The Role of Financial Instruments and Transactions in a Cross-Border Context

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Agenda

Overview

Hybrid Transactions and Entities
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Hybrid Dividends
  – Scope and Effective Date
  – Introductory Observations
  – Section 245A(e) Proposed Regulations
    • Hybrid Dividends
    • Tiered Hybrid Dividends
Hybrid Transactions and Entities
Scope and Effective Date of §267A Proposed Regulations

– Provide exclusive list of transactions pursuant to which 267A disallows deductions and anti-abuse rule

– Disallowance limited to deductions for interest (broadly defined) and royalties

– Deductions disallowed only with respect to transactions between related persons or “structured arrangements” involving unrelated persons

– Largely do not apply in outbound (US-parented group) context because of subpart F/GILTI exception; apply primarily in inbound (foreign-parented group) context

– Generally would be effective for tax years beginning after 12/31/17; certain provisions would be effective for tax years beginning on or after date filed with Federal Register
Observations on §267A Proposed Regulations

– Address deduction/no inclusion (D/NI) outcomes resulting from hybrid and branch arrangements
  • Do not address D/NI outcomes resulting other than from identified transactions and arrangements (i.e., there is a causation requirement)
    – Causation requirement tested using counterfactual analysis
    – Do not treat zero or low tax rates as NI
  • Generally treat long-term deferral (longer than 36 months) as NI
  • Require determinations under foreign countries’ tax laws
  • Do not address double deduction outcomes
  • Generally intended to be consistent with OECD hybrid mismatch reports
    – Apply after other rules that otherwise disallow/defer deductions (e.g., §§267(a)(3) and 163(j))
    – Disallowance of deductions under §267A does not affect E&P
Definitional Rules
Disallowed Amounts (Prop. §1.267A-1(b))

- Disqualified Hybrid Amount (DHA)
  - DHA rules generally police D/NI outcome if TR/TB to which interest/royalty paid has NI
    - Payment pursuant to Hybrid Transaction
    - Disregarded Payment
    - Deemed Branch Payment
    - Payment to Reverse Hybrid
    - Branch Mismatch Payment

- Disqualified Imported Mismatch Amount (DIMA)
  - DIMA rules generally police D/NI outcome if TR/TB to which interest/royalty paid or accrued includes it in income and Hybrid Deduction directly or indirectly offsets income
  - Apply DHA principles to TR/TB, thereby policing NI of counterparty on transaction that gives rise to Hybrid Deduction

- Specified Payment subject to anti-abuse rule
Interest and Royalties

– Interest
  • Defined broadly, similarly to definition in §163(j) proposed regulations
  • Includes: OID, QSI, repurchase premium, imputed interest under §§ 483, 467, 7872, 163(c), and 636, time value component of swaps with significant nonperiodic payments, certain amounts that affect the effective cost of borrowing, and certain structured payments

– Royalty
  • Definition intended to be consistent with definition of royalty in treaties
  • Includes: amounts paid for use of copyright, including of literary, artistic, scientific, or other work (such as software), patent, trademark, design, plan, formula, process, or goodwill, and industrial, commercial, or scientific experience
  • Excludes: amounts paid for after-sale services, warranty services, and technical services
Definitions
Prop. §1.267A-5

– Specified Payment (SP) – Interest or royalty paid or accrued by a Specified Party

– Specified Party – (i) US Tax Resident, (ii) CFC with at least one US shareholder that owns stock under §958(a), or (iii) US Taxable Branch
  • US Tax Resident – Entity/individual liable to tax as resident under US tax law
  • Tax Resident (TR) – Entity/individual liable to tax as resident under country’s tax law
  • US Taxable Branch – US trade or business/US permanent establishment of Tax Resident of other country
  • Branch – Taxable presence of TR in other country under either TR’s tax law or other country’s tax law
  • Taxable Branch (TB) – Branch that has taxable presence under Branch’s tax law

– Specified Recipient (SR) – With respect to SP, any TR that derives SP as income under its tax law or any TB to which SP is attributable under its tax law

– Home Office – TR that has a Branch

– Entity – Any person other than an individual, including a disregarded entity

– Investor – TR/TB that directly or indirectly owns an interest in an Entity
Relatedness Requirement

– Generally, SR, TR/TB, Investor, or Home Office taken into account for purposes of DHA rules only if it is:
  • Related (within meaning of §954(d)(3) with modifications) to the Specified Party, or
  • Party to a Structured Arrangement pursuant to which SP is made

– Structured Arrangement – Requires either:
  • Hybrid mismatch to be priced into terms of arrangement, or
  • Hybrid mismatch to be a principal purpose of arrangement
Disqualified Hybrid Amounts
Income Inclusions for Determining DHA
Prop. §1.267A-3

– TR/TB includes SP in income to extent that under tax law of TR/TB:
  • TR/TB includes payment in income or tax base at full marginal rate imposed on ordinary income, and
  • SP is not reduced or offset by an exemption, exclusion, deduction, credit, or other similar relief
    – Examples of such reductions include under participation exemption, dividends received deduction, patent box, or indirect foreign tax credit regimes
    – Does not include if SP is offset by generally applicable deduction or attribute, such as depreciation or NOL
  • Determination is made without taking into account defensive/secondary rule under tax law of TR/TB that would require TR/TB to include SP in income if deduction for SP was not allowed under US tax law (otherwise would create circularity)

– DHA generally reduced to extent:
  • SR that is US TR or US TB includes amount in gross income, or
  • Amount is taken into account as gross Subpart F income/gross tested income (Subpart F/GILTI exception)
Payment Pursuant to Hybrid Transaction Prop. §1.267A-2(a)

