Section 267A New Final Anti-Hybrid Regulations

THURSDAY, AUGUST 13, 2020, 1:00-2:50 pm Eastern

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Section 267A New Final Anti-Hybrid Regulations

August 13, 2020

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ANTI-HYBRID PROVISIONS OF §267A

August 13, 2020

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ANTI-HYBRID PROVISIONS OF §267A

I. Background and Overview

II. Introduction to the Anti-Hybrid Rules

III. Hybrid and Branch Transactions

IV. Imported Mismatch Amounts

V. Rules for Implementation

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ANTI-HYBRID PROVISIONS OF §267A

BACKGROUND AND OVERVIEW

BACKGROUND AND OVERVIEW

- Focus globally on cross border tax and the potential to shift profits between countries to avoid tax
- OECD BEPS (Base Erosion and Profit Shifting) – Identified hybrids as a priority
  - "Hybrid mismatch arrangements can be used to achieve double non-taxation including long-term tax deferral. They reduce the collective tax base of countries around the world even if it may sometimes be difficult to determine which individual country has lost tax revenue" – OECD BEPS Action 2

BACKGROUND AND OVERVIEW

- BEPS Action Plan – Action 2 “Neutralising the effects of hybrid mismatch arrangements”
  - Deduction / no inclusion (D/NI) – deductible payment for payor but not included in income of the payee
  - Double deduction (DD) – a single payment triggers two deductions and is therefore double counted
  - Indirect deduction / no inclusion (indirect D/NI)- income is offset by a deduction at the intermediary payee level and not includible in income at the ultimate payee level

BACKGROUND AND OVERVIEW

- BEPS Action 2 - "Neutralising the Effects of Branch Mismatch Arrangements"
  - Similar issues (to hybrids) can arise through the use of a branch where the residence jurisdiction and branch jurisdiction allocate income and expense differently
- In the EU - ATAD 1 and ATAD 2 – anti-tax avoidance directives implemented by the EU to combat hybrid mismatches among other issues.
- Preamble to the 267A proposed regulations – discusses the OECD reports when discussing the purpose and policy goals of the underlying code and regulations.

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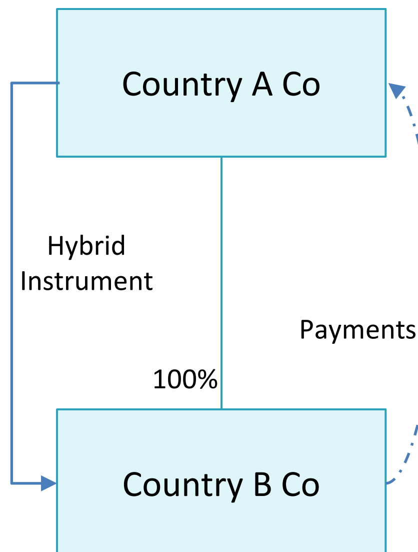
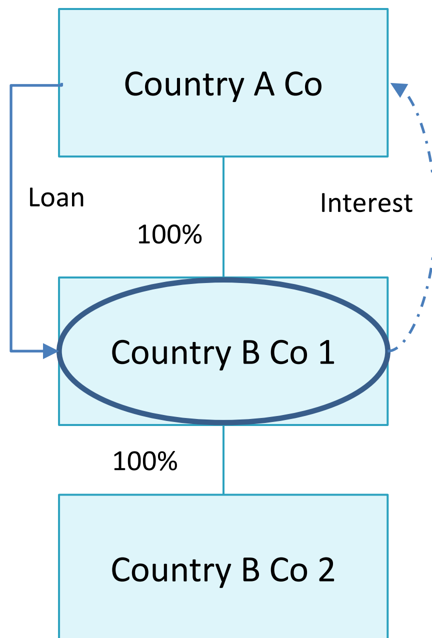
EXAMPLE - DEDUCTION / NO INCLUSION (D/NI) – HYBRID INSTRUMENT



Example from OECD report: Neutralising the effects of hybrid mismatch arrangements

- Targeting: deductible payment for payor but not included in income of the payee
- Country A Co finances subsidiary Country B Co in part with a hybrid financial instrument (ex PEC).
- Country B Co views the instrument as debt. When country B Co makes a payment on the debt then Country B Co takes an interest deduction.
- Country A Co does not recognize income when the payments are made because they do not recognize the payment as a payment of interest.
  - Could also be in the form of an exemption, exclusion, or indirect tax credit.
- Issue/result – the tax base in Country B can be stripped down without recognizing income in any jurisdiction

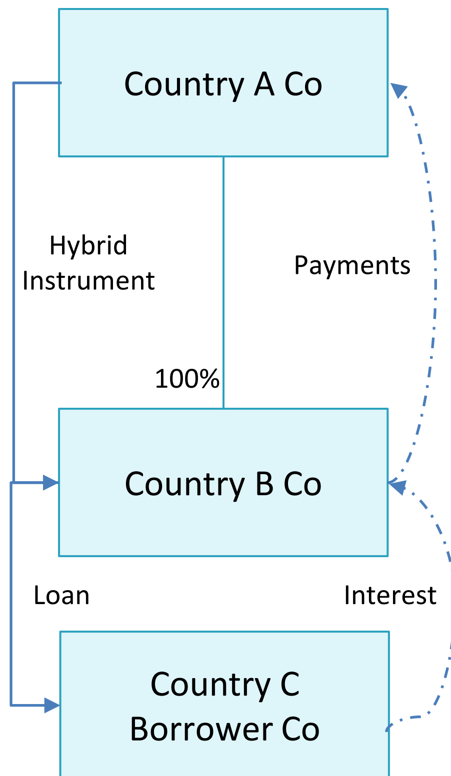
EXAMPLE - DEDUCTION / NO INCLUSION (D/NI) – HYBRID ENTITY



Example from OECD report: Neutralising the effects of hybrid mismatch arrangements

- Country A Co finances subsidiary Country B Co 1 in part with debt.
- Country B Co 1 is a hybrid entity treated as transparent (disregarded) in Country A and as a corporation in Country B.
- When Country B Co 1 pays interest on the loan there is a deduction in Country B but and no income inclusion in Country A (transactions between Country A Co and Country B Co 1 are disregarded).
- Country A Co includes all of the income earned by Country B Co 1 – so on its own this would not be an issue.
- In Country B – Country B Co 1 and Country B Co 2 file a consolidated return.
- The interest that Country B Co 1 pays to Country A Co can reduce the tax base/income of Country B Co 2 without the income of Country B Co 2 being included in Country A.

EXAMPLE - INDIRECT DEDUCTION / NO INCLUSION (INDIRECT D/NI)



Example from OECD report: Neutralising the effects of hybrid mismatch arrangements

<u>Imported Mismatch</u>

- Targeting: income is offset by a deduction at the intermediary payee level and not includible in income at the ultimate payee level
- Country A Co finances subsidiary Country B Co in part with a hybrid financial instrument (ex PEC).
- Country B Co loans proceeds to an unrelated borrower in Country C.
- Country C Borrower Co pays interest on the loan. Country B Co recognizes income on the payment. Country B Co also takes a deduction for the payment it makes to Country A Co.
- Country A Co recognizes no income. In Country B – the transactions are tax and revenue neutral (income and corresponding deduction). In Country C – there is an interest deduction.

