US Activities of Foreigners & Tax Treaties

267A Update

Pamela Endreny | Skadden, Arps, Slate, Meagher & Flom LLP
Sam Kaywood | Alston & Bird LLP
Jeffrey L. Rubinger | Bilzin Sumberg
Agenda

(1) Overview of Old Anti-Hybrid Rules
(2) §267A Anti-Hybrid Rules
(3) §245A Anti-Hybrid Rules
Overview of Old Anti-Hybrid Rules
Reg. §1.894-1(d)(1) Hybrids

- Treaty benefits denied for items of income subject to withholding (§871(a), §881(a), §1441, etc.) unless the item of income is “derived by a resident of the applicable treaty jurisdiction.”

- The item of income can be “derived” by the entity, the interest holder or both of them.

- An item of income is derived by the entity only if the entity is not “fiscally transparent” under the laws of the entity’s jurisdiction with respect to that item.
Reg. §1.894-1(d)(1) Hybrids

• An item of income is derived by the interest holder if:
  • The interest holder itself is not fiscally transparent in its jurisdiction; and
  • The entity is fiscally transparent under the laws of the interest holder’s jurisdiction.

• Focus on whether:
  • The entity’s jurisdiction taxes the income;
  • The interest holder’s jurisdiction taxes the income;
  • Both jurisdictions tax the income; or
  • Neither jurisdiction taxes the income.
Introduction re: Hybrids

- **X Treaty Applies**
  - Y = Transparent
  - X = Transparent
  - X Treaty Applies

- **No Treaty benefits**
  - Y = Transparent
  - X = Regarded

- **Both Treaties Apply**
  - Y = Regarded
  - X = Transparent
  - Both Treaties Apply

- **Y Treaty Applies**
  - Y = Regarded
  - X = Regarded
  - Y Treaty Applies
Domestic Reverse Hybrids – 1.894-1(d)(2)

- Payments by domestic reverse hybrids recharacterized as dividends.
- No interest deduction.
- Apply treaty rate on dividends.
Permitted Under DRH Regulations

- Interest paid to Bank potentially deductible in jurisdiction of Foreign Interest Holder and the US.
- Most foreign countries now disallow the second deduction.
§267A Anti-Hybrid Rules – The Statute
§267A Anti-Hybrid Rules – The Statute

• No deduction allowed for
  • “Disqualified related party amount” paid or accrued
  • If either
    • Pursuant to a “hybrid transaction” or
    • By or to a “hybrid entity”
  • “Disqualified related party amount”
    • Interest or royalty
    • Paid or accrued to a “related party” (see §954(d)(3), as modified)
    • Such amount is not included in the income of (or deductible by) the related party under the tax laws of which such related party is a resident for tax purposes or is subject to tax (“ROSTT Country”)

Excludes payment to the extent included in income of a CFC’s US shareholder under §951(a)
§267A Anti-Hybrid Rules – The Statute

- Hybrid transaction
  - Transaction, series of transactions, agreement, or instrument, with respect to which
  - One or more payments are
    - Treated as interest or royalties under US tax law, and
    - Treated otherwise under the tax law of the recipient’s ROSTT Country
- Hybrid entity
  - Fiscally transparent under US tax law, but not so treated under the tax law of the entity’s ROSTT Country, or
  - Fiscally transparent under “such” tax law, but not so treated for US tax purposes
§267A Anti-Hybrid Rules – The Statute

- Treasury to issue guidance as may be necessary or appropriate, including guidance addressing:
  - Conduit arrangements
  - Branches or domestic entities
  - Certain structured transactions
  - Treatment of a tax preference as an exclusion from income if reduces generally applicable tax rate by 25% or more
  - Treatment of a participation exemption as an exclusion or deduction
  - The tax residence of an entity that is otherwise considered a tax resident of more than one country, or no country
- Exceptions for:
  - Cases where disqualified related party amount is taxed by country other than related party’s residence country,
  - Other cases that do not present risk of eroding US tax base
- Effective for taxable years beginning after 2017
§267A Anti-Hybrid Rules – Observations