– Hybrid Transaction – Transaction pursuant to which a payment is:
  • Treated as interest/royalty under US tax law, and
  • Not treated as interest/royalty under SR’s tax law
– DHA equals SP made pursuant to Hybrid Transaction to extent:
  • SR has NI with respect to SP
  • SR’s NI is result of fact that SP is made pursuant to Hybrid Transaction
    – Causation requirement satisfied if NI would not result if SP had been treated as interest/royalty under SR’s tax law
– Repo/securities lending transaction – Special rules take into account treatment of connected payment recognized under SR’s tax law (e.g., dividend on stock subject to repo transaction)
Payment Pursuant to Hybrid Transaction Prop. §1.267A-6(c)(1), Ex. 1(i)-(ii)

**Facts:**

- FX holds all the interests of US1. FX holds an instrument issued by US1 that is treated as equity for Country X tax purposes and indebtedness for U.S. tax purposes (the FX-US1 instrument).

- On date 1, US1 pays $50x to FX pursuant to the instrument. The amount is treated as an excludible dividend for Country X tax purposes (by reason of the Country X participation exemption) and as interest for U.S. tax purposes.
Payment Pursuant to Hybrid Transaction Prop. (cont’d) §1.267A-6(c)(1), Ex. 1(i)-(ii) (cont’d)

Analysis:

- US1 is a specified party and thus a deduction for its $50x specified payment is subject to disallowance under section 267A.

- (A) US1’s payment is made pursuant to a hybrid transaction because a payment with respect to the FX-US1 instrument is treated as interest for U.S. tax purposes but not for purposes of Country X tax law (the tax law of FX, a specified recipient that is related to US1). See §1.267A-2(a)(2) and (f). Therefore, §1.267A-2(a) applies to the payment.
Analysis:

- (B) For US1’s payment to be a disqualified hybrid amount under §1.267A-2(a), a no-inclusion must occur with respect to FX. See §1.267A-2(a)(1)(i). As a consequence of the Country X participation exemption, FX includes $0 of the payment in income and therefore a $50x no-inclusion occurs with respect to FX. See §1.267A-3(a)(1). The result is the same regardless of whether, under the Country X participation exemption, the $50x payment is simply excluded from FX’s taxable income or, instead, is reduced or offset by other means, such as a $50x dividends received deduction. See id.
Payment Pursuant to Hybrid Transaction Prop. (cont’d) §1.267A-6(c)(1), Ex. 1(i)-(ii)

Analysis:

- (C) Pursuant to §1.267A-2(a)(1)(ii), FX’s $50x no-inclusion gives rise to a disqualified hybrid amount to the extent that it is a result of US1’s payment being made pursuant to the hybrid transaction. FX’s $50x no-inclusion is a result of the payment being made pursuant to the hybrid transaction because, were the payment to be treated as interest for Country X tax purposes, FX would include $50x in income and, consequently, the no-inclusion would not occur.
Causation Requirement
Prop. §1.267A-6(c)(1), Ex. 1(iv)

**Facts:**
- The facts are the same as in §1.267A-6(c)(1)(i), except that Country X has a pure territorial regime (that is, Country X only taxes income with a domestic source).

**Analysis:**
- Although US1’s payment is pursuant to a hybrid transaction and a $50x no-inclusion occurs with respect to FX, FX’s no-inclusion is not a result of the payment being made pursuant to the hybrid transaction.
  - This is because if Country X tax law were to treat the payment as interest, FX would include $0 in income and, consequently, the $50x no-inclusion would still occur.
Causation Requirement (cont’d)
Prop. §1.267A-6(c)(1), Ex. 1(iv)

Analysis:

– Accordingly, US1’s payment is not a disqualified hybrid amount. See §1.267A-2(a)(1)(ii).

– The result would be the same if Country X instead did not impose a corporate income tax.
Subpart F/GILTI Exception
Prop. §1.267A-6(c)(1), Ex. 7(i)-(ii)

Facts:

– US1 and FW hold 60% and 40%, respectively, of the interests of FX, and FX holds all the interests of FZ. Each of FX and FZ is a CFC. FX holds an instrument issued by FZ that it is treated as equity for Country X tax purposes and as indebtedness for U.S. tax purposes (the FX-FZ instrument). On date 1, FZ pays $100x to FX pursuant to the FX-FZ instrument. The amount is treated as a dividend for Country X tax purposes and as interest for U.S. tax purposes. In addition, pursuant to section 954(c)(6), the amount is not foreign personal holding company income of FX.

– Further, under section 951A, the payment is included in FX’s tested income. Lastly, Country X tax law provides an 80% participation exemption for dividends received from nonresident corporations and, as a result of such participation exemption, FX includes $20x of FZ’s payment in income.
Analysis:

– FZ, a CFC, is a specified party and thus a deduction for its $100x specified payment is subject to disallowance under section 267A. But for §1.267A-3(b), $80x of FZ’s payment would be a disqualified hybrid amount (such amount, a “tentative disqualified hybrid amount”). See §§1.267A-2(a) and 1.267A-3(b)(1).

– Pursuant to §1.267A-3(b), the tentative disqualified hybrid amount is reduced by $48x. See §1.267A-3(b)(4). The $48x is the tentative disqualified hybrid amount to the extent that it increases US1’s pro rata share of tested income with respect to FX under section 951A (calculated as $80x multiplied by 60%). See id.

