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Proposed Anti-Hybrid Regulations under Sections 267A, 245A, and 1503(d)

Proskauer

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On December 20, 2018, the Internal Revenue Service (the "IRS") and the Department of the Treasury (the "Treasury") released proposed "anti-hybrid" regulations (the "Proposed Regulations") under sections 267A, 245A(e), and 1503(d) of the Internal Revenue Code.[1] Sections 267A and 245A(e) were enacted in 2017 as part of the tax reform act.[2] Very generally, these sections deny U.S. tax deductions associated with a financial instrument, transaction, or entity that is treated differently under the tax laws of the United States and the tax laws of another country. Such an instrument, transaction, or entity is referred to as a "hybrid"; and sections 267A and 245A(e) are referred to as "anti-hybrid" provisions. Hybrids, by exploiting the differences between tax laws, can be used to claim tax benefits in multiple countries or achieve "double nontaxation".

The Proposed Regulations will generally be retroactively effective from January 1, 2018 if they are finalized by June 22, 2019.[3] If they are not finalized by that date, then they will be effective as of December 20, 2018. The deadline for comments on the Proposed Regulations is February 26, 2019.[4]

This post provides both a summary and detailed explanation of some of the most important aspects of the Proposed Regulations. For more information, please contact any of the Proskauer tax lawyers listed on this post or your regular Proskauer contact.

I. Background: Sections 267A, 245A, and 1503(d).

Section 267A generally denies a deduction for any "disqualified related party amount" paid or accrued pursuant to a hybrid transaction or paid or accrued either by or to a hybrid entity.[5] A "disqualified related party amount" is any interest or royalty that is paid or accrued to a related party if either (i) the amount is not included in the income of the related party under the tax law of the country of which the related party is a resident for tax purposes or is subject to tax, or (ii) the related party is allowed a deduction with respect to that amount under the tax law of that country.[6] A disqualified related party amount does not include any payment to the extent that the payment is included in the gross income of a United States shareholder as subpart F income under section 952 or as an investment in U.S. property under section 956.[7]

Very generally, a hybrid transaction is a transaction that gives rise to interest or royalties for U.S. federal tax purposes but is not so treated under the tax laws of the foreign recipient.[8] A hybrid entity is one that is treated as "fiscally transparent" in the United States or another jurisdiction, but as a taxable entity in the other.[9] Fiscally transparent generally means that the owners or investors of an entity are taxed on the income earned by the entity rather than the entity itself. The income earned by the entity is not subject to tax at the entity level, but rather flows or passes through to its owners or investors.

Section 245A(e) denies the dividends-received deduction under section 245A(a) for "hybrid dividends".[10]Section 245A(e) also requires that any hybrid dividend received by a CFC from a lower-tier CFC (a "tiered hybrid dividend") be treated as subpart F income and included in the gross income of a U.S. shareholder.[11]Any foreign tax credits or foreign tax deductions associated with hybrid dividends or tiered hybrid dividends are also disallowed.[12]

Section 1503(d) generally prevents a corporation that is a tax resident of the United States and another jurisdiction from using a single economic loss to generate deductions that offset income in both jurisdictions (the "dual consolidated loss rules").

The OECD previously addressed the international tax arbitrage opportunities presented by hybrid transactions and hybrid entities in its proposals under Action 2 of the OECD's Base Erosion and Profit Shifting ("BEPS") project.[13] Section 267A grants the Treasury Department broad authority to issue regulations, and the legislative history to section 267A indicates that the section was intended to be consistent with "many of the approaches to the same or similar problems" taken in the BEPS project, bilateral income tax treaties, and provisions or rules of other countries. The Joint Committee on Taxation's "Blue Book" describing the tax reform act indicates that Treasury's regulatory authority properly extends to addressing the "overly broad or under-inclusive application" of section 267A.[14]

II. Summary of the Proposed Regulations

- The Proposed Regulations dramatically expand the scope of section 267A beyond the statutory language, based on the broad grant of regulatory authority. If the Proposed Regulations are finalized as proposed, they will represent a reversal of over twenty years of U.S. tax policy that has facilitated cross-border tax arbitrage since the "check-the-box regulations" were finalized in 1996.[15] The Proposed Regulations would effectively prevent much of the arbitrage that the check-the-box regulations permit.
- The Proposed Regulations do not address all cross-border arbitrage. They limit disallowance under section 267A to (i) deductions for interest and royalty payments to related parties and (ii) arrangements with an unrelated party where the arbitrage is priced into the terms of the arrangement or, the arbitrage is a principal purpose of the arrangement ("structured arrangements"). The Proposed Regulations appear to allow taxpayers to avoid section 267A by "transmutating" interest payments into capitalized depreciation deductions and royalty payments into the cost of goods sold, which do not appear to be subject to limitation. However, the final regulations may change this result.
- The Proposed Regulations apply to payments that produce a deduction under U.S. tax law, but no corresponding income inclusion under foreign tax law (referred to as a "deduction/no-inclusion" or "D/NI" outcome). However, disallowance under section 267A must result from the hybrid nature of a transaction or arrangement. Section 267A does not disallow a deduction if the deduction/no-inclusion outcome is the result of a feature of foreign tax law unrelated to the hybrid nature of the transaction or arrangement, such as a jurisdiction that does not impose an income tax.
- The Proposed Regulations limit disallowance under section 267A to (i) a tax resident of the United States, (ii) a CFC for which there is one or more 10% United States shareholders, and (iii) a U.S. taxable branch (each, a "specified party"). However, the Proposed Regulations adopt a very broad definition of interest (corresponding to the very broad definition in the section 163(j) proposed regulations).[16]
- The Proposed Regulations expand the scope of section 267A to apply to payments to reverse hybrids as well as to timing mismatches of more than 36 months.
- The Proposed Regulations provide information and reporting requirements for transactions that result in a disallowance under sections 245A and 267A.
- The Proposed Regulations extend the application of the existing dual consolidated loss rules under section 1503(d) to domestic reverse hybrid entities.

