Initial impressions of final regulations implementing "anti-hybrid" provisions (sections 245A(e), 267A, and 1503(d))

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Introduction

Final regulations were published on April 8, 2020, in the Federal Register as guidance under sections 245A(e), 267A, and the section 1503(d) dual consolidated loss (DCL) rules.

Read the **Final Regulations** [PDF 501 KB] (56 pages as published in the Federal Register).

The Final Regulations (T.D., 9896) broadly adopt, with certain revisions and clarifications, the December 2018 version of proposed regulations under such sections. Read ***TaxNewsFlash*** [PDF 330 KB] about the 2018 Proposed Regulations.

This report provides early impressions and observations about the Final Regulations. Further analysis of these regulations will also be forthcoming.

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Background

Sections 245A(e) and 267A were enacted on December 22, 2017, as part of the new U.S. tax law (Pub. L. No. 115-97) (also referred to as the "Tax Cuts and Jobs Act" (TCJA)) as new "anti-hybrid" provisions. These anti-hybrid provisions, along with the changes to the DCL rules, broadly had the effect of bringing the U.S. international tax system closer to the recommendations from the Action 2 Report from the OECD's base erosion and profit shifting (BEPS) initiative.

Section 245A(e) is a provision that aims to correct "deduction/no inclusion" results arising from dividends paid with respect to instruments that are treated as equity for U.S. tax purposes but for which the issuer

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is allowed a foreign tax deduction. To implement this rule, the provision denies the section 245A dividends received deduction (DRD) to certain "hybrid dividends," thereby treating such dividends as taxable at ordinary rates. This treatment also applies to "tiered dividends" between controlled foreign corporations (CFCs), by treating the dividend as subpart F income in the recipient CFC that is not eligible for any subpart F exception.

Section 267A also seeks to combat instances of "deduction/no inclusion" results, but focuses on related-party payments of interest or royalties when the recipient is explicitly or effectively exempted from foreign tax on the interest or royalty amount as a result of differing characterizations of the transaction among different jurisdictions. The statute focuses upon disallowing a deduction for any "disqualified related-party amount" paid or accrued pursuant to a "hybrid transaction" or by, or to, a "hybrid entity," and provides Treasury with expansive regulatory authority to carry out the purposes of section 267A.

As noted above, Treasury issued the 2018 Proposed Regulations on December 20, 2018. The 2018 Proposed Regulations provided a comprehensive set of rules implementing sections 245A(e) and 267A. In doing so, the 2018 Proposed Regulations dramatically reshaped and largely supplanted the statutory framework provided in sections 245A(e) and 267A.

Initial impressions — Final Regulations under sections 245A(e) and 267A

The Final Regulations largely maintain the general organization and operative framework contained in the 2018 Proposed Regulations, but provide a significant number of revisions that generally appear to address certain taxpayer comments in a more narrowly tailored, surgical fashion. In this regard, the Final Regulations continue to require the very detailed and complex set of rules set forth in the 2018 Proposed Regulations. Indeed, the changes to the 2018 Proposed Regulations generally result in additional layers of complexity, even where such revisions are taxpayer favorable.

Section 245A(e) — Highlights

Important developments in the Final Regulations include:

Hybrid deduction account (HDA) reduction for certain amounts included in income by U.S. shareholders

- Under the 2018 Proposed Regulations, an HDA is reduced only to the extent that an amount in the account gives rise to a hybrid dividend or a tiered hybrid dividend. As a result, a shareholder's HDA in respect of CFC stock could grow each year even when such CFC's earnings and profits are fully includible in U.S. taxable income under the subpart F and GILTI[1] inclusion regimes.

- In response to comments received, the preamble to the Final Regulations acknowledges that "the double non-taxation effects of the hybrid arrangement are neutralized" to the extent that the CFC's earnings and profits are included in income under subpart F or GILTI. Thus, Treasury has issued a separate package of **proposed regulations** [PDF 377 KB] (the 2020 Proposed Regulations) that

[1] Global intangible low-taxed income

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provides rules to determine the amount by which HDAs with respect to the stock of a CFC should be reduced to the reflect the U.S. shareholder's "fully taxed" subpart F and GILTI inclusions in respect of such CFC(s). These rules, although complex in their mechanical operation, broadly have the effect of spreading hybrid deductions ratably between subpart F inclusions, GILTI inclusions, and untaxed earnings and limiting the HDA to the amount that the rules attribute to untaxed earnings.