– Accordingly, $32x of FZ’s payment ($80x less $48x) is a disqualified hybrid amount under §1.267A-2(a) and, as a result, $32x of the deduction is disallowed under §1.267A-1(b)(1).
Facts:

- FX holds all the interests of US1, and US1 holds all the interests of US2. On date 1, US1 and FX enter into a sale and repurchase transaction. Pursuant to the transaction, US1 transfers shares of preferred stock of US2 to FX in return for $1,000x paid from FX to US1, subject to a binding commitment of US1 to reacquire those shares on date 3 for an agreed price, which represents a repayment of the $1,000x plus a financing or time value of money return reduced by the amount of any distributions paid with respect to the preferred stock between dates 1 and 3 that are retained by FX. On date 2, US2 pays a $100x dividend on its preferred stock to FX. For Country X tax purposes, FX is treated as owning the US2
preferred stock and therefore is the beneficial owner of the dividend. For U.S. tax purposes, the transaction is treated as a loan from FX to US1 that is secured by the US2 preferred stock. Thus, for U.S. tax purposes, US1 is treated as owning the US2 preferred stock and is the beneficial owner of the dividend. In addition, for U.S. tax purposes, US1 is treated as paying $100x of interest to FX (an amount corresponding to the $100x dividend paid by US2 to FX). Further, the marginal tax rate imposed on ordinary income under Country X tax law is 25%. Moreover, instead of a participation exemption, Country X tax law provides its tax residents a credit for underlying foreign taxes paid by a non-resident corporation from which a dividend is received; with respect to the $100x dividend received by FX from US2, the credit is $10x.
Repo (cont’d)
Prop. §1.267A-6(c)(1), Ex. 2(i)-(ii)

Analysis:

– US1 is a specified party and thus a deduction for its $100x specified payment is subject to disallowance under section 267A. As described in paragraphs (c)(2)(ii)(A) through (D) of this section, $40x of the payment is a disqualified hybrid amount under the hybrid transaction rule of §1.267A-2(a) and, as a result, $40x of the deduction is disallowed under §1.267A-1(b)(1).

– Although US1’s $100x interest payment is not regarded under Country X tax law, a connected amount (US2’s dividend payment) is regarded and derived by FX under such tax law. Thus, FX is considered a specified recipient with respect to US1’s interest payment. See §1.267A-2(a)(3).
Repo (cont’d)
Prop. §1.267A-6(c)(1), Ex. 2(i)-(ii)

Analysis:

- US1’s payment is made pursuant to a hybrid transaction because a payment with respect to the sale and repurchase transaction is treated as interest for U.S. tax purposes but not for purposes of Country X tax law (the tax law of FX, a specified recipient that is related to US1), which does not regard the payment. See §1.267A-2(a)(2) and (f). Therefore, §1.267A-2(a) applies to the payment.
Analysis:

- For US1’s payment to be a disqualified hybrid amount under §1.267A-2(a), a no-inclusion must occur with respect to FX. See §1.267A-2(a)(1)(i). As a consequence of Country X tax law not regarding US1’s payment, FX includes $0 of the payment in income and therefore a $100x no-inclusion occurs with respect to FX. See §1.267A-3(a).

  However, FX includes $60x of a connected amount (US2’s dividend payment) in income, calculated as $100x (the amount of the dividend) less $40x (the portion of the connected amount that is not included in Country X due to the foreign tax credit, determined by dividing the amount of the credit, $10x, by 0.25, the tax rate in Country X). See id. Pursuant to §1.267A-2(a)(3), FX’s
inclusion in income with respect to the connected amount correspondingly reduces the amount of its no-inclusion with respect to US1’s payment. Therefore, for purposes of §1.267A-2(a), FX’s no-inclusion with respect to US1’s payment is considered to be $40x ($100x less $60x). See §1.267A-2(a)(3).
Analysis:

- Pursuant to §1.267A-2(a)(1)(ii), FX’s $40x no-inclusion gives rise to a disqualified hybrid amount to the extent that FX’s no-inclusion is a result of US1’s payment being made pursuant to the hybrid transaction. FX’s $40x no-inclusion is a result of US1’s payment being made pursuant to the hybrid transaction because, were the sale and repurchase transaction to be treated as a loan from FX to US1 for Country X tax purposes, FX would include US1’s $100x interest payment in income (because it would not be entitled to a foreign tax credit) and, consequently, the no-inclusion would not occur.
Disregarded Payment
Prop. §1.267A-2(b)

– Disregarded Payment – SP to extent:
  • SP is not regarded under tax law of payee TR/TB, and
  • If SP were so regarded, TR/TB would include SP in income

– Disregarded Payment can result from:
  • Transaction treated as between disregarded entity and owner
  • Transaction disregarded or offset under consolidation, fiscal unity, group relief, loss sharing, or similar regime

– DHA equals excess of:
  • Specified party’s Disregarded Payments for tax year, over
  • Specified party’s Dual Inclusion Income for tax year

– Dual Inclusion Income equals excess of:
  • Specified Party’s items of income or gain for US tax purposes to extent included in income of TR/TB, over
  • Specified Party’s items of deduction or loss for US tax purposes (excluding deductions for Disregarded Payments) to extent allowable under tax law of TR/TB
Disregarded Payment  
Prop. §1.267A-6(c)(1), Ex. 3(i)-(ii)  