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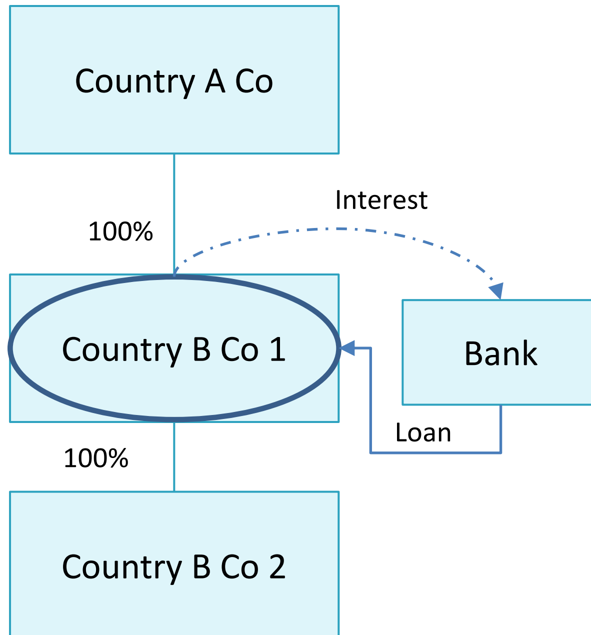
EXAMPLE – DOUBLE DEDUCTION (DD)



Example from OECD report: Neutralising the effects of hybrid mismatch arrangements

- Country B Co 1 obtains a loan from a local bank to finance the operations of its subsidiary Country B Co 2.
- Country B Co 1 is a hybrid entity treated as transparent (disregarded) in Country A and as a corporation in Country B.
- In Country B – Country B Co 1 and Country B Co 2 file a consolidated return.
- The interest that Country B Co 1 pays to the bank can reduce the tax base/income of Country B Co 2. Country A Co also takes a deduction for the interest without including the income of Country B Co 2.
- Issue/result – the group receives two separate deductions for each payment of interest.

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ANTI-HYBRID PROVISIONS OF §267A

INTRODUCTION TO THE ANTI-HYBRID RULES

INTRODUCTION TO THE ANTI-HYBRID RULES

- The anti-hybrid provisions deny deductions for disqualified related party amounts paid or accrued pursuant to a
  - (1) hybrid transaction or to a
  - (2) hybrid entity
- Disqualified related party amount – interest or royalty payments to a related party if:
  - There is no income inclusion in the related party's country of tax residence (D/NI)
  - The related party is allowed a deduction for the payment in its country of tax residence (DD)
  - Exception – if the income is included in the income of a U.S. shareholder under §951(a) – Subpart F

INTRODUCTION TO THE ANTI-HYBRID RULES

- Regulations expand on the code to clarify that the amounts that are disallowed include and are limited to interest or royalty deductions on payments from a specified party to the extent that the payments are a:
  - Hybrid or Branch Arrangement
  - Imported Mismatch
  - Anti-avoidance rule payment
- De minimis exception – applies to the extent that all payments described above or less than $50,000 for the year.
  - For purpose of the exception specified parties that are related are treated as a single specified party
  - Related – uses the control test (controls or is controlled by) in §954(d)(3) with specified party replacing CFC

KEY TERMS AND DEFINITIONS

- Specified party –
  - Tax resident of the U.S.
  - CFC with a U.S. shareholder that owns 10% or more under directly or indirectly §958(a)
  - A U.S. taxable branch.
- Specified payment – payment or accrual of interest or royalty by a specified party
- Specified recipient – a taxable person who is the recipient of a specified payment under their jurisdiction or any taxable branch to which a payment is attributable to under its tax law.

KEY TERMS AND DEFINITIONS

- Related party – any person that controls or is controlled by the payor and any person hat is controlled by the same person or persons that control the payor.
  - Control – more than 50% of stock of a corporation by vote or value or more than 50% of the beneficial interests in a partnership, trust, or estate.
  - Related party rules reference §954(d)(3)
- Hybrid transaction – a transaction, instrument, or agreement where
  - Payments are treated as interest or royalties for U.S. tax purposes and
  - Payments are not treated as interest or royalties under the tax law of the recipient's country of residence (ex – distribution or recovery of principal).
- Hybrid entity – an entity that is:
  - Transparent for U.S. tax purposes (partnership, DRE) but not for purposes of the other country
  - Transparent for purposes of the other country but not for U.S. tax purposes (reverse hybrid)

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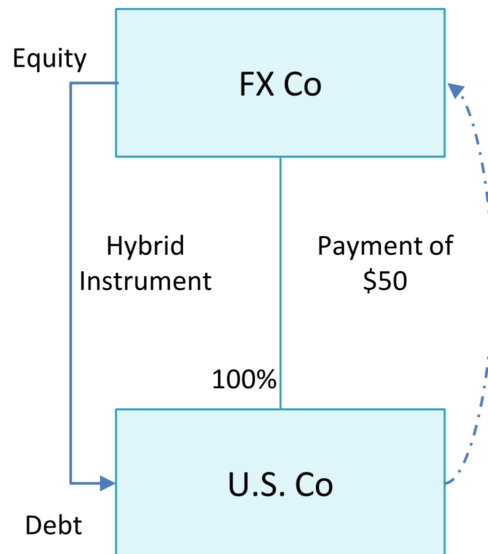
ANTI-HYBRID PROVISIONS OF §267A

HYBRID AND BRANCH ARRANGEMENTS

HYBRID TRANSACTIONS

- Disqualified hybrid amounts - Specified payments made pursuant to hybrid transactions are (non-deductible) to the extent –
  - A specified recipient does not include the payment in income
  - Non-inclusion is the result of the payment being made pursuant to a hybrid transaction.
- Hybrid Transactions –
  - Any transaction or series of transactions where at least one payment is treated as interest or royalties for U.S. tax purposes but not are not under the tax law of a specified recipient's country of residence.
  - Transactions with long-term deferral – where a specified recipient takes a payment into account under local tax law more than 36 months after the end of the year where the specified party would be allowed a deduction under U.S. tax law

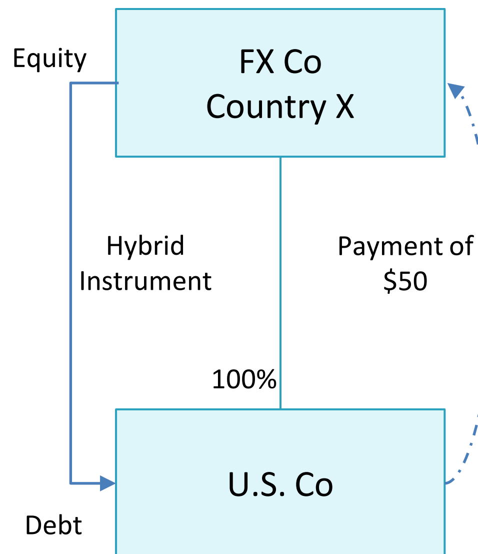
EXAMPLE 1 – HYBRID FINANCIAL INSTRUMENT



Example §1.267A-6(c)(1)

- FX Co is corporate entity established in Country X that owns 100% of a U.S. corporation U.S. Co.
- FX Co has financed U.S. Co in part with a hybrid instrument that is treated as debt for U.S. tax and equity for Country X purposes.
- A payment of $50 is made on the hybrid instrument. The payment is treated as an excludible dividend (because of a participation exemption) in Country X and as interest in the U.S.
- U.S. Co is a specified party
- U.S. Co's payment of $50 is made pursuant to a hybrid transaction because it is treated as interest for U.S. purposes but not for Country X purposes