III. Hybrid Transactions and Hybrid Entities under the Proposed Regulations

The Proposed Regulations under section 267A disallow deductions of a "specified party" for interest or royalty payments paid or accrued to related parties to the extent that the payment or accrual (a “specified payment”) produces a deduction/no-inclusion outcome as a result of:

1. a “disqualified hybrid amount”,
2. a “disqualified imported mismatch amount”, or
3. an abusive transaction.[17]As mentioned above, a specified party is a U.S. tax resident, a CFC for which there is one or more “10% United States shareholders”[18], or a U.S taxable branch, including a U.S. permanent establishment of a tax treaty resident.[19] A partner in a partnership may be a specified party, but a partnership is not a specified party.[20]
4. The Proposed Regulations provide a *de minimis* rule to the effect that deductions are not to be disallowed under section 267A if the sum of the specified party’s interest and royalty deductions (determined without regard to the Proposed Regulations) for a taxable year is less than $50,000.[21]
5. Each of these three categories is described below.

A. Disqualified hybrid amounts

Under the Proposed Regulations, a specified payment generally gives rise to a disqualified hybrid amount (and thus is subject to disallowance under section 267A) if the specified payment is:

1. a payment made pursuant to a “hybrid transaction”,
2. a disregarded payment in excess of the “dual inclusion income” of a specified party,
3. a “deemed branch payment”,
4. a payment to a “reverse hybrid”, or
5. a “branch mismatch payment”.
6. Each of these terms is described below.

1. Payments pursuant to a hybrid transaction

A hybrid transaction is defined under the Proposed Regulations as any transaction, series of transactions, agreement, or instrument one or more payments with respect to which are treated as interest or royalties for U.S. tax purposes, but are not so treated for purposes of the tax law of a recipient of the payment.[22] The classic example is a payment that is treated as interest on debt for U.S. tax purposes, but as a distribution on equity for purposes of the tax law of country where the specified recipient is a tax resident.[23]

A specified payment is deemed to be made pursuant to a hybrid transaction if there is no inclusion by a specified recipient within 36 months from the end of the taxable year in which the specified party would be allowed a deduction.[24]

If a payment is made pursuant to a hybrid transaction, then the payment is a disqualified hybrid amount (that is subject to disallowance under section 267A) to the extent that (i) a “specified recipient” does not include the payment in income, and (ii) this “no-inclusion” is the result of the hybrid nature of the transaction.[25] A specified recipient is, with respect to a specified payment, any tax resident that derives the payment under its tax law or any taxable branch to which the payment is attributable under its tax law.[26]

The requirement that a disqualified hybrid amount be the result of the hybrid nature of the transaction requires a connection or link between the deduction/no-inclusion outcome and the hybrid treatment itself. For example, the Proposed Regulations do not apply to a payment pursuant to hybrid transaction if the deduction/no-inclusion outcome is the result of a foreign tax law that exempts all foreign-source income from taxation, does not have a corporate tax, or classifies the specified party as a tax-exempt entity.[27] Thus, payments to Cayman Island entities would not be treated as disqualified hybrid amounts because the Cayman Islands does not have a corporate income tax.

However, assume that a foreign parent corporation in a jurisdiction with a participation exemption owns a Cayman Island entity that is treated as a corporation for U.S. tax purposes, but as a flow-through entity under the tax law of the foreign parent's country, and the Cayman Island entity owns a U.S. corporation. If the U.S. corporation makes a payment to the Cayman entity on an instrument that is treated as debt for U.S. tax purposes, but as equity under the tax law of the foreign parent's country, both the Cayman entity and the foreign parent would be treated as specified recipients of the payment because they derive the payment under the tax law of their respective countries. Although the payment does not give rise to a deduction/no-inclusion outcome with respect to the Cayman entity (because the Cayman Islands does not have an income tax), the payment would produce a deduction/no-inclusion outcome with respect to the foreign parent because the hybrid nature of the instrument results in the foreign parent's participation exemption. Therefore, the payment would constitute a disqualified hybrid amount, and the interest deduction of the U.S. corporation would be disallowed.

Finally, the Proposed Regulations do not cover transactions that result in double-deduction outcomes (i.e., transactions where a single payment gives rise to a deduction for two different taxpayers in two different jurisdictions). However, as discussed below, the dual consolidated loss rules do apply to certain double-deduction outcomes.[28]

2. Disregarded payments

A disregarded payment is a payment that (i) is disregarded under the foreign tax law of a tax resident or taxable branch receiving the payment, but that (ii) would be included in the tax resident's or the taxable branch's income (as interest or a royalty) if the payment were regarded under that country's tax law.[29] For example, if a U.S. entity makes an interest payment to a foreign parent in a jurisdiction that does not regard the payment because it treats the U.S. payor as a disregarded entity, but that would require the foreign parent to include the payment as interest income if the transaction were regarded, the interest payment would be a disregarded payment. Disregarded payments result in deduction/no-inclusion outcomes because, as a result of being disregarded, they give rise to a deduction in the country of the payor, but do not produce an offsetting inclusion in the country of the recipient. A deemed branch payment (as discussed below) is not a disregarded payment.[30]

Specified payments pursuant to a purchase-repurchase (“repo”) transaction or other similar transaction where legal title to property is transferred and the property is reacquired or expected to be reacquired in the future are excluded from the definition of disregarded payments.[31] Instead, if a specified payment is made pursuant to a repo transaction or other similar transaction and is disregarded under a foreign tax law, but another amount connected to the payment (the “connected amount”) is regarded under such foreign tax law, the identity of the specified recipient of the specified payment is determined under foreign tax law with respect to the connected amount. In addition, if the specified recipient includes the connected amount, then the amount of the specified recipient’s no-inclusion with respect to the specified payment is correspondingly reduced.[32]

Under the Proposed Regulations, a specified party’s “disregarded payments” give rise to a disqualified hybrid amount to the extent that these payments exceed the total amount of that party’s “dual inclusion income” in a taxable year.[33]

Dual inclusion income is defined as a specified party’s total income or gain for U.S. tax purposes during a taxable year to the extent included in income of the tax resident or taxable branch receiving the disregarded payments, over the specified party’s total deductions or losses for U.S. tax purposes (other than for disregarded payments) to the extent these items are allowable as deductions under the tax law of the tax resident or taxable branch receiving the disregarded payments.[34]