**Facts:**  
- FX holds all the interests of US1. For Country X tax purposes, US1 is a disregarded entity of FX. During taxable year 1, US1 pays $100x to FX pursuant to a debt instrument. The amount is treated as interest for U.S. tax purposes but is disregarded for Country X tax purposes as a transaction involving a single taxpayer. During taxable year 1, US1’s only other items of income, gain, deduction, or loss are $125x of gross income and a $60x item of deductible expense. The $125x item of gross income is included in FX’s income, and the $60x item of deductible expense is allowable for Country X tax purposes.
Disregarded Payment
Prop. §1.267A-6(c)(1), Ex. 3(i)-(ii)

Analysis:

– US1 is a specified party and thus a deduction for its $100x specified payment is subject to disallowance under section 267A. As described in paragraphs (c)(3)(ii)(A) and (B) of this section, $35x of the payment is a disqualified hybrid amount under the disregarded payment rule of §1.267A-2(b) and, as a result, $35x of the deduction is disallowed under §1.267A-1(b)(1).
Disregarded Payment
Prop. §1.267A-6(c)(1), Ex. 3(i)-(ii)

Analysis:

– US1’s $100x payment is not regarded under the tax law of Country X (the tax law of FX, a related tax resident to which the payment is made) because under such tax law the payment is a disregarded transaction involving a single taxpayer. See §1.267A-2(b)(2) and (f). In addition, were the tax law of Country X to regard the payment (and treat it as interest), FX would include it in income. Therefore, the payment is a disregarded payment to which §1.267A-2(b) applies. See §1.267A-2(b)(2).
Disregarded Payment
Prop. §1.267A-6(c)(1), Ex. 3(i)-(ii)

Analysis:

- Under §1.267A-2(b)(1), the excess (if any) of US1’s disregarded payments for taxable year 1 ($100x) over its dual inclusion income for the taxable year is a disqualified hybrid amount. US1’s dual inclusion income for taxable year 1 is $65x, calculated as $125x (the amount of US1’s gross income that is included in FX’s income) less $60x (the amount of US1’s deductible expenses, other than deductions for disregarded payments, that are allowable for Country X tax purposes). See §1.267A-2(b)(3). Therefore, $35x is a disqualified hybrid amount ($100x less $65x). See §1.267A-2(b)(1).
Deemed Branch Payment
Prop. §1.267A-2(c)

– Deemed Branch Payment – Interest/royalties allowable as deduction in computing Business Profits of US Taxable Branch that is a US Permanent Establishment of treaty resident to extent amount is:
  • Deemed paid to Home Office (or other Branch of Home Office), and
  • Not included under Home Office’s tax law (or other Branch’s tax law)

– DHA equal to SP that is Deemed Branch Payment to extent that Home Office’s tax law provides exclusion/exemption of income attributable to Branch
Deemed Branch Payment
Prop. §1.267A-6(c)(1), Ex. 4(iii)

Facts:

– FX1 and FX2 are foreign corporations that are bodies corporate established in and tax residents of Country X. FX1 holds all the interests of FX2, and FX1 and FX2 file a consolidated return under Country X tax law. FX2 has a U.S. taxable branch (“USB”). Under Country X tax law, income attributable to USB is not included in income because Country X tax law exempts income attributable to a branch.

– Under an income tax treaty between the United States and Country X, USB is a U.S. permanent establishment and, for taxable year 1, $25x of royalties is allowable as a deduction in computing the business profits of USB and is deemed paid to FX2.
Deemed Branch Payment (cont’d)
Prop. §1.267A-6(c)(1), Ex. 4(iii)

Analysis:

- Under Country X tax law, the $25x is not regarded. Accordingly, the $25x is a specified payment that is a deemed branch payment. See §§1.267A-2(c)(2) and 1.267A-5(b)(3)(i)(B). The entire $25x is a disqualified hybrid amount for which a deduction is disallowed because the tax law of Country X provides an exclusion or exemption for income attributable to a branch. See §1.267A-2(c)(1).
Payment to Reverse Hybrid
Prop. §1.267A-2(d)

– Reverse Hybrid – Entity (domestic or foreign) that is:
  • Fiscally transparent under its tax law, and
  • Not fiscally transparent under tax law of an Investor in Entity

– DHA equal to SP to Reverse Hybrid to extent:
  • An Investor of Reverse Hybrid does not include SP, and
  • The Investor’s NI is result of payment being made to Reverse Hybrid
    – Causation requirement satisfied if NI would not result if Investor’s tax law treated Reverse Hybrid as fiscally transparent
Payment to Reverse Hybrid
Prop. §1.267A-6(c)(1), Ex. 5(i)-(ii)

**Facts:**

- FX holds all the interests of US1 and FY. FY is fiscally transparent for Country Y tax purposes but is not fiscally transparent for Country X tax purposes.
- On date 1, US1 pays $100x to FY. The amount is treated as interest for U.S. tax purposes and Country X tax purposes.
Analysis:

- US1 is a specified party and thus a deduction for its $100x specified payment is subject to disallowance under section 267A.
- US1’s payment is made to a reverse hybrid because FY is fiscally transparent under the tax law of Country Y (the tax law of the country in which it is established) but is not fiscally transparent under the tax law of Country X (the tax law of FX, an investor that is related to US1). See §1.267A-2(d)(2) and (f). Therefore, §1.267A-2(d) applies to the payment.
Payment to Reverse Hybrid (cont’d)
Prop. §1.267A-6(c)(1), Ex. 5(i)-(ii)

Analysis:

- For US1’s payment to be a disqualified hybrid amount under §1.267A-2(d), a no-inclusion must occur with respect to FX. See §1.267A-2(d)(1)(i). Because FX does not derive the $100x payment under Country X tax law (as FY is not fiscally transparent under such tax law), FX includes $0 of the payment in income and therefore a $100x no-inclusion occurs with respect to FX. See §1.267A-3(a).