EXAMPLE 1 – HYBRID FINANCIAL INSTRUMENT



Example §1.267A-6(c)(1)

- U.S. Co's payment to FX Co is a disqualified hybrid amount because there is no inclusion in Country X as a result of the participation exemption.
  - (D/NI) is required for a disqualified hybrid amount. If a dividend were includible then we would not have a disqualified hybrid amount.
- The deduction on the entire $50 payment is disallowed because the entire amount is a disqualified hybrid amount.
- Reporting –
  - Book to tax adjustment on Form 1120
  - Form 5472

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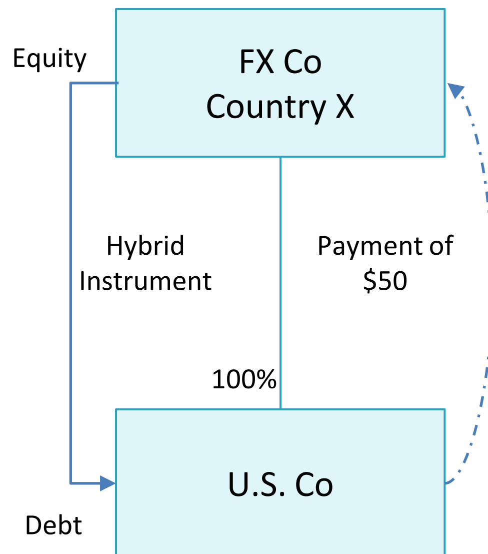
EXAMPLE 2 – HYBRID FINANCIAL INSTRUMENT



Example §1.267A-6(c)(1)

- Same facts as Example 1 except that Country X has a territorial tax regime (it only taxes domestic sourced income).
- If instrument were not a hybrid instrument and Country X treated the payment of $50 as interest then FX Co would still not include the income (because it is extraterritorial).
- Result – the non-inclusion is not the result of the payment being made pursuant to a hybrid transaction.
- The payment is therefore not a disqualified hybrid amount and the deduction of the payment is not limited under §267A.

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HYBRID TRANSACTIONS

- Interest free loans – are hybrid transaction where interest is imputed in the U.S. but not in the jurisdiction of the recipient
  - In the U.S. we could have imputed interest under §482 or §7872 (ex below market loan).
- Exceptions – will not cause the payment to be treated as a hybrid transaction
  - Tax residence of a specified recipient does not impose an income tax under local law
  - Royalties / licenses that are that are treated as an exchange of property under foreign law are not hybrid transactions.

HYBRID TRANSACTIONS

- A specified recipient includes a payment in income –
  - To the extent that the specified recipient includes the payment in its tax base at the full marginal rate imposed on interest or royalties as applicable and
  - The payment is not reduced or offset by an exemption, exclusion, or any other similar relief.
    - Examples highlighted include participation exemptions, dividends received deductions, patent box regimes (for royalties), indirect tax credits (withholding credits are ok but indirect credits are considered offsets).
    - An offset does not include a generally applicable deduction (depreciation, net operating losses).

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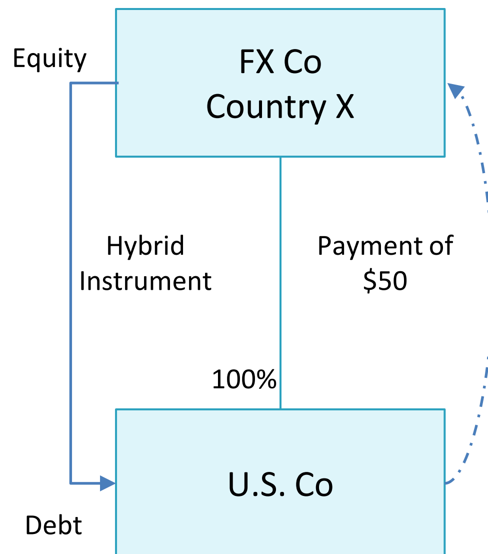
EXAMPLE 3 – HYBRID FINANCIAL INSTRUMENT



Example §1.267A-6(c)(1)

- Same facts as Example 1 except that Country X has a preferential 4% rate on dividends compared to the ordinary rate (that applies to interest) of 20%.
- FX Co is deemed to include $10 of the payment in income for these purposes.
  - $50(payment) * [4% (preferential rate) / 20% (standard rate)]
- $40 is deemed to be a disqualified hybrid amount because that is the amount that is considered not included in income and the non-inclusion is the result of the payment being made pursuant to a hybrid transaction.

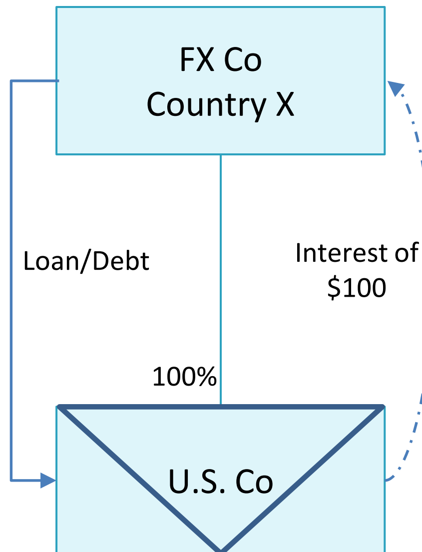
DISREGARDED PAYMENTS

- Rule: The excess of a specified party's disregarded payment over dual inclusion income is a disqualified hybrid amount.
- Disregarded Payment: Specified payment where the payment is not regarded under the tax law of the recipient and were the payment regarded it would be includible in income.
  - Situations where there is a single taxpayer or members of a group under local tax law.
  - Payments where consolidation rules and similar regimes that allow for a deduction or other offset under a consolidation, fiscal unity, group relief, or any similar regime.
- U.S. taxable branch – specified payments made by a branch are not disregarded payments if the payment is taken into account under the local tax law of the payee.

DISREGARDED PAYMENTS

- Dual inclusion income – excess of
  - Specified party's items of income or gain over
  - Specified party's items of deduction or loss
  - To the extent they are includible / allowable in the jurisdiction of the tax resident or to the taxable branch to which disregarded payments are made.
- Indirect payments - Payments made to an entity that is owned directly or indirectly by a tax resident or taxable branch are considered made to that tax resident or taxable branch to the extent they are included in income under local law because the entity to whom the payment is made is fiscally transparent.

EXAMPLE 1 – DISREGARDED PAYMENT



Other U.S. Co income = $65 = $125 of gross income and $60 of deductible expense

Example from §1.267A-6(c)(3)

- FX Co is corporate entity established in Country X that owns 100% of a U.S. corporation U.S. Co.
- U.S. Co is treated as fiscally transparent by Country X and is disregarded from FX Co for Country X purposes.
- U.S. Co makes a payment of $100 that is treated as interest for U.S. tax purposes but is disregarded for Country X purposes (because there is a single taxpayer).
- U.S. Co's other income totals $65 including $125 of gross income and a $60 expense. Both the income and expense are included in FX Co's income in Country X.