- Not expressly limited to any particular class of persons
- Incoherent with respect to any entity with no ROSTT Country
- In contrast with BEAT and old earnings-stripping rules, no exception for payments subject to full 30% withholding tax
§267A Anti-Hybrid Rules – Proposed Regulations
Basic Rules – Deduction Disallowance

- Deduction disallowance only applies to “specified party”
  - US tax resident
  - CFC (with direct or indirect US shareholders)
  - Taxable branch

- Deduction disallowed for any interest or royalty paid or accrued with respect to the specified party (“specified payment”) to the extent such payment is:
  1. A disqualified hybrid amount (“DHA”);
  2. A disqualified imported mismatch amount (“DIMA”); or
  3. One to which the anti-avoidance rule of §1.267A-5(b)(6) applies.

- $50,000 de minimis exception (applied on a group wide basis)
Basic Rules – What is a DHA?

• If a specified payment is made pursuant to a hybrid transaction, the payment is a DHA to the extent that –
  • A “specified recipient” does not include the payment in income (a “no-inclusion”)
  • The specified recipient’s no inclusion is a result of the payment being made pursuant to a “hybrid transaction”
  • “Specified recipient” = any tax resident that derives the payment under its law or a taxable branch to which the payment is attributable under its tax law
  • Apply the “fiscally transparent” rules of §1.894-1(d)(1)
  • These can be more than one specified recipient with respect to a specified payment.

• Specified recipient (and certain others) only taken into account if
  – related to the specified party, or
  – party to a structured arrangement
Basic Rules – What is a DHA

- Hybrid Transaction
  - Any transaction, series of transactions, agreement or instrument where one or more payments are treated as interest or royalties for US tax purposes but not for purposes of the tax law of a specified recipient of the payment.
  - *E.g.*, Instrument classified as debt for US tax purposes but as equity under tax laws of specified recipient
  - Includes a transaction where the specified recipient recognizes the payment under its tax laws in a taxable year that ends more than 36 months after the end of the taxable year in which the specified party is otherwise allowed a deduction under US tax law
Special Rules for DHAs

- Repos
- Disregarded Payments in excess of dual inclusion income Deemed Branch Payments
- Payments to reverse hybrids
- Branch mismatch payments
Reduction of Tentative DHA

• Any amount that is otherwise a DHA (a “tentative DHA”) is reduced to the extent such amount:
  • Is included in the income of a specified recipient that is a tax resident of the US or a US taxable branch.
  • Is received by a CFC, and includible in the gross income of a US shareholder under §951(a)(1), to the extent either the US shareholder or another person taking into account such income is a US tax resident.
  • Increases a US shareholder’s pro rata share of tested income, or decreases a US shareholder’s pro rata share of tested loss, under §951A, to the extent either the US shareholder or another person taking into account such income is a US tax resident.
§267A Anti-Hybrid Rules – Examples
Example 1(i) – Hybrid Instrument

- $50 payment is interest for US tax purposes and an excludable dividend for Country X purposes.

Results:
- Payment made pursuant to a hybrid transaction.
- A “no-inclusion” occurs because of the participation exemption in Country X.
- Payment is a non-deductible DHA.
Example 1(iv) – Hybrid Instrument, Preferential Rate

- Same facts as Ex. 1(i), except:
  - No participation exemption
  - FX is taxed at 20% on ordinary income and at 4% on dividend income
  - FX would be taxed at 20% if the specified payment were interest under Country X law

Results:
- Amount of no-inclusion is backed into as follows

Inclusion

\[
\frac{\text{Preferential rate}}{\text{Ordinary Rate}} \times \frac{\text{Specified Payment}}{\text{Payment}} = \text{Inclusion}
\]

\[
\frac{4\%}{20\%} \times \$50 = \$10
\]

No-Inclusion

\[
\$50 - \$10 = \$40 = \text{Disqualified hybrid amount}
\]
Example 1(v) – Pure Territorial System, No-Inclusion Not the Result of Hybridity

- Same facts as Ex. 1(i), except Country X has a pure territorial regime and taxes neither foreign source dividends nor foreign source interest.