3. Deemed branch payments

A deemed branch payment is any amount of interest or royalties allowable as a deduction in computing the business profits of the U.S. permanent establishment of a treaty resident under an income tax treaty between the United States and the treaty country to the extent that the amount is deemed paid to the home office (or other branch of the home office) and is not regarded (or otherwise taken into account) under the tax law of the home office (or the other branch).[35] For example, a deemed branch payment may arise where a U.S. branch office that constitutes a permanent establishment pays royalties to its home office and those royalties are allowable as a deduction in computing the business profits of the U.S. permanent establishment under the income tax treaty between the United States and the country of the home office.[36]

If a specified payment is a deemed branch payment, the payment is a disqualified hybrid amount if the tax law of the home office country provides an exclusion or exemption for income attributable to the branch.[37]

4. Payments to a reverse hybrid

A reverse hybrid is any entity that is “fiscally transparent” under the tax law of the country in which it is established, but not fiscally transparent under the tax law of an investor of the entity.[38]

A payment made to a reverse hybrid is a disqualified hybrid amount to the extent that the investor does not include the payment in income, and this no-inclusion is a result of the payment being made to the reverse hybrid.[39] For this purpose, an investor's no-inclusion is a result of the payment being made to the reverse hybrid only to the extent that the no-inclusion would not have occurred if the investor's tax law had treated the reverse hybrid as fiscally transparent and the payment as interest or royalty income.[40]

5. Branch mismatch payments

A specified payment is a branch mismatch payment if the payment is treated as income attributable to a branch of a home office under the tax law of home office's country, and either (i) the branch is not a taxable branch or (ii) the payment is not treated as income attributable to the branch under the tax law of the branch's country.[41] A branch mismatch payment gives rise to a disqualified hybrid amount only to the extent that the home office does not include the payment in income, and this no-inclusion is the result of the payment being a branch mismatch payment.[42] For this purpose, the home office's no-inclusion is a result of the specified payment being a branch mismatch payment only to the extent that the no-inclusion would not occur if the tax law of the home office's country treated the payment as interest or royalty income that is not attributable to a branch of the home office.[43]

6. Amounts not treated as disqualified hybrid amounts

The Proposed Regulations provide that a tentative disqualified hybrid amount is generally reduced to the extent (i) the amount is included in the income of a U.S. tax resident or U.S. taxable branch, (ii) the amount is included in a United States shareholder's gross income as subpart F income, or (iii) the amount is included in a United States shareholder's income under the GILTI rules.[44]

7. Structured arrangements

The Proposed Regulations provide that disqualified hybrid amounts arise only with respect to specified payments pursuant to (i) transactions that involve parties related to a specified party[45] and (ii) "structured arrangements".[46] A structured arrangements is an arrangement involving an unrelated party where the hybrid mismatch is priced into the terms of the arrangement or, based on the totality of the circumstances, the hybrid mismatch is a principal purpose of the arrangement.[47]

B. Disqualified imported mismatch amounts

Even if a specified payment does not give rise to a disqualified hybrid amount, under the Proposed Regulations, the specified payment is disallowed if the payment constitutes a "disqualified imported mismatch amount".

A specified payment is treated as a disqualified imported mismatch amount to the extent that the income attributable to the payment is directly or indirectly offset by a “hybrid deduction” that is incurred by a taxable person that is related to the specified party.[48] A hybrid deduction is generally an amount for which a foreign tax resident or taxable branch is allowed an interest or royalty deduction under its tax law to the extent the deduction would be disallowed if that tax law contained rules substantially similar to those in the Proposed Regulations under section 267A.[49] A deduction allowed to a tax resident with respect to equity, such as a notional interest deduction, may also be a disqualified imported mismatch amount.[50] The Proposed Regulations provide a series of ordering and funding rules to determine whether a hybrid deduction directly or indirectly offsets income attributable to a specified payment.[51]

The underlying principle of these rules is that a deduction/no-inclusion outcome may occur as a result of an offshore hybrid arrangement that is imported into the United States through a non-hybrid arrangement. By taking into account the overall effect of multiple transactions that produce a deduction/no-inclusion outcome, the rules are intended to prevent taxpayers from using these arrangements to circumvent the application of section 267A.

For example, assume a foreign parent corporation that is a tax resident of Country X wholly owns both a U.S. corporation and a foreign subsidiary that is a tax resident of Country Y. In year one, the U.S. corporation makes a $100 payment to the foreign subsidiary on an instrument that is treated as indebtedness under U.S. tax law and Country Y tax law (i.e., the instrument is not a hybrid instrument). As a result, the foreign subsidiary includes the payment in income as interest, and the U.S. corporation would be allowed a deduction (absent the Proposed Regulations under section 267A). In the same year, the foreign subsidiary makes a $100 payment to its foreign parent on an instrument that is treated as equity under Country X tax law, but as debt under Country Y tax law (a hybrid instrument). Furthermore, assume that Country X tax law contains a participation exemption for dividends from foreign subsidiaries. Therefore, the second payment is deductible for the foreign subsidiary and not included in the income of the foreign parent. The first payment by the U.S. corporation to the foreign subsidiary is not a disqualified hybrid amount because the underlying instrument is not hybrid. However, the payment would be a disqualified imported mismatch amount because, while it is not a hybrid instrument, the interest income to the foreign subsidiary on the first instrument is offset by the deduction for the payment to the foreign parent on the second instrument, and this deduction would be disallowed if Country Y had rules similar to those in the Proposed Regulations (as the payment would constitute a disqualified hybrid amount). Therefore, the U.S. corporation’s deduction on the first instrument would bedisallowed as a disqualified imported mismatch amount.