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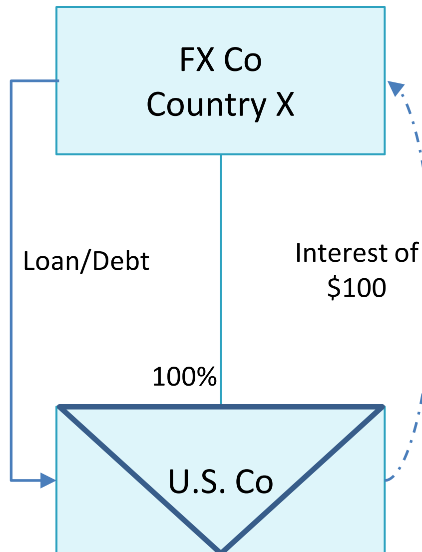
EXAMPLE 1 – DISREGARDED PAYMENT



Other U.S. Co income = $65 = $125 of gross income and $60 of deductible expense

Example from §1.267A-6(c)(3)

- U.S. Co is a specified party.
- The payment of $100 is a disregarded payment:
    - U.S. Co's payment of $100 is not regarded in Country X because there is a single taxpayer for Country X purposes.
    - Were the payment regarded in Country X then FX Co would have to include it in income.
- $35 is a disqualified hybrid amount (non-deductible).
    - The excess of a disregarded payment over dual inclusion income is a disqualified hybrid amount.
    - The $65 of other net income at U.S. Co is dual inclusion income.

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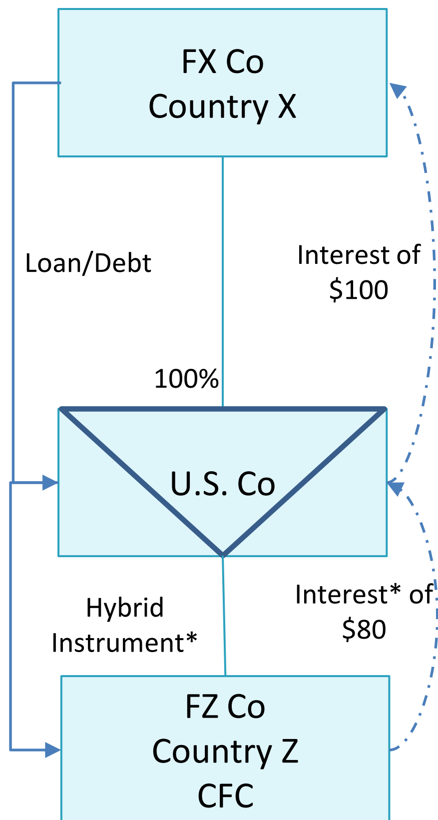
EXAMPLE 2 – DISREGARDED PAYMENT



Example from §1.267A-6(c)(3)

- Facts are the same as our previous example except that U.S. Co owns 100% of FZ Co (a CFC) and U.S. Co's only income is $80 paid from FZ Co.
- The $80 is treated as interest by the U.S. and by Country Z. The $80 is treated as a payment on equity by Country X.
- In Country X the $80 is treated as an excludible dividend (participation exemption).
- Even though U.S. Co has $80 of other income no portion of the $80 is treated as dual inclusion income because of the participation exemption in Country X.
- The entire $100 payment from U.S. Co to FX Co is treated as a disqualified hybrid amount.

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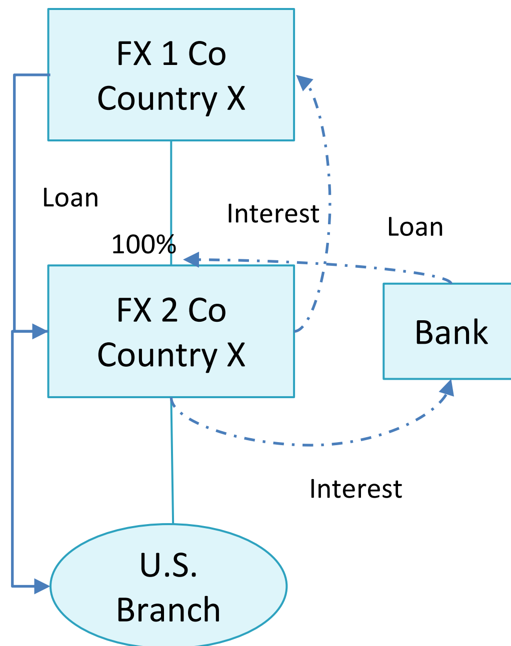
EXAMPLE 3 – DISREGARDED PAYMENT / BRANCH PAYMENT



Example from §1.267A-6(c)(4)

Hybrid Instrument*

- FX 1 Co and FX 2 Co are Country X corporations that file a consolidated return in Country X. FX Co 2 is funded in part with a loan. FX Co 1 and FX Co 2 file a consolidated return in Country X.
- FX 2 Co has a taxable U.S. branch.
- FX Co 2 makes a payment of $50 to FX1 on the loan from FX 1. The payment is disregarded in Country X because FX Co 1 and FX Co 2 file a consolidated return
- FX Co 2 pays $100 of interest to an unrelated bank.
- FX Co 2's other income is $200 that is attributable to the U.S. Branch. Country X's tax law exempts income attributable to the branch.
- The entire $200 is ECI for U.S. tax purposes and $75 of interest is allocable to ECI.

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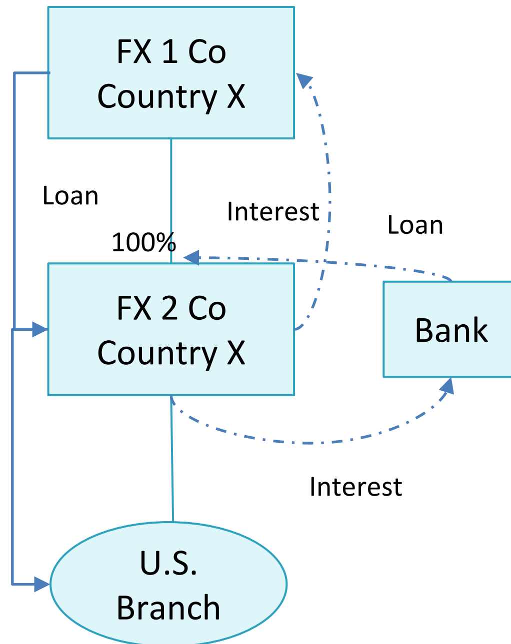
EXAMPLE 3 – DISREGARDED PAYMENT / BRANCH PAYMENT



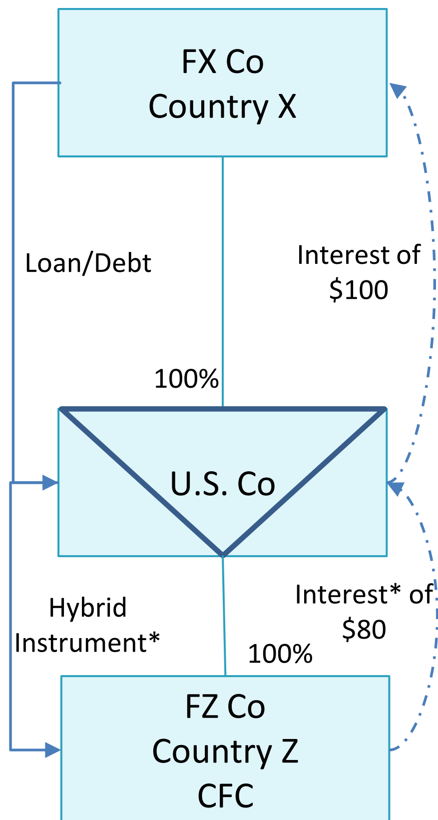
Example from §1.267A-6(c)(4)

- Recap of the rule: specified payments made by a branch are not disregarded payments if the payment is taken into account under the local tax law of the payee.
- The $75 allocable to ECI is a specified payment. $25 of that payment is treated as paid to FX 1 Co.
  - $50 (payment to FX 1 Co)/ $150 (total interest) = 1/3 * $75 = $25.
  - The $25 payment to FX 1 Co. is not taken into account under local law (because of the consolidated return).
- The $25 is a specified payment treated as a disqualified hybrid amount.
  - Dual inclusion income is $0 because Country X exempts income from the U.S. branch.