Country X: FY is not fiscally transparent
Country Y: FY is fiscally transparent
Payment to Reverse Hybrid (cont’d)
Prop. §1.267A-6(c)(1), Ex. 5(i)-(ii)

Analysis:

— Pursuant to §1.267A-2(d)(1)(ii), FX’s $100x no-inclusion gives rise to a disqualified hybrid amount to the extent that it is a result of US1’s payment being made to the reverse hybrid. FX’s $100x no-inclusion is a result of the payment being made to the reverse hybrid because, were FY to be treated as fiscally transparent for Country X tax purposes, FX would include $100x in income and, consequently, the no-inclusion would not occur.
Causation Requirement
Prop. §1.267A-6(c)(1), Ex. 5(v)

Facts:

- The facts are the same as in §1.267A-6(c)(5)(i), except that the $100x is viewed as a royalty for U.S. tax purposes and Country X tax purposes, and Country X tax law contains a patent box regime that provides an 80% deduction with respect to certain royalty income.
Causation Requirement (cont’d)
Prop. §1.267A-6(c)(1), Ex. 5(v)

Analysis:

– If the payment would qualify for the Country X patent box deduction were FY to be treated as fiscally transparent for Country X tax purposes, then only $20x of FX’s $100x no-inclusion would be the result of the payment being paid to a reverse hybrid, calculated as $100x (the no-inclusion with respect to FX that actually occurs) less $80x (the no-inclusion with respect to FX that would occur if FY were to be treated as fiscally transparent for Country X tax purposes). See §1.267A-3(a).

– Accordingly, in such a case, only $20x of US1’s payment would be a disqualified hybrid amount.
Branch Mismatch Payment
Prop. §1.267A-2(e)

- Branch Mismatch Payment – SP to extent that:
  • SP treated as income attributable to Branch of a Home Office under Home Office’s tax law, and
  • Either:
    – Branch is not a Taxable Branch, or
    – SP is not attributable to Branch under Branch’s tax law

- DHA equal to SP that is Branch Mismatch Payment to extent that:
  • Home Office’s tax law treats SP as attributable to Branch,
  • Home Office does not include SP, and
  • NI is result of SP being a Branch Mismatch Payment
    – Causation requirement satisfied if NI would not occur if Home Office were to treat SP as not attributable to Branch
Facts:

– FX holds all the interests of US1 and FZ. FZ owns BB, a Country B branch that gives rise to a taxable presence in Country B under Country Z tax law but not under Country B tax law.

– On date 1, US1 pays $50x to FZ. The amount is treated as a royalty for U.S. tax purposes and Country Z tax purposes. Under Country Z tax law, the amount is treated as income attributable to BB and, as a consequence of Country Z tax law exempting income attributable to a branch, is excluded from FZ’s income.
Branch Mismatch Payment (cont’d)
Prop. §1.267A-6(c)(1), Ex. 6(i)-(ii)

Analysis:

– US1 is a specified party and thus a deduction for its $50x specified payment is subject to disallowance under section 267A. As described in paragraphs (c)(6)(ii)(A) through (C) of this section, the entire $50x payment is a disqualified hybrid amount under the branch mismatch rule of §1.267A-2(e) and, as a result, a deduction for the payment is disallowed under §1.267A-1(b)(1).
Branch Mismatch Payment (cont’d)
Prop. §1.267A-6(c)(1), Ex. 6(i)-(ii)

Analysis:

– US1’s payment is a branch mismatch payment because under Country Z tax law (the tax law of FZ, a home office that is related to US1) the payment is treated as income attributable to BB, and BB is not a taxable branch (that is, under Country B tax law, BB does not give rise to a taxable presence). See §1.267A-2(e)(2) and (f). Therefore, §1.267A-2(e) applies to the payment. The result would be the same if instead BB were a taxable branch and, under Country B tax law, US1’s payment were treated as income attributable to FZ and not BB. See §1.267A-2(e)(2).
Branch Mismatch Payment (cont’d)
Prop. §1.267A-6(c)(1), Ex. 6(i)-(ii)

Analysis:

– For US1’s payment to be a disqualified hybrid amount under §1.267A-2(e), a no-inclusion must occur with respect to FZ. See §1.267A-2(e)(1)(i). As a consequence of the Country Z branch exemption, FZ includes $0 of the payment in income and therefore a $50x no-inclusion occurs with respect to FZ. See §1.267A-3(a).

**Diagram:**
- US1
- FX
- FZ
- BB

**Country Z:** BB is branch; income of branch not included

**Country B:** BB is not taxable presence

$50 royalty
Branch Mismatch Payment (cont’d)
Prop. §1.267A-6(c)(1), Ex. 6(i)-(ii)

Analysis:

- Pursuant to §1.267A-2(e)(1)(ii), FZ’s $50x no-inclusion gives rise to a disqualified hybrid amount to the extent that it is a result of US1’s payment being a branch mismatch payment. FZ’s $50x no-inclusion is a result of the payment being a branch mismatch payment because, were the payment to not be treated as income attributable to BB for Country Z tax purposes, FZ would include $50x in income and, consequently, the no-inclusion would not occur.
Disqualified Imported Mismatch Amounts
DIMA
Prop. §1.267A-4(b)

– DIMA equal to SP to extent that:
  • SP is not a DHA (i.e., DHA regime takes priority over DIMA regime), and
  • Income attributable to SP is directly or indirectly offset by a Hybrid Deduction incurred by TR/TB that is related to Specified Party (i.e., relatedness requirement applies)

