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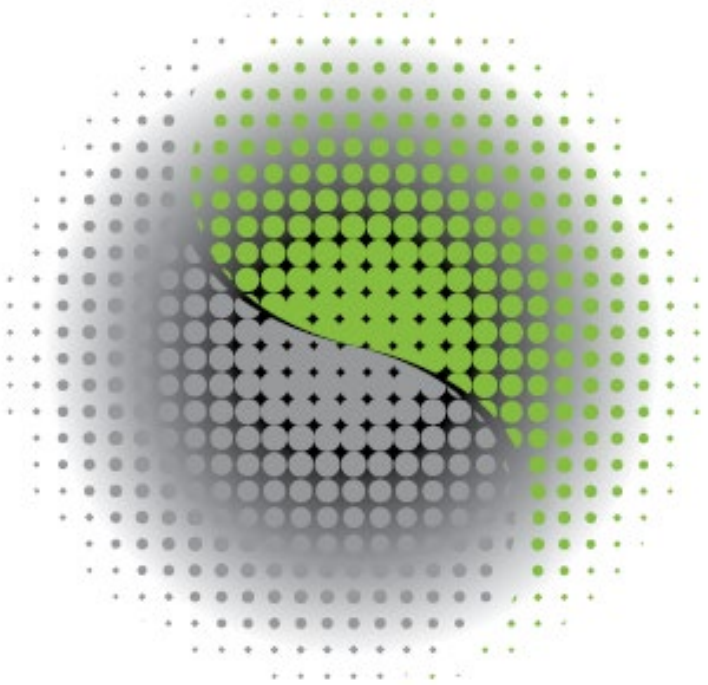

Canadian Tax Alert

New final and proposed U.S. regulations – impact on Canadian businesses

April 16, 2020

On April 7, 2020, the Treasury Department released final regulations (TD 9896) addressing section 267A of the Internal Revenue Code (IRC). Section 267A is intended to address situations where a U.S. taxpayer obtains a deduction for an interest or royalty payment, generally to a related party, without a corresponding income inclusion in the foreign jurisdiction with respect to that payment, thereby resulting in a deduction/no inclusion (D/NI) outcome.

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The Treasury Department also issued new proposed regulations (REG-106013-19) on the same day that include, amongst other items, an expansion of the IRC section 881 anti-conduit rules to address certain financial instruments treated as equity for U.S. tax purposes but debt for foreign tax law purposes.

Section 267A and the associated regulations may impact many Canadian businesses with U.S. operations. Given the need for capital that many businesses are currently experiencing, it is important for them to understand how section 267A - as well as other interrelated rules such as the thin capitalization rules of IRC section 163(j) and the base erosion and anti-abuse tax (the BEAT) contained in IRC section 59A - can have adverse implications.

In order to assist readers to understand the new rules, we have set out below a series of questions and answers, based on questions that we have received and questions that we anticipate receiving from clients. Given the complexity of the rules and the unique facts and circumstances of each business, we recommend that these be discussed with a U.S. tax advisor.

Questions and answers:

1. **Question:** Did the final regulations delay the effective date of the hybrid mismatch provisions?

   Answer: No – the final regulations adopt the effective date of the proposed regulations with respect to these provisions. Accordingly, these rules generally apply to taxable years ending on or after December 20, 2018, provided that such tax year began after December 31, 2017. Certain provisions, consistent with the proposed regulations, such as the imported mismatch rules and branch mismatch rules, apply to taxable years beginning on or after December 20, 2018. There is a delayed effective date for certain structured arrangements in place before the end of 2017; such rules would apply starting in 2021.

2. **Question:** Is any of the interest accrued in 2019 under an arrangement caught by the hybrid mismatch provisions deductible for a calendar year taxpayer?

   Answer: No – if the deduction for interest is disallowed under the hybrid mismatch provisions, any interest accrued under that arrangement in 2019 is also disallowed.

   For fiscal year taxpayers, a portion may be deductible to the extent the denial is related to an imported mismatch or branch mismatch. For example, this may mean that for some fiscal year taxpayers that have financed their U.S. operations through a foreign jurisdiction that provides a notional deduction to offset interest income received, a portion may remain deductible.

3. **Question:** Do the final regulations permit otherwise disallowed interest to nevertheless be capitalized into fixed assets or inventory?

   Answer: No – the final regulations coordinate section 267A and the capitalization provisions such that a disallowed payment under section 267A is not taken into account for purposes of any capitalization provision.

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4. **Question:** Does section 267A apply before the section 163(j) limitation rules?

   Answer: Yes - The final regulations provide a clarification that section 267A applies before the application of section 163(j). Accordingly, disallowed interest can be removed from the section 163(j) interest limitation calculation.

5. **Question:** Do the final section 267A regulations change the application of the section 59A BEAT?

   Answer: No – the final section 267A regulations do not have a direct effect on how the BEAT rules must be applied.

6. **Question:** May a payment for which a deduction is disallowed under section 267A be disregarded for purposes of the BEAT even if that payment otherwise would have been considered a "base eroding payment"?

   Answer: Yes – if the deduction for a payment is disallowed, it is no longer a base eroding payment for purposes of the BEAT. Taxpayers that were subject to BEAT due to related party interest payments may need to reevaluate their 2019 BEAT calculations and income tax provisions.

7. **Question:** Amounts accrued in prior periods –

   a. My company accrued a payment to a related party in a year prior to the effective date of section 267A and its regulations, and no deduction was available at that time for U.S. tax purposes, as the amount was accrued, but not paid. If the cash payment is made this year, may this payment be considered a specified payment under the final section 267A regulations?

   b. My company expects to claim a deduction for previously accrued interest deferred under section 163(j). Do the final section 267A regulations disallow a deduction for this interest?

   Answer: No – in both instances, a deduction is still available for interest or other amounts that were accrued in a year when section 267A or the regulations thereunder would not disallow a deduction for that interest or other amount.

   Payments made or accrued in a taxable year beginning prior to January 1, 2018 are not subject to disallowance under section 267A. Deductions for payments made or accrued in a taxable year beginning prior to December 20, 2018 are not disallowed even if a deduction would be disallowed under the final section 267A regulations. (For example, a payment of interest made under an imported mismatch arrangement is not treated as a hybrid deduction and disallowed, if such interest accrued in an accounting period that began prior to December 20, 2018.)

8. **Question:** If a payment is subject to a withholding tax, is it still be considered a D/NI payment?

   Answer: Yes – the application of a withholding tax does not prevent a payment from being characterized as a D/NI payment.

9. **Question:** My company expects a deduction for previously accrued interest deferred under section 163(j). Do the final section 267A regulations disallow a deduction for this interest?

Answer: No – a deduction is still available for interest that was accrued in a taxable year beginning prior to January 1, 2018 even if such interest, had it been accrued in 2020 or later, would have been disallowed under section 267A.

10. **Question:** Do the deferred payment rules of the final section 267A regulations require my company to revisit payments after 36 months to determine whether they were included in the foreign recipient's income?

    Answer: No – the final regulations permit a deduction as long as there is a reasonable expectation at the time of the payment that the amount would be included in the foreign recipient's income within the 36-month period.

11. **Question:** Are there still opportunities to efficiently finance operations in the United States after these regulations?

    Answer: Yes –it is still possible for a Canadian company to provide efficient financing to its U.S. subsidiaries or operations.

12. **Question:** Do the updates to the anti-conduit rules apply to pre-existing arrangements that include equity instruments?

    Answer: Yes – however, the updates to the anti-conduit rules are not retroactive and are not effective until those regulations are finalized.

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