- The proposed HDA reduction rule for certain CFC inclusion amounts is perhaps the most substantial change to the 2018 Proposed Regulations. This proposed rule likely would prove helpful, for example, to taxpayers that have HDAs in respect of upper-tier CFCs that own lower-tier CFCs with substantial amounts of non-PTEP[2], especially when there is a desire to repatriate excess cash to the U.S. corporate shareholders.

Coordination with foreign disallowance rules

- The Final Regulations confirm that a deduction or other tax benefit is allowed, and thus may be a hybrid deduction, **without regard to** whether such deduction is (1) used in the current year under the relevant foreign tax law or (2) otherwise suspended under a separate provision of the relevant foreign tax law (e.g., a foreign jurisdiction's thin capitalization rules).

- The Final Regulations do not fully adopt a foreign hybrid mismatch ordering rule implicitly established under the 2018 Proposed Regulations that would determine hybrid deduction status for section 245A(e) purposes **only after** the application of the relevant foreign tax law's hybrid mismatch rules. While this ordering rule is partially retained in the Final Regulations, the determination of whether a foreign tax law allows a deduction or other tax benefit is made **prior to** the application of foreign hybrid mismatch rules if the amount gives rise (or is reasonably expected to give rise) to a dividend for U.S. tax purposes that will be paid in the subsequent tax period.

Notional interest deduction ("NID") structures remain directly targeted

- The treatment of NIDs as hybrid deductions under the 2018 Proposed Regulations for section 245A(e) purposes is generally retained by Final Regulations. The Final Regulations, however, offer limited taxpayer relief by delaying (relative to the 2018 Proposed Regulations) the effective date pertaining to the treatment of NIDs as hybrid deductions. The Final Regulations provide that only NIDs allowed to a CFC for tax years beginning on or after December 20, 2018, are hybrid deductions.

Rules pertaining to transfers of stock

- **Non-recognition transactions:** The Final Regulations generally retain the rules contained in the 2018 Proposed Regulations that govern the treatment of HDAs in certain non-recognition transactions. In response to comments, however, the Final Regulations also specifically address the treatment of HDAs in a section 355 spin-off transaction. The Final Regulations generally provide that HDAs will be allocated in the same manner as E&P in a section 355 transaction.

- **Mid-year transfers of stock**: In response to comments, the Final Regulations generally adjust the HDA to be proportionately allocated between the seller and buyer based on the number of days in the tax year. Such rules also coordinate the end-of-year adjustments that are required to be made on the transfer date.

- **Section 338(g) transactions**: The Final Regulations confirm that when a 338(g) election is made

[2] Previously taxed earnings and profits

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with respect to a CFC target, the shareholder of "new" target does not succeed to a HDA with respect to a share of stock of "old" target.

Other issues

- **The tiered hybrid dividend rule no longer applies to non-corporate U.S. shareholders.** Under the 2018 Proposed Regulations, the tiered hybrid dividend rule was intended to operate as follows: If an upper-tier CFC receives a tiered hybrid dividend from a lower-tier CFC, and a domestic corporation is a U.S. shareholder of both CFCs, then the tiered hybrid dividend would be treated as subpart F income of the upper-tier CFC and the domestic corporation would include in gross income its pro rata share of the subpart F income. An unintended result in the tiered hybrid dividend rule could arise, however, when a domestic corporation and a U.S. individual were each U.S. shareholders of both CFCs. In such case, the individual U.S. shareholder would include its pro-rata share of the upper-tier CFC's subpart F income resulting from the tiered hybrid dividend, notwithstanding that the U.S. individual is ineligible to claim section 245A DRDs as a general matter. Accordingly, the Final Regulations modify the 2018 Proposed Regulations and provide that the tiered hybrid dividend rule applies only as to a domestic corporation that is a U.S. shareholder of both CFCs. As a result, the tiered hybrid dividend rule under the Final Regulations does not apply to cause a subpart F inclusion to the individual U.S. shareholder.

- **Nexus between hybrid dividends and HDAs.** Under the 2018 Proposed Regulations, a dividend received by a U.S. shareholder from a CFC generally is a hybrid dividend to the extent of the total sum of such shareholder's HDAs with respect to **each** share across **all** classes of stock of the CFC, even if the distribution is made in respect of a particular class of stock for which no HDA exists. For example, if a U.S. shareholder owns shares of preferred **and** common stock of a CFC and such U.S. shareholder's HDA is solely in respect of the CFC preferred stock, then the 2018 Proposed Regulations would provide that a dividend distribution in respect of the CFC's common stock nonetheless constitutes a hybrid dividend to the extent of the shareholder's HDA with respect to *all* stock of the CFC, including the preferred stock.