DISREGARDED PAYMENTS - DIVIDENDS

- Dividends – are still considered dual inclusion income if:
  - They are not included in the income of the person to whom disregarded payments are made because of a participation exemption, credit, or some other similar relief if (1) they are included in a specified party's income and (2) they are not deductible and no other benefit in the payor's jurisdiction.
  - They are not included in the specified party's income because of a dividends received deduction (§245A) if (1) they are included in the income of the person to whom disregarded payments are made and (2) they are not deductible and no other benefit in the payor's jurisdiction.

EXAMPLE 4 – DISREGARDED PAYMENT - DIVIDEND



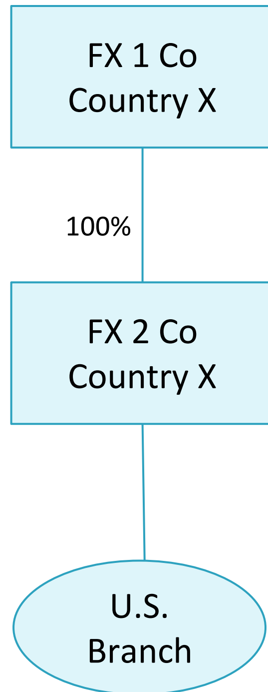
Example from §1.267A-6(c)(3)

- Facts are the same as Example 2 except the $80 is treated as interest by the U.S. only. The $80 is treated as a payment on equity by Country X and Country Z.
- The entire $80 is dual inclusion income.
  - It is not deductible in Country Z (where it is treated as a dividend) and FZ Co receives no tax benefit.
  - It is included in U.S. Co's income as interest.
  - It is treated as an excludible dividend in Country X.
- $20 of the $100 payment from U.S. Co to FX Co is treated as a disqualified hybrid amount ($100 - $80).

DEEMED BRANCH PAYMENTS

- Deemed branch payment where we have –
  - U.S. taxable branch that is a U.S. PE of a treaty resident parent.
  - Payment of interest or royalties allowable as a deduction in computing U.S. business profits
  - The amount is not taken into account under the home office's tax law and were the payment to be regarded then the payment would be included in income in that jurisdiction.
- Deemed branch payment treated as disqualified hybrid amounts if –
  - There is a specified payment that is a deemed branch payment where the home office jurisdiction provides an exclusion or exemption for the branch income.

EXAMPLE 1 – DEEMED BRANCH PAYMENTS



Example from §1.267A-6(c)(4)

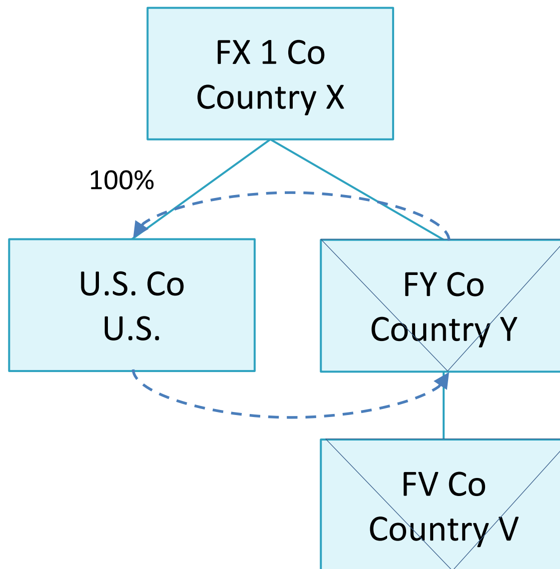
- FX 1 Co and FX 2 Co are Country X corporations that file a consolidated return in Country X.
- There is an income tax treaty between Country X and the U.S. and the U.S. Branch is a permanent establishment under that treaty.
- In computing the ECI of U.S. Branch there a $25 royalty deduction is allowed and is treated as deemed paid to FX 2 Co.
- Under Country X tax law the income of the U.S. branch is exempt from tax and the $25 is disregarded.
- Result: the $25 is a specified payment and deemed branch payment.
- The $25 is disallowed as a disqualified hybrid amount because Country X exempts the U.S. Branch income.

Hybrid Instrument*

REVERSE HYBRID PAYMENTS

- Reverse hybrid for purposes of §267A – an entity that is transparent under the entity's country of residence but is regarded (not-transparent) under the tax law of an investor / shareholder.
- Payments made to reverse hybrids are disqualified hybrid amounts if -
  - The investor / shareholder does not include the payment in income because the entity is not transparent.
- Indirect reverse hybrid payments – specified payments made to an entity that is directly or indirectly, under §958(a), owned by a reverse hybrid if
  - The payment to whom the entity is made and any intermediate entities are transparent under the tax law of an investor.

EXAMPLE – REVERSE HYBRID PAYMENTS



Example from §1.267A-6(c)(5)

- FX Co owns 100% of U.S. Co, FY Co, and FV Co.
- FY Co and FV Co are treated as fiscally transparent in Country Y and Country V but are treated as regarded entities in Country X.
- U.S. Co is a specified party and makes a payment of $100 of interest to FY Co.
- There is a deduction at U.S. Co but no inclusion in any country (D/NI) → because FY Co is transparent in Country Y and is not a taxpayer there and because Country X views FY Co as a regarded entity.
  - Reason there is no inclusion is because the reverse hybrid entity is not transparent
- Result → U.S. Co's payment to FY Co is a disqualified hybrid amount.

BRANCH MISMATCH PAYMENTS

- Branch Mismatch Payment – specified payment where home office views the payment as income attributable to the branch and
  - The branch is not a taxable branch or under the tax law of the branch jurisdiction the payment is not attributable to the branch.
- Branch mismatch payments are disqualified hybrid amounts if
  - Home office jurisdiction does not include the payment in income and
  - The no inclusion is a result of the home office treating the payment as attributable to the branch.