– Hybrid Deduction – A deduction to extent:
  • Allowed to TR/TB that is not Specified Party for interest/royalties paid or accrued; both determinations made under TR/TB’s tax law, and
  • Would be disallowed if TR/TB’s tax law contained rules similar to Prop. §§ 1.267A-1 to -3 and -5 (i.e., DHA rules)

– Special rule treats deduction with respect to equity (e.g., notional interest deduction) as Hybrid Deduction
Offset Requirement
Prop. §1.267A-4(c)

– Hybrid Deduction directly or indirectly offsets income attributable to payment to extent that payment directly or indirectly funds Hybrid Deduction

– Offset ordering rules
  • First, Hybrid Deduction offsets income attributable to factually related payment (i.e., payment made pursuant to same plan under which Hybrid Deduction incurred)
  • Second, Hybrid Deduction offsets income attributable to payment that directly funds Hybrid Deduction
  • Third, Hybrid Deduction offsets income attributable to payment that indirectly funds Hybrid Deduction
Offset Requirement (cont’d)
Prop. §1.267A-4(c)

– Funding rules
  • Payment directly funds Hybrid Deduction to extent payee incurs Hybrid Deduction
  • Payment indirectly funds Hybrid Deduction to extent payee is allocated Hybrid Deduction, which generally occurs if payee directly or indirectly makes a payment that is deductible under its tax law to TR/TB that incurs the Hybrid Deduction

– Special offset rule that can reduce the amount treated as DIMA if:
  • Tax law of TR/TB contains hybrid mismatch rules and
  • Under provision substantially similar to DIMA rules, TR/TB is denied deduction under its tax law
Facts:

- FX holds all the interests of FW, and FW holds all the interests of US1. FX holds an instrument issued by FW that is treated as equity for Country X tax purposes and indebtedness for Country W tax purposes (the FX-FW instrument).

- FW holds an instrument issued by US1 that is treated as indebtedness for Country W and U.S. tax purposes (the FW-US1 instrument).

- In accounting period 1, FW pays $100x to FX pursuant to the FX-FW instrument. The amount is treated as an excludible dividend for Country X tax purposes (by reason of the Country X participation exemption) and as interest for Country W tax purposes.
Facts:

— Also in accounting period 1, US1 pays $100x to FW pursuant to the FW-US1 instrument. The amount is treated as interest for Country W and U.S. tax purposes and is included in FW’s income. The FX-FW instrument was not entered into pursuant to the same plan or series of related transactions pursuant to which the FW-US1 instrument was entered into.
Analysis:

- US1 is a specified party and thus a deduction for its $100x specified payment is subject to disallowance under section 267A. The $100x payment is not a disqualified hybrid amount. In addition, FW’s $100x deduction is a hybrid deduction because it is a deduction allowed to FW that results from an amount paid that is interest under Country W tax law, and were Country X law to have rules substantially similar to those under §§1.267A-1 through 1.267A-3 and 1.267A-5, a deduction for the payment would be disallowed (because under such rules the payment would be pursuant to a hybrid transaction and FX’s no-inclusion would be a result of the hybrid transaction). See §§1.267A-2(a) and 1.267A-4(b).
Imported Mismatch Rule (cont’d)
Prop. §1.267A-6(c)(1), Ex. 8(i)-(ii)

Analysis:

- Under §1.267A-4(a), US1’s payment is an imported mismatch payment, US1 is an imported mismatch payer, and FW (the tax resident that includes the imported mismatch payment in income) is an imported mismatch payee. The imported mismatch payment is a disqualified imported mismatch amount to the extent that the income attributable to the payment is directly or indirectly offset by the hybrid deduction incurred by FX (a tax resident that is related to US1). See §1.267A-4(a).
Prop. §1.267A-6(c)(1), Ex. 8(i)-(ii)

Analysis:

– Under §1.267A-4(c)(1), the $100x hybrid deduction directly or indirectly offsets the income attributable to US1’s imported mismatch payment to the extent that the payment directly or indirectly funds the hybrid deduction. The entire $100x of US1’s payment directly funds the hybrid deduction because FW (the imported mismatch payee) incurs at least that amount of the hybrid deduction. See §1.267A-4(c)(3)(i).

– Accordingly, the entire $100x payment is a disqualified imported mismatch amount under §1.267A-4(a) and, as a result, a deduction for the payment is disallowed under §1.267A-1(b)(2).
Imported Mismatch Rule Cont’d
Prop. §1.267A-6(c)(1), Ex. 8(iv)

Facts:

– The facts are the same as in paragraph (c)(8)(i) of this section, except that the FX-FW instrument does not exist and thus FW does not pay any amounts to FX during accounting period 1.

– However, during accounting period 1, FW is allowed a $100x notional interest deduction with respect to its equity under Country W tax law.

Analysis:

– Pursuant to §1.267A-4(b), FW’s notional interest deduction is a hybrid deduction. The results are the same as in [§1.267A-6(c)(8)(ii)]. That is, the income attributable to US1’s $100x imported mismatch payment is offset by FW’s hybrid deduction for the reasons described in [§1.267A-6(c)(8)(ii)].

– As a result, a deduction for the payment is disallowed under §1.267A-1(b)(2).
Imported Mismatch Rule Cont’d
Prop. §1.267A-6(c)(1), Ex. 8(v)

Facts:
– The facts are the same as in [§1.267A-6(c)(8)(i)], except that the tax law of Country W contains hybrid mismatch rules and under such rules FW is not allowed a deduction for the $100x that it pays to FX on the FX-FW instrument.