  Despite comments that this proposed rule is overly broad, the Final Regulations retain the rule without modification.

- **Anti-avoidance rule.** The 2018 Proposed Regulations include a broad anti-avoidance rule that requires appropriate adjustments to be made, including adjustments that would disregard a transaction or arrangement, if a transaction or arrangement is engaged in with a principal purpose of avoiding the purposes of the section 245A(e) regulations. Notwithstanding comments received that asked Treasury to narrow the scope of the anti-avoidance rule, the Final Regulations generally retain the anti-avoidance rule in the 2018 Proposed Regulations, except to preclude application of the anti-avoidance rule to transactions in which a hybrid arrangement is restructured into a non-hybrid arrangement.

- **Relevant foreign tax law.** The Final Regulations provide that when determining whether a CFC or a related person has been allowed a deduction or other tax benefit under relevant foreign tax law in the hybrid deduction context, such tax law also will include subnational taxes to the extent such subnational taxes are considered a covered tax in the applicable U.S. income tax treaty (e.g., Germany's trade tax).

- **Applicability date:** The Final Regulations generally retain the applicability date contained in the 2018 Proposed Regulations. Accordingly, the hybrid deduction account rules generally apply to distributions made after December 31, 2017, provided such distributions occur during tax years

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ending on or after December 20, 2018.

Section 267A—Highlights

Important developments in the Final Regulations include:

Interest-free loan (IFL) and NID structures directly targeted

- The treatment of NIDs as hybrid deductions under the 2018 Proposed Regulations for purposes of the disqualified imported mismatch amount rule is generally retained by Final Regulations. Treasury rejected comments requesting that the Final Regulations reserve on their treatment.

- While the 2018 Proposed Regulations explicitly targeted NID structures for purposes of section 267A, their application to IFL structures was less clear. IFL structures generally produce deduction / no inclusion (D/NI) outcomes due to a mismatch between the transfer pricing rules that apply under the respective tax jurisdictions of the borrower and holder. Such mismatch was not treated as a targeted form of hybridity under Action 2 of the BEPS initiative, and other countries' enabling legislation has therefore not treated these instruments as violating the anti-hybrid rules, instead viewing them as a transfer pricing coordination matter. Although not free from doubt, it appeared that the 2018 Proposed Regulations as drafted likely would have applied to IFL structures, notwithstanding that the 2018 Proposed Regulations did not provide an example of such or treat generally transfer pricing mismatches as a prohibited form of hybridity.

- The Final Regulations erase any doubt regarding the treatment of IFLs for purposes of section 267A, and confirm that a D/NI outcome caused by a mismatch in the recognition of imputed interest generally ought to result in a deduction disallowance under the disqualified hybrid amount and/or disqualified imported mismatch amount rules. The Final Regulations remove this ambiguity by directly addressing imputed interest arising on IFLs under the hybrid transaction provision (see Reg. 1.267A-2(a)(4)). The rules in the Final Regulations addressing NIDs and IFLs and similar arrangements apply for tax years beginning on or after December 20, 2018.

U.S. outbound structures remain generally unaffected by section 267A

- The Final Regulations generally retain the taxpayer-favorable "amounts included or includible in U.S. income" exception (the U.S. income exception) contained in the 2018 Proposed Regulations. The U.S. income exception broadly precludes the application of the section 267A deduction disallowance regime to U.S. parented outbound structures, except in a few limited circumstances. More fully, the U.S. income exception generally provides that interest or royalty deductions are not subject to disallowance under section 267A to the extent that: (1) the U.S. tax resident or U.S. taxable branch would take such payment into account in its gross income; or (2) the U.S. shareholder would include such item in its subpart F income or take the amount into account when determining its pro rata share of CFC tested income. The Final Regulations clarify that an amount is treated as included in subpart F income without regard to the application of section 952(c). In addition, the Final Regulations include a (very) minor change to limit the CFC tested income inclusion rule to adjust for rate differentials in what appear to be very unusual fact patterns where the payor's deduction would otherwise offset subpart F income, U.S. effectively connected income (ECI), or U.S. corporate taxable income and the recipient's income would qualify as tested income.