**Results:**

- Due to the Country X pure territorial regime, FX would exclude the $50 specified payment even if it were interest.
- Since, the no-inclusion would exist even if the specified payment were interest, the no-inclusion is not a result of the payment being pursuant to a hybrid transaction.
- Thus the payment is not a DHA.
- Same is true if Country X does not impose a corporate tax of any kind.
- *See Prop. Reg. §1.267A-2(a)(1)(ii).*
Example 1(iii) – Multiple Specified Recipients

• Same facts as in Ex. 1(i) except:
  • FZ owns US1
  • FX owns FZ
  • The hybrid instrument is held by FZ, not FX
  • FZ is nontransparent for Country Z purposes
  • FZ is transparent for Country X purposes, and Country X excludes the payment from income.
  • Payment treated as interest for Country Z purposes.

Results:
• Both FX and FZ are specified recipients.
• Since a no-inclusion occurs with respect to one specified recipient, FX, the payment is a DHA.
• Does not matter if FZ is taxed at a high rate in Country Z.
• Treasury considered and rejected exception from DHA status for payment included in income of at least one of the specified recipients, as inclusion may be at a low rate; however, if tax rate high enough policy concern should not apply
Example 2(i): Repo Transaction

- FX pays $1,000 to US1 for US2 preferred stock from US1, in transaction treated as loan for US tax purposes, and as a sale/repurchase for Country X tax purposes
- US2 pays dividend of $100
- For US tax purposes, US1 considered to receive dividend of $100 and to pay interest of $100
- For Country X tax purposes, dividend from US2 taxed at regular rate of 25%, but FX allowed an indirect FTC of $10, so FX tax reduced from $25 to $15
- FX tentatively has a no-inclusion of $100, but this is reduced by the portion of the connected amount considered to have been included in income, i.e., $60
- $40 is a nondeductible DHA
Example 2(iii): Structured Repo

- Same facts as Ex. 2(i), but FX is a bank and unrelated to US1 and the REPO is a “structured arrangement”
- Even though FX is unrelated to US1, because it is party to the structured arrangement, FX is still a specified recipient
- Same result as in Ex. 2(i)
Disregarded Payments

- The excess of a specified party’s “disregarded payments” over its “dual-inclusion income” is a DHA.
- A “disregarded payment” is a specified payment to the extent that, under the tax law of a tax resident or taxable branch to which the payment is made, the payment is not regarded and were the payment regarded (e.g., treated as interest or a royalty) under such tax law, the tax resident or taxable branch would include the payment in income.
Disregarded Payments

• Dual-inclusion income is the excess of:
  (i) The specified party’s items of income or gain for US tax purposes that are also included in income of the tax resident or taxable branch to which the disregarded payments are made under the tax law of the tax resident or taxable branch, over
  (ii) The specified party’s items of deduction or loss for US tax purposes (other than for disregarded payments) that are allowable (or have been or will be allowable no more than 36 months after the end of the specified party’s taxable year) under the tax law of such tax resident or taxable branch.
Example 3(i) – Disregarded Payment

- US1 is regarded for US tax purposes but disregarded for Country X purposes
- US1 has $125 of income and $60 of deductible payments from and to third parties
- FX must include $125 - $60 = $65 in income for Country X purposes, so $65 of dual inclusion income

Results:
- DHA = specified payment – dual inclusion income
- DHA = $100 - $65 = $35

Overlap
- Disallowed under domestic reverse hybrid regulations?
Example 3(iii) – Non-Dual Inclusion Income Arising From Hybrid Transaction

- Country X disregards the $100 payment by US1 to FX (as in the prior example).
- Since US1 is disregarded for Country X purposes, FX is treated as receiving the $80 payment from FZ to US1.

Results:

**US1 – FZ Loan**
- The US1 – FZ loan is a hybrid transaction.
- There is an $80 no-inclusion arising from that hybrid transaction.
- However, since US1, the specified recipient is a US tax resident and includes the income, the tentative DHA of $80 is reduced by $80, so no portion of the $80 is a DHA.