Analysis:
– The $100x paid by FW therefore does not give rise to a hybrid deduction. See §1.267A-4(b).
– Accordingly, because the income attributable to US1’s payment is not directly or indirectly offset by a hybrid deduction, the payment is not a disqualified imported mismatch amount.
– Therefore, a deduction for the payment is not disallowed under §1.267A-2(b)(2).
Specific Effective Dates
Prop. §1.267A-7

– Following rules apply to tax years beginning after 12/31/17:
  • Payment pursuant to Hybrid Transaction
  • Payment to Reverse Hybrid

– Following rules apply to tax years beginning on or after date proposed regulations filed in Federal Register:
  • Disregarded Payment
  • Deemed Branch Payment
  • Branch Mismatch Payment
  • DIMA
Hybrid Dividends
Hybrid Dividends

Introduction

– Under § 245A(e),
  • hybrid dividends are not eligible for the § 245A DRD
  • hybrid dividends between CFCs (“tiered hybrid dividends”) are treated as subpart F income (notwithstanding § 954(c))
  • hybrid dividends (including tiered hybrid dividends) do not give rise to FTCs or deductions for taxes on the underlying earnings

– A hybrid dividend is any amount received from a CFC that would otherwise be eligible for the § 245A DRD if the CFC received a deduction (or other tax benefit) therefor
Hybrid Dividends

Scope and Effective Date of § 245A Proposed Regulations

– Define hybrid dividend to include amounts for which the CFC or a related person is allowed a deduction or other tax benefit
– Define “hybrid deduction” to include exemptions, exclusions, and credits equivalent to deductions
– Introduce “hybrid deduction accounts” (and successor rules) to track hybrid deductions allocated to each share of CFC stock with respect to which § 245A eligible dividends could be distributed
– Clarify that § 245A(e) does not apply to distributions of previously-taxed E&P to U.S. shareholders or from one CFC to another
– Provide that gain recharacterized as dividends under § 964(e) or § 1248 may be treated as hybrid dividends subject to § 245A(e)
– Provide anti-avoidance rule that allows the IRS to make “appropriate adjustments” if a transaction or arrangement has a principal purpose of avoiding the purposes of the regulations
– Would be effective for distributions made after December 31, 2017
Hybrid Dividends

Observations on § 245A Proposed Regulations

– Expand the statutory definition of hybrid dividend
– Limit hybrid deductions to those that are “allowed” under foreign tax law, which prevents those that are disallowed under foreign hybrid mismatch rules from triggering § 245A(e)
– Adopt a “connection” approach to define hybrid deductions—hybrid deductions must “relate to or result from” an amount paid, accrued, or distributed with respect to an instrument of the CFC treated as stock for U.S. tax purposes
  • Ensures that § 245A(e) applies even if the dividend and the hybrid deduction do not arise pursuant to the same payment or in the same tax year for purposes of U.S. and foreign law
– Deny benefits of § 964(e)(4) for § 964(e)(1) dividend treated as tiered hybrid dividend
– Limit taxpayers’ ability to restructure or recapitalize stock in a manner that removes the § 245A(e) taint
Hybrid Dividends

**Hybrid Dividend** (§ 1.245A(e)-1(b)(2))

- An amount received by a U.S. shareholder from a CFC that, but for § 245A(e) and the proposed regulations, would be eligible for the § 245A DRD, to the extent of the sum of the U.S. shareholder’s hybrid deduction accounts for each share of the CFC’s stock
- Multiple dividends from the same CFC are determined to be hybrid dividends (or not) based on the order in which they are received

**Tiered Hybrid Dividend** (§ 1.245A(e)-1(c)(2))

- An amount received by one CFC from another to the extent such amount would be a hybrid dividend if the receiving CFC were a domestic corporation
Hybrid Dividends

Hybrid Deduction (§ 1.245A(e)-1(d)(2))

– Any deduction or other tax benefit (such as an exemption, exclusion, or credit equivalent to a deduction) allowed to the CFC or a related person under a “relevant foreign tax law” if it relates to or results from an amount paid, accrued, or distributed with respect to an instrument issued by the CFC and treated as stock for U.S. tax purposes
  • Relatedness is determined under § 954(d)(3)
  • Relevant foreign tax law means any income, war profits, or excess profits tax regime that applies to a CFC, other than a foreign anti-deferral regime under which the CFC’s owner is subject to taxation

– Includes only deductions or other tax benefits allowed with respect to a taxable year under the relevant foreign tax law beginning after December 31, 2017
Hybrid Dividends

Hybrid Deduction (cont’d)

– Intended to capture deductions or other tax benefits only to the extent they cause earnings that funded the distribution to be excluded from income or otherwise not subject to tax under the CFC’s tax law

– Examples include interest deductions, dividends paid deductions, notional interest deductions, and refunds or credits to the shareholder of taxes paid by a CFC on earnings that funded the distribution, but only if the distribution is not taxable to the shareholder under the CFC’s tax law (through inclusion or withholding)
Hybrid Dividends

Hybrid Deduction Account (§ 1.245A(e)-1(d))

- Tracks hybrid deductions allocated to each share of a CFC’s stock held by a “specified owner”
  - A specified owner 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 the upper-tier CFC were a domestic corporation, in each case, that owns the CFC share directly or indirectly through a partnership, trust, or estate

- Hybrid deductions are generally allocated to shares to the extent they relate to an amount paid, accrued, or distributed by the CFC with respect to the share; deductions with respect to equity are allocated to each share pro rata based on the value of the shares

- Maintained in the CFC’s functional currency (taking into account foreign currency gain or loss under foreign law) and adjusted at the close of the CFC’s taxable year first by adding hybrid deductions allocable to the share for the year and then by subtracting hybrid and tiered hybrid dividends distributed during the year
Hybrid Dividends

Hybrid Deduction Account (cont’d)

- An acquirer of CFC stock inherits the transferor’s hybrid deduction account (HDA) unless the acquirer is not a specified owner immediately after the acquisition, in which case the HDA is eliminated.