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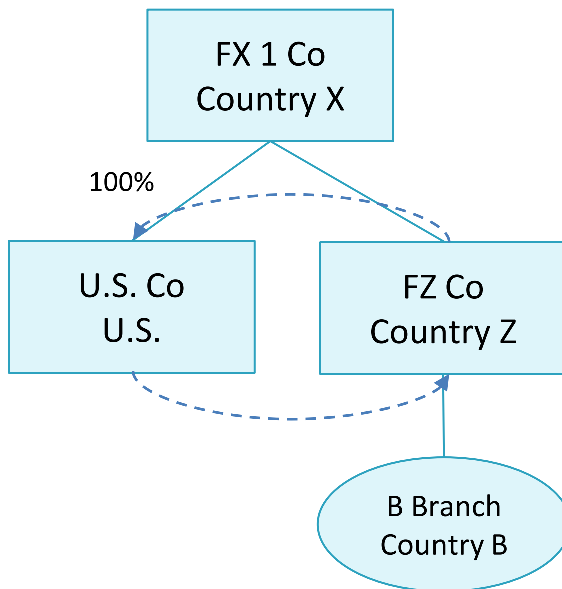
EXAMPLE – BRANCH MISMATCH



Example from §1.267A-6(c)(6)

- FX Co owns 100% of U.S. Co, FZ Co. FZ Co has a branch, B Branch, in Country B.
- U.S. Co pays a royalty of $100 to FZ Co. Under Country Z law the payment is treated as attributable B Branch. Z Country law exempts income attributable to B Branch.
- Under Country B law there is no taxable presence for FZ Co in Country B.
- There is a deduction at U.S. Co but no inclusion in any country (D/NI) → because FZ Co treats the payment as attributable to B Branch and exempts income from B Branch and because Country B doesn't recognize a taxable presence for B Branch / FZ Co.
- Result → U.S. Co's payment to FZ Co is a disqualified hybrid amount.

REDUCTIONS IN TENTATIVE DISQUALIFIED HYBRID AMOUNTS

- After determining tentative disqualified hybrid amounts the reductions below are applied to determine the final disqualified hybrid amount.
  - Amounts that are included in the income of a U.S. tax resident or U.S. taxable branch.
  - Amounts that are included in income of a U.S. shareholder of a CFC as Subpart F income under §951(a)(1)(A)
  - Amounts that are included by a U.S. shareholder of a CFC as tested income under §951A(a).
  - Amounts that are included in the income of a U.S. owner of a QEF under §1293.
- If the U.S. shareholder / owner is a domestic partnership for any of the deemed income then the reduction is only applied to the extent that a U.S. tax resident takes the income into account.

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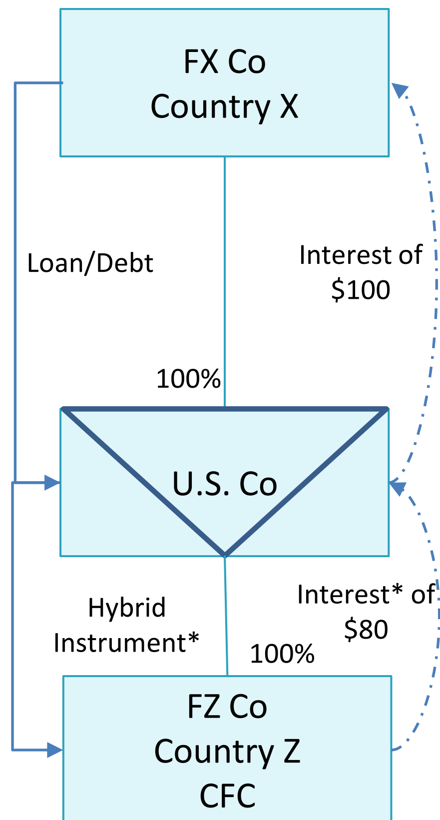
EXAMPLE - REDUCTION IN TENTATIVE DISQUALIFIED HYBRID AMOUNT



Example from §1.267A-6(c)(3)

- From Example 2 – Disregarded Payment / Same facts
- FZ Co – is a specified party because it is a CFC.
- FX Co –is a specified recipient and related to FZ Co.
- U.S. Co – is also a specified recipient.
- The payment of $80 from FZ Co to U.S. Co is made pursuant to a hybrid transaction.
  - It is treated as interest for U.S. tax purposes but not for Country X tax purposes.
- Country X's participation exemption results in a no-inclusion in Country X (D/NI).
- The payment of $80 is <u>not</u> a disqualified hybrid amount because U.S. Co is also a specified recipient and takes the entire payment into account.

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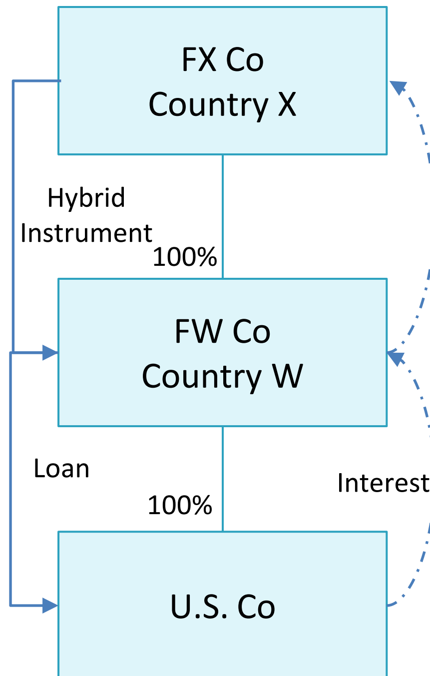
ANTI-HYBRID PROVISIONS OF §267A

IMPORTED MISMATCH AMOUNTS

REDUCTIONS IN TENTATIVE DISQUALIFIED HYBRID AMOUNTS

- Imported mismatch payments are treated as disqualified imported mismatch amounts (deduction not allowed) to the extent that
  - Income from a payment is directly or indirectly offset by a hybrid deduction.
  - The hybrid deduction is incurred by a foreign tax resident or foreign taxable branch that is related to the imported mismatch payer.
- Imported mismatch payment – specified payment that is neither a disqualified hybrid amount nor includible in the income of a U.S. person (anti-deferral).
- Imported mismatch payer – the specified party with respect to an imported mismatch payment.
- Imported mismatch payee – foreign tax resident or foreign taxable branch that includes an imported mismatch payment in income.
- Hybrid deduction – deduction of foreign tax resident that would be disallowed if local tax law contained rules that were substantially similar to §267A

EXAMPLE – IMPORTED MISMATCH



Example from §1.267A-6(c)(8)

- FX Co owns 100% of FW Co which owns 100% of U.S. Co.
- FX Co funded FW Co in part with a hybrid instrument treated as equity in Country X and debt in Country W.
- FW Co funded U.S. Co in part with debt.
- In year 1 – FW pays $100 to FX on the hybrid instrument. It is treated as deductible interest in Country W and as an excludible dividend in Country X (participation exemption).
- U.S. Co pays $100 to FW Co. The amount is treated as interest expense / interest income.
- U.S. 1 is a specified party.
- FW's deduction on the payment to FX is a hybrid deduction. Were Country W to have rules that are substantially similar to the §267A anti-hybrid rules the deduction for the payment from FW to FX would be disallowed.