**FX – US1 Loan**
- As in the prior example, the $100 specified payment arises due to a hybrid transaction.
- However, there is no dual-inclusion at the level of FX (the participation exemption applies to the $80 payment received from FZ).
- Thus, all $100 of the specified payment to FX is a DHA.
Example 4 (i) – Disregarded Payments Allocated to a US Branch

- FX1 & FX2 file a consolidated return in Country X
- FX2 has a US taxable branch, USB
- Thus, the $50 of interest paid by FX2 to FS1 is eliminated for Country X purposes
- FX2 pays $100 of interest to an unrelated bank
- FX Group excludes the $200 of income earned by USB due to a territorial system
- $200 of income is ECI and $75 of the $150 of interest is allocated against ECI under Reg. §1.882-5

Results:
- USB is treated as paying $75 of interest, which is a specified payment subject to possible disallowance
- Must determine the amount of disregarded interest deemed paid by USB to FX1, as that amount is a DHA

\[
DHA = \frac{\$50}{\$100 + \$50} \times \$75 = \$25
\]

- Potential reduction of tentative DHA for dual inclusion income, but here there is none
Example 4 (iii) – Deemed Branch Payment

- FX and USB are entitled to the benefits of a tax treaty
- The treaty imputes a royalty deduction of $25 to USB in calculating income attributable to the permanent establishment
- As in Ex. 4(i), Country X excludes USB’s $200 of ECI under territorial regime

Results:
- The $25 is a specified payment that is a DHA because it is excluded from income in Country X
Payments to Reverse Hybrids

- If a specified payment is made to a reverse hybrid, the payment is a DHA to the extent of:
  - An investor has a no-inclusion.
  - The no-inclusion is a result of the reverse hybrid status of the entity, i.e., the non-inclusion would not occur if the investor’s tax law treated the reverse hybrid as fiscally transparent (and treated the payment as interest or a royalty, as applicable).
- A “reverse hybrid” is an entity (US or foreign) that is fiscally transparent where it is organized but not fiscally transparent under the tax laws of an investor.
Example 5(i) – Payment to a Reverse Hybrid

- FY is a reverse hybrid – transparent for Country Y purposes and regarded for Country X purposes.
- Country X does not tax FX on the specified payment under any anti-deferral regime

Results
- Specified payment of $100 to FY is a DHA
- All of the payment is no-inclusion income
- Basically, the payment is not taxed in either Country X or Country Y due to the reverse hybrid status of FY
- Same result would apply if the payment were made to FV
- Payment not a DHA if it is fully taxed in Country X under a CFC regime (See Ex. 5(iii))

Overlap
- No treaty benefits due to Reg. §1.894–1(d)(1)
- As noted above, no exception for amounts subject to full 30% US WHT
Example 5(v) – No-Inclusion
Not the Result of Hybridity

- County X has a patent box regime which allows an 80% deduction against royalty income.

Results
- If FY were transparent under County X law, then only $20 would be no-inclusion income due to FY’s reverse hybrid status.
- The remaining $80 of no-inclusion income would be exempt due to X’s patent box regime.
- Thus, the DHA is $100 - $80 = $20.
Payments to Reverse Hybrids
Multiple Investors

• An “investor” in an entity is any tax resident or branch that owner directly or indirectly (under §958(a) principles) an interest in that entity. Reg. §1.267A-5(a)(13)
• Does not matter if intermediary entities are domestic or foreign.
• Thus, an entity in a chain of entities would have multiple investors and each one of them might need to be tested for a no-inclusion.
Example 5(iv) – Reverse Hybrids – Multiple Investors

- FZ includes the $100 payment received by FY in income
- FX does not include the $100 payment received by FY in income

**Results**
- FX and FZ are **both** investors in FX
- FZ does not have a no-inclusion with respect to the $100 of interest
- FX has a no-inclusion with respect to the $100 of income
- If FY were transparent for Country X purposes, FX would include $100 of income, so the FX no-inclusion results from FY being a reverse hybrid
- Thus, the $100 payment to FY is a DHA
- The Country Z tax imposed on FZ is irrelevant
Branch Mismatch Payments

- A specified payment that is a branch mismatch payment is a DHA to the extent that
  - A home office has a no-inclusion (i.e., excludes the income as attributable to a foreign branch); and
  - The home office’s no-inclusion would not occur were the home office’s law to treat the income as not attributable to a foreign branch
- A branch mismatch is a specified payment that:
  (i) Under a home office’s tax law, the income is attributable to a branch of the home office; and
  (ii) Either
    (a) The branch is not a taxable branch; or
    (b) Under the branch’s tax law, there is a taxable branch but the payment is not treated as income attributable to the branch
Example 6 – Branch Mismatch Payment

- Under Country B tax law, BB is not a taxable branch

Results
- The $50 royalty is a branch mismatch payment
- The income is no-inclusion income to FZ, *i.e.*, FZ would include the income if the payment were not attributable to the foreign branch
- Thus, the $50 royalty payment is a DHA
- Same result if BB were taxable, but Country B viewed the royalty as not income of FZ and not BB
Example 7 – Reduction of DHA For Amounts Includible in Income

• FX loans money to FZ.