- If shareholder exchanges its CFC stock for new CFC stock in certain tax free reorganizations or recapitalizations, its HDA is attributed to the shares received, unless the shareholder is not a specified owner immediately after the acquisition, in which case the HDA is eliminated.

- Upon the § 332 liquidation of a lower-tier CFC into an upper-tier CFC, each HDA with respect to shares of the upper-tier CFC is increased pro rata by the sum of the HDAs with respect to shares of the liquidating CFC.
Share A and Share B are equal in value.

During Year 1, under Country X tax law, FX accrues $80x of interest with respect to Share A and is allowed a deduction therefor.

During Year 2, FX distributes $30x on Share A and $30x on Share B. Each distribution is treated for U.S. purposes as a dividend eligible for the § 245A DRD.

No deduction is allowed to FX under Country X tax law for either distribution.
Hybrid Dividends

Prop. Regs. § 245A(e)-1(g), Ex. 1(i) (cont’d)

At the end of Year 2, the sum of US1’s HDAs with respect to its FX shares exceeds the sum of the distributions on the FX shares. § 245A(e) applies to deny the § 245A DRD for both distributions. US1’s HDA with respect to Share A is reduced by $60x to $20x.

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<tr>
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<th>HDAs</th>
<th>Distributions</th>
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<tr>
<td></td>
<td>Year 1</td>
<td>Year 2</td>
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<tr>
<td>Share A</td>
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<td>Total</td>
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Facts are the same as in Ex. 1(i), except that in each of Year 1 and Year 2, FX is allowed $10 in notional interest deductions with respect to Share B.

In addition, during Year 2, FX distributes $47.5x on Share A and $47.5x on Share B. Each distribution is treated for U.S. purposes as a dividend eligible for the § 245A DRD.

No deduction is allowed to FX under Country X tax law for either distribution.
Hybrid Dividends

Prop. Regs. § 245A(e)-1(g), Ex. 1(ii) (cont’d)

### Table: HDAs and Distributions

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<tr>
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<td>Year 1</td>
<td>Year 2</td>
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<tr>
<td>Share A</td>
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<td>85+5</td>
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<td>Share B</td>
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At the end of Year 2, the sum of US1’s HDAs with respect to its FX shares exceeds the sum of the distributions on the FX shares.

§ 245A(e) applies to deny the § 245A DRD for both distributions.

US1’s HDA for Share A is reduced to $4.5x and US1’s HDA for Share B is reduced to $0.5x.
Facts are the same as in Ex. 1(i), except that during Year 1, under Country Z tax law, FX accrues $80x of interest with respect to Share A and is allowed a deduction therefor with respect to its Country Z branch income.

During Year 2, FX distributes $30x on Share A and $30x on Share B. Each distribution is treated for U.S. purposes as a dividend eligible for the § 245A DRD.

No deduction is allowed to FX under Country Z or Country X tax law for either distribution.
Hybrid Dividends

Prop. Regs. § 245A(e)-1(g), Ex. 1(iii) (cont’d)

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<tr>
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<td>Total</td>
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At the end of Year 2, the sum of US1’s HDAs with respect to its FX shares exceeds the sum of the distributions on the FX shares. § 245A(e) applies to deny the § 245A DRD for both distributions. US1’s HDA with respect to Share A is reduced by $60x to $20x.
Hybrid Dividends

Prop. Regs. § 245A(e)-1(g), Ex. 2(i)

All 100 FZ Shares have equal value and Country Z’s tax rate is 20%

During Year 2, FZ distributes $10x/FZ Share ($1000x) which is treated as a dividend for both U.S. and Country Z purposes and is not deductible by FZ under County Z tax law.

If FX were a domestic corporation, the dividend would be eligible for the § 245A DRD.

Under Country Z tax law, FX is allowed a refundable tax credit of 75% of the corporate income tax paid by FZ on the earnings funding the distribution ($1250x × 20% × 75% = $187.5x).

FX is not subject to withholding (or any other tax) on the dividend.
The HDA of FX for its FZ Shares at the end of Year 2
is $937.5x ($9.375x/share x 100 FZ Shares)

FX’s $187.5x refundable tax credit is equal to a
deduction of $937.5x ($187.5x/20%)

It is a hybrid deduction of FZ because Country
Z tax law is a relevant foreign tax law, FX is
related to FZ under § 954(d)(3), the deduction
relates to or results from the dividend on the
FZ Shares, and the deduction causes the
earnings that funded the distribution to be
excluded from income under Country Z tax law

Thus, 937.5x of the $1000x distribution is a tiered
hybrid dividend treated as subpart F income of FX
and includible by US1
The facts are the same as in Ex. 2, (i), except that, under Country Z tax law, the $1000x dividend is subject to a 30% gross basis w/h tax (i.e., $300x) that is offset by the $187.5x refundable tax credit. 

The $187.5X refundable tax credit is not a hybrid deduction because the w/h tax exceeds the credit. Thus, the $1000x dividend is not a tiered hybrid dividend treated as subpart F income at FX.
Questions?