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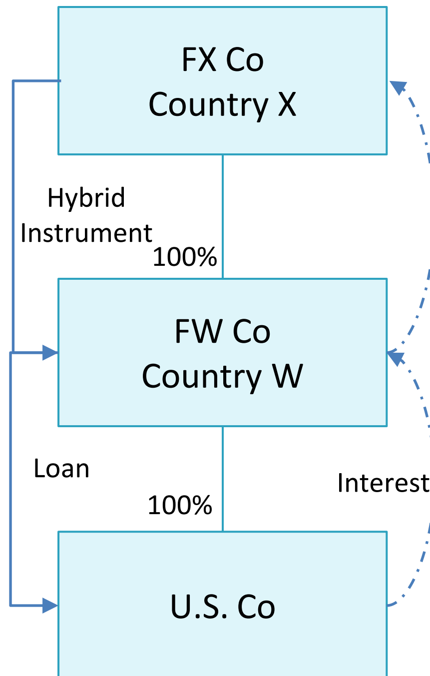
EXAMPLE – IMPORTED MISMATCH



Example from §1.267A-6(c)(8)

- U.S. Co's payment to FW Co is an imported mismatch payment.
- U.S. 1 is an imported mismatch payer and FW is an imported mismatch payee.
- The entire $100 payment from U.S. Co to FW Co is a disqualified imported mismatch amount.
  - The imported mismatch payment is a disqualified imported mismatch amount to the extent that it is directly or indirectly offset by a hybrid deduction.
  - FW has a $100 hybrid deduction on the payment to FX Co that directly offsets the entire payment from U.S. Co to FW Co.

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ANTI-HYBRID PROVISIONS OF §267A

RULES FOR IMPLEMENTATION

RULES FOR IMPLEMENTATION

- Effective dates -
  - In general the anti-hybrid rules apply to years ending after December 20, 2018.
  - Delayed effective dates for structured arrangements, swaps with significant non-periodic payments, notional principal contracts, and interest equivalents in §1.267A-7
- Coordination with other provisions –
  - §267A is applied before 163(j), 461(l), 465, 469.
  - Otherwise 267A is applied after the application of all other provisions.
  - When 267A is applied first if a payment is not disallowed but is disallowed by under another section then that same payment is not subject to 267A again in a future year.
    - Ex – interest expense not limited by 267A in year one but is limited by 163(j) is not subject to 267A again when it is allowed under 163(j)
  - A specified payment disallowed under §267A is not capitalized / taken into account in costs that should be depreciated / amortized.

RULES FOR IMPLEMENTATION

- Foreign currency gain or loss under §988
  - Is taken into account under §267A if
    - A deduction for a specified payment is a disallowed that gives rise to FX gain or loss and
    - The FX gain/loss is in 1.988-2(b)(4) (FX with respect to accrued interest expense) or 1.988-2(c) (Items to be paid or received after the date accrued)
  - A proportionate amount of FX loss, that is associated with a specified payment, is disallowed where a deduction for a specified payment is disallowed.
- Earnings and profits – disallowance of a deduction under §267A does not affect earnings and profits in general.
  - For purposes of §952 (Subpart F) – a CFC's E&P is not reduced by a specified payment where a deduction is disallowed if a principal purpose of the transaction was to limit the CFC's Subpart F income.

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Section 267A New Final Anti-Hybrid Regulations Hybrid Deduction Accounts, Foreign Hybrid Mismatch Rules, and Notional Interest Deductions

August 13, 2020

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Proposed Regulations REG-106013-19 issued on 4/8/2020 - Summary

I. Adjust hybrid deduction accounts to take into account CFC E&P included in U.S. shareholder income

II. Address equity arrangements for purposes of anti-conduit financing rules that give rise to deductions or other benefits under foreign law

III. Relate to treatment of certain prepayments under GILTI rules

IV. Affect U.S. shareholders of foreign corporations and persons that make payments in connection with certain hybrid arrangements

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Proposed Regulations on Guidance Involving Hybrid Arrangements and the Allocation of Deductions Attributable to Certain Disqualified Payments under IRC Section 951A (GILTI)

Proposed Regulations REG-106013-19 issued on 4/8/2020 - Purpose

I. Reductions of hybrid deduction accounts prevent double taxation of CFC E&P subject to GILTI, Subpart F, and IRC § 956 inclusions

II. Conduit financing rules designed to prevent MNCs from avoiding U.S. tax by shifting income to conduit financing arrangements with financial instruments treated as equity for U.S. tax purposes and debt under foreign law

III. GILTI regulations do not address prepayments that accelerate income but do not give rise to a disposition of property such as royalty prepayments

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Proposed Regulations on Guidance Involving Hybrid Arrangements and the Allocation of Deductions Attributable to Certain Disqualified Payments under IRC Section 951A (GILTI)

Proposed Regulations REG-106013-19 issued on 4/8/2020 – Background
IRC § 245A(e) Hybrid Dividends

I. IRC § 245A(e) neutralizes the double non-taxation of hybrid dividends by either denying the 100% DRD (non-CFC) or by requiring a Subpart F income inclusion (CFC)
   A. U.S. shareholder of CFC must maintain hybrid deduction account for each share of CFC stock owned
   B. Dividend received from CFC is a hybrid dividend based on sum of hybrid deduction accounts
   C. Hybrid deduction account reflects the amount of hybrid deductions allocated to share of CFC stock reduced by the amount of deductions that resulted in a hybrid dividend

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Proposed Regulations on Guidance Involving Hybrid Arrangements and the Allocation of Deductions Attributable to Certain Disqualified Payments under IRC Section 951A (GILTI)

Proposed Regulations REG-106013-19 issued on 4/8/2020 – Background
Reg. § 1.881-3 Conduit Financing Arrangements

II. Under IRC § 7701(l) the IRS can recharacterize a multiple-party financing transaction as a transaction directly between two or more parties to disregard one or more intermediate entities acting as conduits

A. Financing arrangement = financing entity advances money or property or grants rights to use property to a financed entity if the advance and receipt are effected through intermediate entities

B. Redeemable Equity - Definition of financing transaction involving equity limited to stock in a corporation (also includes partnership or trust interest) that is subject to certain redemption rights

C. Financed entity must recharacterize disproportionate principal amounts of transaction directly with parties other than intermediary conduits

D. Final regulations (TD 9562) inconclusive on either per se or targeted approach to whether hybrid instruments are financing arrangements

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Proposed Regulations on Guidance Involving Hybrid Arrangements and the Allocation of Deductions Attributable to Certain Disqualified Payments under IRC Section 951A (GILTI)

Proposed Regulations REG-106013-19 issued on 4/8/2020 – Background IRC § 951A GILTI

III. Rule in Reg. § 1.951A-2(c)(5)(i) prevents use of deduction or loss attributable to basis from transfer of property between related CFCs during disqualified period to reduce GILTI tested income or increase tested loss

A. Deduction or loss is allocated to residual CFC gross income
B. Disqualified period: After 12/31/2017 IRC § 965 transition tax E&P measurement date and before the first date when IRC § 951A applies to transferor CFC (e.g., 12/1/2018 for CFC with 11/30 year end)
C. Residual CFC gross income = other than gross GILTI tested income, Subpart F income, or effectively connected income (ECI)

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Proposed Regulations on Guidance Involving Hybrid Arrangements and the Allocation of Deductions Attributable to Certain Disqualified Payments under IRC Section 951A (GILTI)

Proposed Regulations REG-106013-19 issued on 4/8/2020 – Explanation of Provisions: Rules under IRC § 245A(e) to Reduce Hybrid Deduction Accounts

- Reduce hybrid deduction accounts to the extent that the foreign corporation's sheltered E&P not subject to foreign tax is included in U.S. shareholder's taxable income as taxable dividend or Subpart F income
- I.R.C. § 245A(e) is designed to neutralize double non-taxation while proposed regulation prevents double taxation
- Rule for year end adjustments to hybrid deduction accounts to reduce the account by three categories of amounts included in U.S. C corporation shareholder's income from the CFC
  - Proportionate reduction: GILTI inclusion
  - Proportionate reduction: Subpart F income inclusion
  - Dollar for dollar reduction: I.R.C. § 956 inclusion from CFC earnings invested in U.S. property
- Proportionate reduction limited to:

  Hybrid deductions allocated to the share of stock for the year X

  GILTI or Subpart F income / CFC's total taxable income for the year
- Purpose of the proportionate reduction rule is to prevent GILTI or Subpart F income from removing hybrid deductions that sheltered other E&P from hybrid deduction account

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Proposed Regulations on Guidance Involving Hybrid Arrangements and the Allocation of Deductions Attributable to Certain Disqualified Payments under IRC Section 951A (GILTI)

Proposed Regulations REG-106013-19 issued on 4/8/2020 – Explanation of Provisions: Rules under IRC § 245A(e) to Reduce Hybrid Deduction Accounts

- Proposed regulations reduce a hybrid deduction account by adjusted GILTI or Subpart F income inclusions
  - Adjust for IRC § 960 foreign tax credit
  - Adjust for IRC § 250 deduction for GILTI
- First determine the amount of GILTI or Subpart F income inclusion attributable to the share
- Then Two step adjustment process:
  - Add the associated foreign income taxes before FTC limitation to the inclusion
  - Subtract the amount of income offset by the associated foreign income taxes
    - Associated foreign tax credits / corporate tax rate
- Effective date
  - Tax years on or after final regulations published in Federal Register
  - Taxpayer may apply rules of final regulations to prior years if apply consistently
  - Taxpayer may rely on proposed regulations for prior years if apply consistently

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Proposed Regulations on Guidance Involving Hybrid Arrangements and the Allocation of Deductions Attributable to Certain Disqualified Payments under IRC Section 951A (GILTI)

Proposed Regulations REG-106013-19 issued on 4/8/2020 – Explanation of Provisions: Proposed Conduit Regulations under Reg. § 1.881-3 to Address Equity Interests that Give Rise to Deductions or Other Benefits under Foreign Law

- Before proposed regulations: Financing arrangement did not include an interest that is non-redeemable equity that gives rise to deduction under foreign law
- Proposed regulations designed to discourage "the exploitation of differences in treatment of financial instruments across jurisdictions"
- After proposed regulations: These interests may be viewed as avoiding the conduit financing rules and now must take into account the tax treatment of the interest under foreign law
- Rules target intermediate corporations that allow notional interest deduction with routing of income through intermediary or refund of corporate tax paid on related party distribution
- Equity interests of intermediate entity could give rise to a financing transaction but the entity will not be a conduit unless there is a tax avoidance plan
- Expanded definition of financing transaction for equity interests
  - Issuer is allowed deduction or other tax benefit for amounts paid, accrued or distributed
  - Issuer has PE and deduction or benefit allowed on deemed equity or capital of PE
  - Related party shareholder of issuer is allowed a tax refund

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Proposed Regulations on Guidance Involving Hybrid Arrangements and the Allocation of Deductions Attributable to Certain Disqualified Payments under IRC Section 951A (GILTI)

Proposed Regulations REG-106013-19 issued on 4/8/2020 – Explanation of Provisions: Proposed Conduit Regulations under IRC § 1.881-3 Interaction with IRC § 267A

- Proposed conduit regulations may apply to many of the same instruments in IRC § 267A regulations
- Proposed conduit regulations have broader scope to prevent conduit entities from inappropriately obtaining treaty benefits
- IRC § 267A disallows deductions in D/NI situations resulting from hybridity
- D/NI outcome does not result from hybridity if the foreign country does not impose corporate income tax
- Existing conduit rules already apply to D/NI outcomes with respect to offshore financing transaction
- Proposed conduit regulations apply regardless of hybridity causation and instead look to whether there is tax avoidance plan
- Proposed conduit regulations will apply to any financing transaction where intermediate entity is allowed a deduction or benefit similar to IRC § 267A regulations and applicable in imported mismatch context
- Effective date: Applicable for payments made on or after the date final regulations published in Federal Register

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Proposed Regulations on Guidance Involving Hybrid Arrangements and the Allocation of Deductions Attributable to Certain Disqualified Payments under IRC Section 951A (GILTI)

Proposed Regulations REG-106013-19 issued on 4/8/2020 – Explanation of Provisions:
Rules under IRC § 951A to Address Certain Disqualified Payments Made during the Disqualified Period

- Deduction or loss from disqualified basis created from transfers between related CFCs during the disqualified period is allocated and apportioned to residual CFC income
- Depreciation, amortization, or cost recovery allowances attributable to disqualified basis are not properly allocable to property produced or acquired for resale under IRC § 263
- Related CFC prepayments of royalties during disqualified period that are not included in Subpart F income, GILTI, or I.R.C. § 965 transition tax E&P
  - Deduction would only occur as economic performance occurs over time
  - Deductions could decrease GILTI tested income or increase GILTI tested loss
  - Deductions for prepayments including rents and royalties treated same as deductions or loss attributable to disqualified basis
  - Allocate deductions for prepayments to residual CFC income
- Effective date: Applicable to tax years of foreign corporations ending on or after 4/7/2020 and tax years of U.S. shareholders that end with or within the CFC's tax year
- Rules limited to payments during disqualified period that give rise to deductions or loss in CFC's tax year ending on or after 4/7/2020
- Rules not applicable to payments during disqualified period for which deduction or loss is taken into account in year paid

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Alison N. Dougherty provides tax services as a Director at Aronson LLC. She specializes in U.S. international tax reporting, compliance, consulting, planning, and structuring. She has extensive experience assisting clients with U.S. tax reporting and compliance for offshore assets and foreign accounts. She provides outbound U.S. international tax guidance to U.S. businesses and individuals with activities in other countries. She also provides inbound U.S. international tax guidance to foreign businesses and nonresident individuals with activities in the United States. She has worked extensively in the area of U.S. international tax reporting and compliance with the preparation and review of the U.S. Federal Forms 5471, 926, 8992, 8993, 8865, 8858, 5472, 1042, 1042-S, 8621, 8804, 8805, 8813, 8288, 8288-A, 8288-B, 1116, 1118, 1120-F, 1040-NR, 3520, 3520-A, 2555, 5713, 8832, 8833, 8840, 8843, 8854, 8938, and FBAR. She has advised U.S. taxpayers regarding the outbound formation, capitalization, acquisition, operation, reorganization, and liquidation of foreign companies. She has significant experience with U.S. Federal nonresident tax withholding, foreign partner tax withholding, and FIRPTA withholding. She works closely with nonresident individuals and businesses regarding inbound U.S. real property investment. She has assisted U.S. taxpayers with IRS amnesty program disclosures of offshore assets and foreign accounts.

Alison is a tax attorney and a CPA with more than 10 years of experience working in public accounting with a focus on international tax services for businesses and individuals. Alison practiced law as a corporate tax attorney and she worked as a corporate tax manager in private industry prior to joining Aronson in 2010.

Alison is a candidate in the online Graduate Accounting Certificate program at Southern New Hampshire University. Alison completed the LL.M. (Master of Laws) in Securities and Financial Regulation in 2004 with academic distinction at Georgetown University Law Center. She completed the LL.M. (Master of Laws) in Taxation in 2000 and the Juris Doctor in 1999 at the University of Denver College of Law. She completed a Bachelor of Arts degree in Foreign Language in 1995 at Virginia Commonwealth University.

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