• For US tax purposes, it is treated as a loan and FZ pays “interest” to FX.

• For Country X purposes, the instrument is treated as equity, and the $100 “dividend” is subject to an 80% participation exemption.

• FX includes $20 of income

Results

• There is a tentative DHA of $80, i.e., the amount of the specified payment excluded under Country X law.

• Since the $80 is included in tested income for GILTI purposes, the tentative DHA is reduced for US1’s share (60%).

• Thus, the DHA is $80 x 40% = $32.
Disqualified Imported Mismatch Amounts

- A DIMA is a specified payment (other than a DHA) to the extent that, under certain set-off rules, the income attributable to the payment is directly or indirectly offset by a “hybrid deduction” incurred by a tax resident or taxable branch that is related to the specified party (or party to the structured arrangement).

- Some terminology
  - **Imported mismatch payment** = specified payment other than a DHA
  - **Imported mismatch payer** = the specified party
  - **Imported mismatch payee** = the tax resident or taxable branch that includes the imported mismatch payment in income (or the tax resident or taxable branch the tax law of which otherwise prevents the imported mismatch payment from being a DHA, *e.g.*, because under such tax law the no-inclusion is not due to hybridity)
DIMA: What is a Hybrid Deduction?

- With respect to a tax resident or taxable branch that is not a specified party, a deduction allowed to the tax resident or taxable branch under its tax law for an amount that is interest or royalty under such tax law, to the extent a deduction for the amount would be disallowed if such tax law contained rules similar to Reg. §§1.267A-1 through 3 and 1.267A-5.

- With respect to a tax resident that is not a specified party, a deduction allowed to the tax resident with respect to equity, such as a notional interest deduction.

- With respect to a particular accounting period, a loss carryover attributable to a hybrid deduction in a prior period beginning on or after December 20, 2018.
Example 8(i) - Disqualified Imported Mismatch Amounts (DIMA)

- FP excludes the hybrid dividend from its income under a participation exemption

**Result:**

- Payment of interest by US is a DIMA to the extent income attributable to the payment is directly or indirectly offset by a “hybrid deduction” incurred by a tax resident or taxable branch related to the specified party.

- A “hybrid deduction” arises here, because the (Imported Mismatch) Payee is allowed a deduction under its tax law that would be a DHA under §267A if its country of tax residence had such rules.

- The interest paid by US is therefore a DIMA and US’s deduction is disallowed
Examples 8(iii) & (iv) – DIMA

- Same results would apply if the loan from Foreign Parent were not a hybrid loan, but where there is a “long-term deferral.” For example, if Foreign Parent is on the cash method while the Payee is on the accrual method and interest will not be paid for more than 36 months after the end of the accounting period.

- Same results would apply if there is no loan at all, but the Payee is allowed a notional interest deduction.
Example 8(iv) – DIMA

- The payment is not a DIMA (and is therefore deductible) if foreign law disallows the Payee from deducting its payment to Foreign Parent under a hybrid mismatch type rule.
• US1 pays $100 interest to FX on a vanilla loan.

• FZ pays $80 to BB, a branch in Country B, which treats the branch as a taxable presence in Country B.

• Country X excludes income attributable to BB under its territorial regime.

• BB is entitled to a deemed royalty under the X-B Treaty.

• FX does not include the deemed royalty in income.

• BB include the $80 of interest in income for Country B purposes, but offsets that income with the imputed royalty.
Results

• US1’s payment of $100 interest to FZ is not a DHA.

• But BB’s imputed royalty is a hybrid deduction because it is not regarded by FX, and is excludable for Country X purposes – the deemed royalty would be a deemed branch payment under §267A principles.