C. Anti-abuse rule

Under the Proposed Regulations, a specified party’s deduction may be disallowed under section 267A if (i) a payment is not included in the income of a tax resident or taxable branch and (ii) a principal purpose of the plan or arrangement is to avoid the purposes of the Proposed Regulations.[52]

D. Definitions

For purposes of the Proposed Regulations, interest is any amount paid, received or accrued as compensation for the use or forbearance of money under the terms of an instrument or contractual arrangement that is treated as indebtedness under the Code, or an amount that is treated as interest under the Code. These items include original issue discount, qualified stated interest, acquisition discount, amounts treated as interest in certain integrated transactions, and accrued market discount.[53] This definition corresponds to the broad definition of interest in the recently proposed regulations under section 163(j). For instance, interest includes certain amounts that are closely related to interest and that affect the economic yield or cost of funds of a transaction involving interest, but that may not be compensation for the use or forbearance of money on a stand-alone basis or otherwise treated as interest under general principles.[54]

A royalty is generally defined under the Proposed Regulations as any amount paid or accrued as consideration for the use of, or the right to use, any copyright, patent, trademark, secret formula or process, other similar property (including goodwill) or any information concerning industrial, commercial or scientific experience other than payments for after-sale services, services rendered under a warranty, pure technical assistance, or an opinion given by an engineer, lawyer, or accountant.[55]

By limiting specified payments to interest and royalties, the Proposed Regulations appear to allow U.S. taxpayers to achieve deductions or the economic equivalent by converting interest and royalty deductions to other deductible or excludible amounts that, technically, do not constitute interest or royalties for U.S. tax purposes.

For example, assume a U.S. corporation pays interest to a related foreign party under circumstances that would cause the deduction to be disallowed under the Proposed Regulations, but the U.S. corporation uses the loan to construct a building and the interest deductions are capitalized into the cost of the building and thereby give rise to increased depreciation deductions. Because the Proposed Regulations deny deductions only for specified payments, which are defined as “any interest or royalty” paid or accrued with respect to a specified party,[56] and the U.S. corporation would deduct only depreciation, it appears that the U.S. corporation’s deductions would not be disallowed under the Proposed Regulations.

Likewise, assume that a U.S. corporation makes royalty payments to a related foreign party under circumstances that would cause the deduction to be disallowed under the Proposed Regulations, but the U.S. corporation uses the intellectual property to manufacture goods and the royalty expense becomes a component of the cost of goods sold. Again, because the U.S. corporation would not claim a royalty deduction, it appears that the U.S. corporation’s deductions would not be disallowed under the Proposed Regulations. These and similar “transmutation” situations may be addressed when the Proposed Regulations are finalized, and the final regulations may disallow the U.S. tax benefit, even if it is no longer treated as interest or royalties.[57]

IV. Hybrid Dividends under the Proposed Regulations

A. Definition of a hybrid dividend

As mentioned above, section 245A(e) denies the section 245A 100% dividends-received deduction for "hybrid dividends", and any foreign tax credits or foreign tax deductions with respect to hybrid dividends. Under the Proposed Regulations, a hybrid dividend is a dividend that is otherwise eligible for the section 245A 100% dividend-received deduction, but for which the CFC is or was allowed a "hybrid deduction".

A hybrid deduction is a deduction or other tax benefit allowed under a "relevant foreign tax law" that relates to an amount paid, accrued or distributed with respect to an instrument that is issued by a CFC and treated as equity for U.S. tax purposes.[58] This deduction gives rise to a deduction/no-inclusion outcome because the CFC is entitled to a deduction under relevant foreign tax law, but absent section 245A(e), would not be taxable by the United States (by reason of the 100% dividends-received deduction). For example, a hybrid deduction arises if an equity investment in a CFC is treated as debt in the CFC's resident country (thus giving rise to an interest deduction) and as equity in the United States. If the foreign country has hybrid mismatch rules that deny a deduction for payments on a hybrid instrument in order to prevent a deduction/no-inclusion outcome, then there is no hybrid deduction (and therefore the 100% dividends-received deduction would be permitted) because the deduction is not "allowed."[59] A deduction or other tax benefit is treated as a hybrid deduction only if it relates to a payment on an instrument of the CFC that is treated as stock for U.S. tax purposes.[60] For example, hybrid deductions (subject to disallowance of the 100% dividends-received deduction) include dividends-paid deductions and notional interest deductions allowed on equity under the tax law of the CFC's resident country, but do not include exemptions provided to a CFC for branch profits under its tax law because there is no connection between the tax benefit and the hybrid instrument.[61]

B. Distributions of PTEP

The Proposed Regulations clarify that hybrid dividends generally do not include distributions from a CFC to a United States shareholder out of previously taxed earnings and profits ("PTEP"), because PTEPs are generally ineligible for the section 245A deduction.[62] This exclusion covers both distributions of PTEP received by the United States shareholder directly and dividends received by lower-tier CFCs.[63]

C. Tiered hybrid dividends

Hybrid dividends include amounts received by a CFC from another CFC to the extent that the amounts would be hybrid dividends under the Proposed Regulations if the receiving CFC were a domestic corporation ("tiered hybrid dividends"). The Proposed Regulations clarify that this treatment applies notwithstanding any other provision of the Code. Thus, if one CFC makes a hybrid dividend payment to another CFC, but the dividend would not be subpart F income by reason of the earnings and profits limitation under section 952(c), the "same country" exception for income received from related persons under 954(c)(3), or the look-through rule for related CFCs under section 954(c)(6), the payment will still be treated as a tiered hybrid dividend and thus treated as subpart F income of the receiving CFC, includible in the gross income of a U.S. shareholder (i.e., the domestic corporation that owns both the receiving CFC and the paying CFC), and ineligible for any foreign tax credits or foreign tax deductions.[64] Furthermore, if gain recognized by a CFC on the sale or exchange of stock in another foreign corporation that is treated as a dividend under section 964(e) also constitutes a tiered hybrid dividend, the tiered hybrid dividend rules apply before section 964(e) so that no section 245A deduction or foreign tax credits or deductions is allowed for that amount.[65]

D. Hybrid deduction accounts

A payment by a CFC that is treated as a dividend for U.S. tax purposes may not give rise to the corresponding hybrid deduction until a later time, as a result of differences in recognition, accounting methods, or other timing rules.[66] The Proposed Regulations reflect this concept by requiring "specified owners" to maintain a perpetual "hybrid deduction account" with respect to each share of CFC stock for which a section 245A deduction may be available upon a distribution on the share.[67] The hybrid deduction account is maintained in the "functional currency" of the CFC and tracks the amount of hybrid deductions of the CFC that are allocated to the share based on the relative value of the CFC's stock.[68] The account is increased by the amount of hybrid deductions of the CFC allocable to a share for a taxable year and decreased by the amount of hybrid deductions in the account that gave rise to a hybrid dividend or tiered hybrid dividend during a taxable year.[69]

When a distribution is made by a CFC to a shareholder that maintains a hybrid deduction account with respect to the CFC, the dividend is treated as a hybrid dividend and no section 245A deduction, foreign tax credits, or foreign tax deductions are available with respect to the dividend. As mentioned, the hybrid deduction account is correspondingly reduced by the amount of hybrid deductions that give rise to the hybrid dividend or tiered hybrid dividend. The Proposed Regulations provide that the distribution is treated as a hybrid dividend or a tiered hybrid dividend to the extent of the balance in all of the shareholder's hybrid deduction accounts with respect to the CFC, even if the dividend is paid on a share that has not had any hybrid deductions allocated to it.[70] This approach prevents taxpayers from structuring dividend payments so that they are made only on shares of stock to which a hybrid deduction has not been allocated.

