether (and how) the presence of hybrid entities affects the ability of treaty residents to claim the benefit of a treaty provision such as this one.

**Domestic Hybrids and BPT**

As noted above, the intersection of BPT policy and hybrid entity policy in the context of U.S. tax treaties has produced interesting debates. Consider the following (not uncommon) scenario in which non-U.S. investors engaged in a U.S. trade or business through an LLC.

*Diagram 11: Inbound investment through an LLC*

As discussed above, neither Canco nor U.K. individual derive the business profits earned by LLC since, under both U.K. and Canadian law, the LLC is treated as fiscally opaque. As a consequence, neither Canco nor U.K. individual may assert the benefits of their respective treaties to lower the rate of U.S. withholding tax on that FDAP. Similarly, in the discussion in connection with Diagram 6 above, it was argued that non-U.S. persons in the position of Canco and U.K. individual above should not be able claim the benefits of Article 5 of their respective treaties with respect to the business profits earned through LLC.
Consistency and parity would seem to require a parallel result with respect to BPT. At this juncture, however, it's instructive to recognize there's a low-lying conceptual discontinuity between the BPT and the "derived by" test that cannot be easily reconciled. In particular, the BPT works by imposing a tax on what is in many respects a notional amount – the dividend equivalent amount. While the dividend equivalent amount is tethered to economic reality in the sense that it tracks capital flows from the U.S. branch to the foreign home office, these flows may be imperceptible from a foreign tax perspective and incapable of being "derived" by the foreign taxpayer. In such a case, there would be no possibility of the foreign taxpayer to satisfy the "derived by" test. So, while parity and consistency are intellectually appealing, it also seems equally dissatisfying to go through the charade of applying a hybrid entity rule that, by its very nature, is incapable of being satisfied.

The dissonance underlying the reasoning described above has led some commentators to question whether taxpayers in the position of Canco and U.K. individual should be barred from claiming treaty benefits in respect of the BPT in scenarios like the one illustrated above. Specifically, these commentators address the impasse by going back to the basic policy considerations underpinning the BPT. Particularly, if the purpose of the BPT is to minimize the tax disparity to a foreign investor between conducting a U.S. business through a U.S. subsidiary, on the one hand, and conducting that same business through a U.S. branch, the job of the BPT may be viewed as ensuring (as close as possible) that repatriations of branch earnings are subject to the same U.S. tax treatment as repatriations of earnings from a U.S. subsidiary. Viewed in this light, and given the notional nature of the BPT rule to begin with, one may rationally argue that it's not appropriate to follow a strict and literal application of the Hybrid Entity rule with the result that, if Canco and U.K. individual would have been eligible for reduced treaty rates had they received dividends directly from a U.S. subsidiary, they should similarly be able to assert the benefits of the BPT treaty rate with respect to repatriations they receive from their U.S. branch. In other words, the presence of a hybrid entity (which admittedly gives rise to "derived by" issues with respect to real items of income like FDAPI or business profits) should not result in a disallowance of treaty benefits because it pre-emptson derivation of a "notional" income item that neither X nor Y could have derived in any circumstance.

The weighing of these competing considerations is indicative of how difficult it can be to apply the Hybrid Provision with high confidence in practice. Specifically, the theatre in which these rules operate is challenging by its nature since it will frequently implicate scenarios where there may be more than one cross-border asymmetry in play (for example, one jurisdiction may see an income item where the other does not) and the literal invocation of the Hybrid Rule may be too blunt. For example, this example illustrates that the "derived by" concept, which is the conceptual anchor of the Hybrid Rule, is predicated on there being a "real" item of income that is recognized by all jurisdictions involved. Once that premise is disturbed (for example in the context of deemed items of income like a dividend equivalent amount or transfer pricing adjustment), the derived by concept quickly becomes an unreliable normative tool since it is not capable of being applied. The practitioner in a scenario like this is left with little guidance on how (or whether) to apply the Hybrid Provision.