• US1’s payment of $100 is an imported mismatch payment and is a DIMA to the extent the income in the hands of FZ is indirectly offset by the $80 deemed royalty payment incurred by BB.

• $80 of the $100 paid by US1 to FZ indirectly funded BB’s deemed royalty deduction

• Thus, US1 has non-deductible DIMA of $80.
Example 10 – Imported Mismatch Ordering Rules

- FX makes a hybrid loan to FW – all other loans are treated as loans for all purposes.
- For purposes of determining the DIMA for US1, US2 and US3, the $125 hybrid deduction must be allocated between US1, US2 and US3 as follows:
  - **First**, to income attributable to a factually related imported mismatch payment, *i.e.*, the $50 of interest paid by US1;
  - **Second**, to non-factually related payments to directly fund the hybrid deduction, *i.e.*, the $50 of interest paid by US2; and
  - **Then to**: non-factually related payments that indirectly fund the hybrid deduction (to the extent remaining), *i.e.*, $25 of the interest paid by US3.
Anti-Avoidance Rule

- A specified party’s deduction for a specified payment is disallowed to the extent:
  
  (1) The payment (or the income attributable thereto) is not included in the income of a tax resident or taxable branch, as determined under certain rules set forth in Reg. §1.267A-3(a), but disregarding certain de minimis and full inclusion rules, and
  
  (2) A principal purpose of the plan or arrangement is to avoid the purposes of the regulations under §267A
Effective Date of Section 267A Regulations

- Certain provisions, however, are effective for taxable years beginning on or after December 20, 2018.
  - Disregarded payments
  - Deemed branch payments
  - Branch mismatch payments
  - Disqualified imported mismatch amounts
  - Application to structured arrangements
§245A Anti-Hybrid Rules
Overview of §245A(e) Anti-Hybrid Rules

- Under the new quasi-territorial regime in effect following the so-called TCJA, §245A(a) normally allows a DRD for the foreign-source portion of any dividend received by a C corporation from a foreign corporation if the C corporation is a US shareholder.
- However, §245A(e)(1) disallows the DRD for any dividend from a CFC if it is a “hybrid dividend,” i.e., if:
  - Qualifies for DRD, but for §245A(e)
  - CFC receives deduction (or other tax benefit) with respect to such amount under any foreign country’s tax laws
- In this case, if FX receives a deduction in Country X for the “interest” it pays US, the DRD should be disallowed under §245A(e)(1)
- Per §245A(e)(2), if upper-tier CFC receives a hybrid dividend from lower-tier CFC of which the C corporation is also a US shareholder, the dividend is treated as Subpart F income of upper-tier CFC and “the United States shareholder” must include pro rata share in gross income.
Hybrid Dividends

Introduction

- Under §245A(e),
  - hybrid dividends are not eligible for the §245A DRD
  - hybrid dividends between CFCs (“tiered 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
Hybrid Dividends

Prop. Regs. §245A(e)-1(g), Ex. 1(i)

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)

<table>
<thead>
<tr>
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<th>HDAs</th>
<th>Distributions</th>
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<tbody>
<tr>
<td></td>
<td>Year 1</td>
<td>Year 2</td>
</tr>
<tr>
<td>Share A</td>
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<tr>
<td>Share B</td>
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<tr>
<td>Total</td>
<td><strong>80</strong></td>
<td><strong>80</strong></td>
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</table>

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.
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(iii) (cont’d)

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<td>Year 1</td>
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<td>Share A</td>
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<td>Share B</td>
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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 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(iv) (cont’d)

<table>
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<tr>
<th></th>
<th>HDAs</th>
<th>Distributions</th>
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</thead>
<tbody>
<tr>
<td></td>
<td>Year 1</td>
<td>Year 2</td>
</tr>
<tr>
<td>Share A</td>
<td>80</td>
<td>80</td>
</tr>
<tr>
<td>Share B</td>
<td>0</td>
<td>0</td>
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<tr>
<td>Total</td>
<td>80</td>
<td>80</td>
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</tbody>
</table>

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.
Hybrid Dividends

Prop. Regs. §245A(e)-1(g), Ex. 2(iii)

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.