E. Transfers of stock with a hybrid deduction account

The Proposed Regulations also include rules to ensure that section 245A(e) properly applies to dividends that give rise to a deduction/no-inclusion outcome where the receiving shareholder is different than the shareholder that held the stock when the hybrid deduction arose. These rules apply only when stock is transferred among parties that are required to maintain hybrid deduction accounts. If a specified owner transfers a share of stock with a positive balance in its hybrid deduction account to another shareholder that is also a specified owner immediately after the acquisition, then the balance in the hybrid deduction account transfers with the share to the new specified owner.[71] If the acquirer is not a specified owner immediately after the transaction, then the hybrid deduction account is eliminated.[72] However, an anti-avoidance rule provides that, if a transaction or arrangement is undertaken with a principal purpose of avoiding section 245A(e), “appropriate adjustments” (including disregarding the transaction or arrangement) will be made.[73]On a section 332 liquidation by a CFC with a hybrid deduction account to an upper-tier CFC, the upper-tier CFC increases its hybrid deduction account accordingly.[74] The Proposed Regulations include similar rules for reorganizations and recapitalizations.[75]

F. Distributions to which the Proposed Regulations apply

The Proposed Regulations generally apply to distributions made after December 31, 2017.[76]

V. Reporting Requirements under the Proposed Regulations

The Proposed Regulations require taxpayers to report specified payments for which a deduction is disallowed under section 267A and hybrid dividends (including tiered hybrid dividends) under section 245A(e) in accordance with sections 6038 and 6038A. Taxpayers are required to report this information on the appropriate reporting forms for accounting periods or tax years (as applicable) beginning after December 20, 2018. For hybrid dividends under section 245A(e), a CFC paying the dividends must report such dividends on Form 5471.[77] For specified payments under section 267A, the reporting requirements depend on the tax characteristics of the party making the payment. If the payor is a CFC, then it must report the specified payment on Form 5471.[78] If the payor is a 25% foreign-owned U.S. corporation, then the information is reported on Form 5472.[79] If the payor is a controlled foreign partnership, the controlling 50% partner must provide the information on Form 8865.[80]

VI. Dual Consolidated Loss Rules

As mentioned above, the Proposed Regulations under section 267A do not cover hybrid transactions that generate deductions in the United States and another jurisdiction because these transactions are addressed separately by other provisions and doctrines in the Internal Revenue Code, such as the dual consolidated loss rules under section 1503(d). The Proposed Regulations also include proposed changes to the dual consolidated loss rules.[81]

The dual consolidated loss rules generally prevent a corporation that is considered a tax resident of two jurisdictions from using a single economic loss to offset income in both jurisdictions. Under section 1503(d), a dual consolidated loss may not reduce the taxable income of a domestic affiliate for any taxable year. This use of a dual consolidated loss is referred to as a “domestic use”.

A dual consolidated loss is generally defined as any net operating loss of a domestic corporation that is subject to an income tax of a foreign country on its worldwide income without regard to the source country of the income, or is subject to tax on a residence basis.[82] If a taxpayer makes a "domestic use election" certifying that there has not been and will not be a "foreign use" of the dual consolidated loss during a certain period, then the general prohibition against the domestic use of a dual consolidated loss is lifted.[83] A foreign use of a dual consolidated loss generally occurs when any portion of the dual consolidated loss is made available to offset the income of a foreign corporation or the direct or indirect owner of a hybrid entity.[84]

Prior to the Proposed Regulations, an entity classified as a "domestic reverse hybrid" was not subject to the general prohibition on the domestic use of dual consolidated losses because a domestic reverse hybrid was not subject to tax under foreign tax law on a worldwide basis or residence basis.[85] Domestic reverse hybrid entities could result in double-deduction outcomes because the deductions they incurred could offset income for both U.S. and foreign tax purposes.

The Proposed Regulations eliminate this possibility by proposing changes to the regulations under section 1503(d) and the check-the-box rules under section 7701 providing that any U.S. entity electing to be classified as a corporation under the check-the-box rules must consent to being treated as a "dual resident corporation" for purposes of the dual consolidated loss rules under section 1503(d) for taxable years in which (i) a foreign resident corporation derives income, gain, deduction or loss through the electing domestic entity, and (ii) the foreign resident corporation is related to the electing domestic entity.[86] When these conditions are satisfied, the electing entity will become subject to the dual consolidated loss rules and any double-deduction outcome created through the use of such an entity will be disallowed.[87]

The Proposed Regulations apply to a U.S. entity that elects to be treated as a C corporation on or after December 20, 2018.[88] They also apply to an entity that elects to be treated as a C corporation prior to December 20, 2018, by deeming the entity to consent to being subject to the dual consolidated loss rules under 1503(d) as of its first taxable year beginning on or after December 20, 2019 unless the entity elects, effective before December 20, 2019, to be treated as a partnership or disregarded entity.[89]

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[1] Rules Regarding Certain Hybrid Arrangements [REG-104352-18], 83 Fed. Reg. 67612 (Dec. 28, 2018). All references to section numbers are to the Internal Revenue Code or the Proposed Regulations.

[2] Pub. L. No. 115-97, 115 Stat. 2054 (2017).

[3] 83 Fed. Reg. at 67624.

[4] 83 Fed. Reg. at 67624.

[5] Section 267A(a).

[6] Section 267A(b). A related party means a related party as defined under section 954(d)(3) (more than 50% control by total combined voting power or value), except that section 954(d)(3) is applied with respect to the payor of interest or royalties in lieu of the CFC otherwise referred to in that section.