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As a practical matter, however, it seems there is a healthy constituency of advisors who take the position that X and Y should be able to claim the benefit of treaty provisions reducing the BPT in scenarios such as those depicted in Diagram 11.

**Foreign Hybrids and BPT**

As discussed above (see Part [z]), this author believes that a Foreign Hybrid in the scenario described below should be entitled to assert treaty benefits of Article V (Permanent Establishment) in respect of its U.S. ECI, assuming it satisfies the applicable LOB requirements of its treaty. Consider, the following scenario:

*Diagram 12: U.S. business conducted by Foreign Hybrid*

Assuming that ULC meets the LOB requirements of Article XXIXA of the Canada-U.S. tax treaty, ULC should be able, as a qualified resident of Canada, to assert the benefits of that treaty. Assuming that ULC has business profits attributable to its U.S. PE, the next question is whether (and in what form) ULC is able to assert the benefits of Article X(6) which reduces the BPT to 5% in certain circumstances.

Since neither Canco, A nor B are treated as deriving the business profits (or dividend equivalent amount) in question under Article IV(6) of the Canadian treaty, it seems relatively clear that the only person entitled to assert Article X(6) benefits is ULC. However, since Canco, A and B are the relevant taxpayers from a domestic U.S. tax law perspective and the persons required to file U.S. tax returns to report the underlying income items, it appears they are necessarily implicated in the treaty claim. Accordingly, in this scenario, it would be reasonable for each of Canco, A and B to file U.S. tax returns which report the income and to also file an IRS Form 8833 asserting, derivatively through ULC, the benefits of Article X(6) to reduce the BPT on their allocable share of ULC’s dividend equivalent amount from 30% to 5%.

The fact that A and B, as individuals, are not within the class of persons subject to BPT to begin with is neither here nor there because A and B are effectively acting as a mere a reporting agent.
for the "true" taxpayer in this scenario, ULC. A contrary position would offend basic notions of treaty consistency because, once ULC "appears" for U.S. tax purposes as a qualified resident of Canada that asserts Treaty benefits (for example, the benefits of Article V or VII), it would be inconsistent to say that ULC should effectively "disappear" (i.e., we should apply domestic law principles to treat ULC as a flow-through entity and arrive at the conclusion that Section 884 BPT is not applicable to A and B since they are individuals) for purposes of the BPT.

As a result, it would appear that, to avoid whipsaw scenarios, there should be consistency as to the characterization of ULC in this scenario. If ULC invokes its qualified resident status to assert the benefits of the Canadian tax treaty, it ought not to be open to A or B to instead apply domestic U.S. tax law principles to treat ULC as a flow-through and thereby assert that 884 should not apply to X in the first instance given X's status as an individual. However, despite the obvious merits of the treaty consistency principle in general, it may prove difficult to enforce consistency in a scenario like this where there are multiple potential taxpayers and multiple treaties in play.

**Foreign Reverse Hybrids and BPT**

As noted above, the use of foreign reverse hybrids is not uncommon, particular in the context of structuring investment fund investments for non-U.S. investors in U.S. operating business conducted in flow through form. Consider the scenario described below.