[7] Section 267(b)(1) (flush language).

[8] Section 267A(c).

[9] Section 267A(d).

[10] Section 245A allows U.S. corporations a 100% dividends-received deduction for the foreign-source portion of dividends received from a controlled foreign corporation (a "CFC") of which the U.S. corporation owns at least 10% of the vote or value of the CFC's shares. A CFC is a foreign corporation that is owned 50% or more (total combined voting power or value) by U.S. shareholders, which are U.S. persons that own stock representing 10% or more of the combined voting power or value of a foreign corporation. Sections 951(b), 957(a).

[11] Section 245A(e)(1), (2).

[12] Section 245A(e)(3).

[13] *See* OECD, Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2: 2015 Final Report (October 2015), http://www.oecd.org/ctp/neutralising-the-effects-of-hybrid-mismatch-arrangements-action-2-2015-final-report-9789264241138-en.htm.

[14] Joint Comm. Tax'n, General Explanation of Public Law 115-97 at 390 (2018), https://www.jct.gov/publications.html?func=startdown&id=5152.

[15] Treas. Reg. § 301.7701-3.

[16] An in-depth discussion of the proposed regulations under section 163(j) can be found [here](#).

[17] Prop. Reg. § 1.267A-1(b).

[18] A United States shareholder is, with respect to a foreign corporation, a U.S. person who owns 10% or more of the total combined voting power or value of the foreign corporation. Section 951(b). Stock that is held directly, indirectly through foreign parties, or constructively through certain related parties is taken into account for purposes of determining whether a U.S. person is a United States shareholder. Section 958. However, at least 10% of the stock of a CFC must be held directly or indirectly by one or more United States shareholders for the CFC to qualify as a specified party.

[19] Prop. Reg. § 1.267A-5(17).

[20] Prop. Reg. § 1.267A-5(17). For a payment made by a partnership, a U.S. corporate partner is a specified party and its allocable share of the deduction for the payment is subject to disallowance under section 267A.

[21] Prop. Reg. § 1.267A-1(c).

[22] Prop. Reg. § 1.267A-2(a)(2).

[23] Prop. Reg. § 1.267A-2(a)(2).

[24] Prop. Reg. § 1.267A-2(a)(2).

[25] Prop. Reg. § 1.267A-2(a)(1).

[26] There may be multiple specified recipients with respect to a specified payment and the determination is made without regard to whether a tax resident is a resident of a country that has an income tax treaty with the United States. Prop. Reg. § 1.267A-5(a)(18). A tax resident is a body corporate or other entity or body of persons liable to tax under the tax law of a country as a resident. Prop. Reg. § 1.267A-5(a)(23). A taxable branch is a branch that has a taxable presence under its tax law. Prop. Reg. § 1.267A-5(a)(22).

[27] 83 Fed. Reg. at 67613. Absent this rule, the statutory language of section 267A could deny a deduction for a payment made to a hybrid entity that is a resident of a jurisdiction with no income tax where the deduction/no-inclusion outcome occurs simply by reason of the foreign jurisdiction's tax law (and not the hybrid nature of the transaction). The statute could also deny a deduction where a payment is subject to tax in a foreign country. For instance, a royalty payment made to a hybrid entity in the United Kingdom that qualifies for a reduced tax rate under the U.K. patent box regime could be denied a deduction under section 267A. Alternatively, assume a U.K. entity is a limited liability partnership (LLP) that defaults to a corporation under the U.S. check-the-box regulations and further assume that the partners of the LLP are U.K. residents subject to tax on their share of the LLP's income. Section 267A could disallow a deduction for any U.S. source interest or royalty payments to the LLP even though the U.K. partners include the payments in income.

[28] 83 Fed. Reg. at 67615.

[29] Prop. Reg. § 1.267A-2(b)(2).

[30] Prop. Reg. §§ 1.267A-2(b)(2); 1.267A-2(b)(2).

[31] Prop. Reg. § 1.267A-2(b)(2).

[32] Prop. Reg. § 1.267A-2(a)(3).

[33] Prop. Reg. § 1.267A-2(b)(1).

[34] For example, assume a foreign parent wholly owns a U.S. entity that is disregarded for purposes of the tax law of the foreign parent's country. During year one, the U.S. entity pays $100 to the foreign parent pursuant to a debt instrument. This amount is treated as interest under U.S. tax law, but is disregarded under foreign tax law, which views the transaction as involving a single taxpayer. During the same year, the U.S. entity's has $125 of gross income and $60 of deductible expense. The $125 of gross income is included in the foreign parent's income, and the $60 of expense is allowed under the foreign country's tax law. The U.S. entity

qualifies as a specified party and is thus subject to disallowance under section 267A. The payment is a disregarded payment because the transaction is disregarded under the foreign country's tax law, but the payment would have been included in the foreign parent's income as interest income if the transaction were regarded. The excess of the $100 payment over the U.S. entity's dual inclusion income for year one is a disqualified hybrid amount. The U.S. entity's dual inclusion income is $65 ($125 included in the foreign parent's income less $60 expense allowed against the foreign parent's income). Therefore, the disqualified hybrid amount is $35 (the excess of $100 over $65). *See* Prop. Reg. 1.267A-6(c)(3), Example 3.

[35] Prop. Reg. § 1.267A-2(c)(2). In a normal situation, where a foreign corporation is a resident of a country that has entered into an income tax treaty with the United States, the United States is generally permitted to impose tax on the foreign corporation's "business profits" only if the corporation's business operations constitute a permanent establishment within the United States. A foreign corporation generally has a permanent establishment if it has a fixed place of business within the United States (subject to exceptions) or operates through a dependent agent that habitually exercises the authority to conclude contracts on behalf of the corporation within the United States.

[36] Prop. Reg. § 1.267A-2(c)(2). Assume a foreign corporation has a U.S. taxable branch. Under an income tax treaty between the United States and the foreign corporation's resident country, the U.S. taxable branch is a U.S. permanent establishment, and $25 of royalties are allowable as a deduction in computing the business profits of the U.S. taxable branch and are deemed paid to the foreign corporation. Under the tax law of the foreign corporation's resident country, the $25 of royalties are disregarded. Therefore, the $25 payment is a specified payment that is a deemed branch payment and the entire $25 payment is a disqualified hybrid amount for which a deduction is disallowed under the Proposed Regulations because the tax law of the foreign corporation's resident country provides an exclusion or exemption for income attributable to a branch. *See* Prop. Reg. § 1.267A-6(c)(4)(iii), Example 4.

[37] Prop. Reg. § 1.267A-2(c)(1).

[38] Prop. Reg. § 1.267A-5(a)(8); *see* also Treas. Reg. § 1.894-1(d)(3)(ii)-(iii).

[39] Prop. Reg. § 1.267A-2(d).

[40] Prop. Reg. § 1.267A-2(d)(1)(ii). Assume that a foreign parent corporation located in Country X wholly owns a U.S. corporation and a foreign corporation located in Country Y. The foreign subsidiary is fiscally transparent for Country Y tax purposes but is not fiscally transparent for Country X tax purposes. In year one, the U.S. corporation pays $100 to the foreign subsidiary, which is treated as interest for U.S. tax purposes and Country X tax purposes. The U.S. corporation is a specified party for purposes of the Proposed Regulations and its deduction for the $100 payment is subject to disallowance under section 267A. The payment by the U.S. corporation is made to a reverse hybrid because the foreign subsidiary is fiscally transparent under Country Y tax law (the tax law where the foreign subsidiary is established) but is not fiscally transparent under Country X tax law (the tax law of an investor, the foreign parent). There is a no-inclusion outcome because the foreign parent does not derive

the $100 payment under Country X tax law (as the foreign subsidiary is not fiscally transparent under such law) and therefore does not include any of the payment in income. Thus, the foreign parent's $100 no-inclusion gives rise to a disqualified hybrid amount to the extent that it is a result of the payment being made to the reverse hybrid. The entire $100 no-inclusion is a result of the payment being made to the reverse hybrid because, if the foreign subsidiary were treated as fiscally transparent under Country X tax law, the foreign parent would include $100 in income, and consequently, the no-inclusion would not occur. Thus, the U.S. corporation's entire $100 deduction with respect to the payment is denied under the Proposed Regulations. *See* Prop. Reg. § 1.267A-6(c)(5), Example 5.

[41] Prop. Reg. § 1.267A-2(e)(2).

[42] Prop. Reg. § 1.267A-2(e)(1). Assume that a foreign parent located in Country X wholly owns a U.S. corporation and a foreign subsidiary located in Country Y. The foreign subsidiary owns a branch in Country Z that gives rise to a taxable presence in Country Z under Country Y tax law but not under Country Z tax law. In year one, the U.S. corporation pays $100 to the foreign subsidiary and this amount is treated as a royalty for U.S. and Country Y tax purposes. Under Country Y tax law, the $100 is treated as income attributable to the branch and is excluded from the foreign subsidiary's income because Country Y tax law exempts branch profits from taxation. The U.S. corporation is a specified party for purposes of the Proposed Regulations and its deduction for the $100 payment is subject to disallowance under section 267A. The U.S. corporation's payment is a branch mismatch payment because the payment is treated as income attributable to a branch under Country Y tax law, and the branch does not give rise to a taxable presence under Country Z tax law (and thus is not a taxable branch). Because of the branch profits exemption under Country Y tax law, the foreign subsidiary does not include any of the payment in income, and thus there is a $100 no-inclusion outcome with respect to the foreign subsidiary. The $100 no-inclusion gives rise to a disqualified hybrid amount to the extent that it is a result of the payment by the U.S. corporation being a branch mismatch payment. The entire $100 no-inclusion is a result of the payment being a branch mismatch payment because if the payment were not treated as attributable to the branch for Country Y tax purposes, the foreign subsidiary would include the $100 in income. Therefore, the U.S. corporation's deduction with respect to the payment to the foreign subsidiary is disallowed under the Proposed Regulations. *See* Prop. Reg. § 1.267A-6(c)(6), Example 6.

[43] Prop. Reg. § 1.267A-2(e)(1)(ii).

[44] Prop. Reg. § 1.267A-3(b).

[45] Prop. Reg. § 1.267A-2(f).

[46] Prop. Reg. § 1.267A-2(f).

[47] Prop. Reg. § 1.267A-5(a)(20).

[48] Prop. Reg. § 1.267A-4(a).

[49] Prop. Reg. § 1.267A-4(b).

[50] Prop. Reg. § 1.267A-4(b).

[51] Prop. Reg. § 1.267A-4(c).

[52] Prop. Reg. § 1.267A-5(b)(6).

[53] Prop. Reg. § 1.267A-5(a)(12); Prop. Reg. § 1.163(j)-1(a)(20).

[54] These amounts include (i) income, deduction, gain, or loss from transactions used to hedge interest-bearing assets or liabilities, (ii) substitute interest payment, (iii) commitment fees, (iv) debt issuance costs, (v) guaranteed payments for the use of capital, and (vi) the time value component of a non-cleared swap with significant nonperiodic payments. Prop. Reg. § 1.163(j)-1(b)(20).

[55] Prop. Reg. § 1.267A-5(a)(16). This definition is consistent with the meaning of the term under Article 12 of the 2006 U.S. Model Income Tax Convention.

[56] Prop. Reg. § 1.267A-1(b).

[57] Payments that are included in the cost of goods sold or otherwise reduce gross receipts are not treated as base erosion payments that are subject to the base erosion anti-abuse tax ("BEAT") under section 59A. Section 59A(d)(4), Preamble to the Proposed Regulations under Section 59A, REG-104259-18. However, capitalized payments that give rise to depreciation and amortization deductions are treated as base erosion payments that are subject to the BEAT when they give rise to depreciation or amortization. Section 59A(d)(2). Section 267A does not have a provision that is analogous to section 59A(d)(2).

[58] Prop. Reg. § 1.245A(e)-1(d)(2)(i). "Relevant foreign tax law" means any country that imposes an income, war profits or excess tax with respect to income of the CFC, other than a foreign anti-deferral regime under which an owner of the CFC is liable to tax. For example, a relevant foreign tax law includes the tax law of a foreign country of which the CFC is a tax resident ("CFC country"), as well as the tax law applicable to a foreign branch of the CFC. Prop. Reg. § 1.245A(e)-1(f)(4).