**Diagram 13: U.S. Business conducted through Foreign Reverse Hybrid**

As mentioned above, this arrangement has the salutary benefit of blocking U.S. ECI while, at the same time, allowing treaty resident owners to claim reduced rates of U.S. withholding on U.S. source FDAPF under their applicable tax treaties. Further, as discussed in Part [Y] above, this author believes that Ont LP should be able to assert, on behalf of its treaty resident owners, the benefits of Article V under the relevant treaties and should be the entity that is required to file a U.S. tax return and IRS Form 8833.
Based on these positions, and the considerations of consistency and parity referred to above, it would seem relatively straightforward that Ont LP should similarly be entitled to claim the benefits of any treaty reduction of BPT tax on behalf of its treaty resident owners. At this juncture, however, another conceptual incongruity asserts itself. In particular, if Ont LP is viewed as asserting treaty benefits on behalf of its owners, it's not clear how far that "on behalf of" methodology should be carried. In particular, since X is a U.K. resident individual and, as an individual, would not be subject to BPT in the first place if Ont LP had been viewed as fiscally transparent by the U.S., should Ont LP be viewed as asserting an exemption from BPT on the theory that is just "passing through" the same claim that X could have made but for the opaque treatment of Ont LP under domestic U.S. tax law. Or, alternatively, do consistency principles take hold such that, as soon as the parties opt to treat Ont LP as a corporation and enjoy the benefits that come with that (e.g., no return filing obligations, lower tax rates on ECI), they are compelled to accept the collateral consequences of that choice in the form of a branch profits tax (and if so, does consistency require a 30% rate or a 5% rate)? Underlying all this uncertainty is the inconvenient fact that the "dividend equivalent amount" is likely not cognizable under U.K. law and, therefore, incapable of being derived by X makes it more difficult to get principled traction on this question.

The starting point for addressing this problem is to recognize that there is no clearly right answer and that just about any position taken has some conceptual vulnerability to it. As a result of this (and the lack of IRS guidance on point), there are a number of positions being taken on this issue in practice. In lieu of fully principled analysis, many practitioners appear to address this scenario by looking for a position that fairly balances the domestic and treaty-based perspectives. In this vein, having relied on treating the FRH as the taxpayer for purposes of determining the tax rate applicable to the ECI, it may be seen as pushing the Hybrid Provision construct too far to, at the same time, disavow the corporate status of the very taxpayer that is being permitted to claim those benefits on the grounds that it is just making that claim on behalf of its individual owner (X). Taxpayers that follow this analytical path would likely assert that Ontario LP in Diagram 13 is entitled to the treaty rate of 5% on branch profits. Other advisors see no offensive inconsistency with determining tax liability on ECI under the domestic law construct and applying the treaty Hybrid Provision construct to assert that Ontario LP is not subject to BPT on the portion of its earnings attributable to X in Diagram 13.

While respecting the merit to both positions described above and recognizing that the strengths and weakness of any such position in any given situation may be swayed by the specific words used by the treaty in question, this author believes that consistency principles should temper the application of the Hybrid Provision and that in a scenario like Diagram 13, the better view is that if Ontario LP pays tax on its ECI at corporate income tax rates (rather than X paying tax on its allocable share of the ECI at individual rates), then Ontario LP should correspondingly be subject to BPT at a rate of 5% on its dividend equivalent amount allocable to X.

**Conclusion**

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29 See NYSBA Hybrid Report at pg 37 (Discussion of at least 3 alternative approaches that could be applied to determine the branch profits tax treatment applicable to a scenario comparable to that illustrated in Diagram 13).
While the unrestrained use of hybrid entities has imposed significant and systemic challenges on taxing jurisdictions trying to protect their own tax bases, recent strides forward are closing the sophistication gap between taxpayers and taxing authorities. This is an interesting juncture in that, many of the long-standing, cross-border tax planning "norms" (including those related to hybridity in all its forms) are changing as OECD BEPS inspired initiatives ripple their way around the world. But while the predominant focus of these initiatives has been to "clamp-down" on some of the most problematic uses of hybridity, the IRS (and other taxing jurisdictions) would do well to address some of the lower-lying normative inconsistencies that remain embedded in our domestic and treaty-based systems. More particularly, until we have upgraded our hybrid entity rules to the point there is parity between the treatment of both FDAP and business income that are earned through hybrid entities, the problems highlighted in this paper will continue to fester. Over time, allowing uncertainty to persist on such basic and fundamental issues is not likely to play out well for the tax bases of countries that allow it and may risk compromising some of the hard-fought gains that they have recently made in this area.