[59] 83 Fed. Reg. at 67613.

[60] 83 Fed. Reg. at 67613.

[61] Prop. Reg. § 1.245A(e)-1(d)(2)(i)(B). Foreign currency gain or loss with respect to a deduction or other tax benefit is taken into account for purposes of determining hybrid deductions. Prop. Reg. § 1.245A-1(d)(6). Thus, if a payment by a CFC gives rise to foreign currency gain or loss to the CFC under a foreign tax law similar to section 988, then that foreign currency gain or loss would be taken into account. (Section 988 provides rules for the recognition of gains or losses associated with foreign currency transactions.)

[62] Distributions out of PTEP have already been included in a U.S. shareholder's gross income under section 951(a) and are thus excluded from such shareholder's gross income when they are subsequently distributed under section 959(a). Furthermore, they are not treated as dividends (other than to reduce earnings and profits) under section 959(d) so they are not eligible for the section 245A

deduction. *See* 83 Fed. Reg. 67613.

[63] Prop. Reg. § 1.245A(e)-1(c)(2).

[64] 83 Fed. Reg. at 67613.

[65] Under certain circumstances, section 964(e) (i) treats gain recognized by a CFC on the sale or exchange of stock in another foreign corporation as a dividend and as subpart F income of the selling CFC, (ii) requires a U.S. shareholder of the CFC to include in its gross income its pro rata share of the subpart F income, and (iii) allows the U.S. shareholder a section 245A deduction for its inclusion in gross income.

[66] 83 Fed. Reg. at 67614.

[67] Prop. Reg. § 1.245A(e)-1(d)(1). A specified owner of a CFC is (i) a domestic corporation that is a U.S. shareholder of the CFC or (ii) an upper-tier CFC that would be a U.S. shareholder of the CFC if it were a domestic corporation. It also includes persons who own shares directly or indirectly through a partnership, trust, or estate. Prop. Reg. § 1.245A(e)-1(f)(5).

[68] Prop. Reg. § 1.245A(e)-1(d)(4)(i). Functional currency is generally the currency of the economic environment in which a significant part of a business' activities are conducted and which is used by the business to keep its books and records. *See* section 958(b).

[69] Prop. Reg. § 1.245A(e)-1(d)(4)(i).

[70] Assume, for example, that a domestic corporation holds two types of shares of equal value of a foreign corporation that is a CFC. Share A is a treated as a debt in the foreign country and as equity in the United States (and is thus a hybrid instrument) and Share B is treated as equity in both countries. During year one, the foreign corporation accrues $80 of interest to the domestic corporation with respect to share A and is allowed a deduction under the foreign country's tax law. During year two, the foreign corporation distributes $30 to the domestic corporation with respect to each type of share. Absent section 245A(e), the domestic corporation would be permitted a section 245A deduction for both distributions. The entire amount of each dividend received by the domestic corporation from the foreign corporation during year two is a hybrid dividend under the Proposed Regulations because the total of the domestic corporation's hybrid deduction accounts with respect to each of its shares of stock in the foreign corporation at the end of year two ($80 for Share A + $0 for Share B = $80) is at least equal to the amount of the dividends ($60). Therefore, a section 245A deduction is denied with respect to both dividends, even though there are no hybrid deductions allocated to Share B. *See* Prop. Reg. § 1.245A(e)-1(g)(1), Example 1.

[71] Prop. Reg. § 1.245A(e)-1(d)(4)(ii)(A).

[72] Prop. Reg. § 1.245A(e)-1(d)(4)(ii)(A).

[73] Prop. Reg. § 1.245A(e)-1(e).

[74] Prop. Reg. § 1.245A(e)-1(d)(4)(ii)(B)(2). A section 332 liquidation is generally defined as a liquidation in which a 80% or more owned subsidiary is liquidated into its parent.

[75] Prop. Reg. § 1.245A(e)-1(d)(4)(ii)(1), (3).

[76] Prop. Reg. § 1.245A(e)-1(d)(2)(ii)

[77] Prop. Reg. § 1.6038-2(f)(14).

[78] Prop. Reg. § 1.6038-2(f)(13).

[79] Prop. Reg. § 1.6038A-2(b)(5)(iii).

[80] Prop. Reg. § 1.6038-3(g)(3).

[81] The Proposed Regulations under 1503(d) supplement the substantial existing dual consolidated loss rules, which are not discussed in detail here.

[82] Section 1503(d)(2).

[83] Treas. Reg. § 1.503(d)-6(d).

[84] Treas. Reg. § 1.503(d)-3(a).

[85] A domestic reverse hybrid is a domestic entity that, with respect to the item of income, is treated as not fiscally transparent for U.S. tax purposes and as fiscally transparent under the laws of the owner's jurisdiction.

[86] Prop. Reg. §§ 1.503(d)-1(b)(2)(iii), (c); 1.503(d)-3(e)(3); 301.7701-3(a), (c)(iii).

[87] For example, assume a foreign corporation wholly owns a U.S. entity that elects to be treated as a U.S. C corporation, but is treated as fiscally transparent under the tax law of the resident country of the foreign corporation. In year one, the foreign corporation has only $60 income and the domestic entity has only $100 deduction (resulting in $100 net loss for the domestic corporation in year one). By electing to be treated as a U.S. C corporation, the domestic entity consents to be treated as a dual resident corporation subject to the DCL rules. For year one, the domestic entity is treated as a dual resident corporation because the foreign corporation derives or incurs items of income, gain, deduction, or loss of the domestic entity (given that the domestic entity is fiscally transparent under the foreign tax law). Because the loss is available to offset income of the foreign corporation under foreign country tax law, there is a foreign use of the dual consolidated loss in year one. Thus, the $100 dual consolidated loss is subject to the domestic use limitation rule. The result is the same if (i) the foreign corporation holds its interest in the domestic entity through an intermediary that is fiscally transparent under the foreign tax law or (ii) an individual wholly owns the foreign corporation and the foreign corporation is a disregarded entity. *See* Prop. Reg. § 1.1503(d)-7(c)(41), Example 41.

[88] Prop. Reg. § 301.7701-3(c)(3)(iii).

[89] Prop. Reg. § 301.7701-3(c)(3)(ii).