- The Final Regulations generally follow the aggregate approach taken in prior GILTI and subpart F guidance to U.S. Shareholder status for domestic partnerships, by providing that ownership by a

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domestic partnership in a foreign corporation is not taken into account for purposes of determining whether the CFC is a "specified party" that can pay a specified amount potentially subject to section 267A disallowance. The Final Regulations otherwise retain the definition of a specified party, but modify the "U.S. income" exception described above to apply only when the payment is made to a CFC that is a specified party, to the extent of the actual subpart F or GILTI income inclusion by the CFC's U.S. shareholders. This change appears to have neutralized the potential benefit of certain financing arrangements that had been suggested as viable under the Proposed Regulations.

- The Final Regulations also modify the disqualified imported mismatch amount rules to directly apply the "U.S. income" exception, which eliminates an unintended consequence of the 2018 Proposed Regulations that had allowed for the potential application of section 267A to certain U.S. outbound structures unintentionally. This result would arise to subject U.S. outbound structures to section 267A when, for example, a CFC made an interest or royalty payment to a brother-sister foreign corporation that is treated as a disregarded entity (DRE) for U.S. tax purposes and thereby disallow the CFC payor's interest or royalty deduction to the extent that such foreign DRE itself incurred a hybrid deduction (e.g., a NID) (the "Hidden Hybrid" scenario). By directly linking the "amounts included or includible in U.S. income" exception to the disqualified imported mismatch amount rule, the Final Regulations dispose of this "Hidden Hybrid" problem scenario.

No exception for U.S. withholding tax

- Section 267A applies solely with respect to deductions and does not contain an exception—like there is in section 59A's "BEAT" regime for "base erosion payment"—that treats a payment subject to U.S. withholding tax as effectively subject to tax and therefore outside the scope. The Final Regulations confirm this interpretation and again refuse to include a similar exception for specified payments that are subject to U.S. withholding tax or U.S. source-based tax under section 871 or 881.

Coordination and transition rules

- The Final Regulations clarify that section 267A applies prior to section 163(j). Once a specified payment has been tested for section 267A purposes, the deductibility of such payment under section 267A is not re-tested in a future year if a separate provision would apply to defer the deductibility of such payment until a later year (e.g., section 163(j) carryforwards are not subject to section 267A disallowance in a subsequent year).

- Consistent with the approach adopted in the BEAT regulations, the Final Regulations provide that section 267A does not apply to pre-TCJA section 163(j) interest carryforwards or pre-TCJA section 267(a)(3) deferred interest or royalty deductions. In addition, for purposes of application of the disqualified imported mismatch amount rules, hybrid deductions attributable to IFLs and NIDs are not subject to 267A to the extent such deductions arose in a tax year beginning prior to December 20, 2018.

- The Final Regulations also clarify that specified payments treated as: (1) a disqualified hybrid amount, (2) a disqualified imported mismatch amount, or (3) an amount for which the requirements of the anti-avoidance rule are satisfied, are not taken into account for purposes of computing costs that are required to be capitalized and recovered though depreciation, amortization, costs of goods sold (COGS), adjustment to basis, or any similar form of recovery.

Other issues

- Despite comments recommending its elimination, the Final Regulations retain the controversial

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"multiple specified recipient" rule. This rule provides that a specified payment generally is a disqualified hybrid amount to the extent that a D/NI outcome occurs with respect to any foreign country as a result of a hybrid or branch arrangement—even if the payment is included in income by a tax resident or taxable branch in another foreign country. This approach is harsher and more administratively burdensome than the OECD BEPS standard, which provides that a payment does not run afoul of the anti-hybrid rules as long as one specified recipient includes the payment in income.

- The Final Regulations provide that when determining whether a specified recipient includes an item of income under the tax law of a foreign country, such tax law will also include subnational taxes to the extent such subnational taxes are considered a covered tax in the applicable U.S. income tax treaty (e.g., Germany's trade tax). This modification is consistent with the corresponding modification to the definition of relevant foreign tax law for purposes of section 245A(e) under the Final Regulations.

- The Final Regulations modify the structured arrangement rule for purposes of determining whether the section 267A relatedness requirement is satisfied. Under the 2018 Proposed Regulations, an arrangement is a structured arrangement if either (1) a pricing test is satisfied or (2) a principal purpose test is satisfied, meaning that based on all the facts and circumstances, a hybrid mismatch is a principal purpose of the arrangement. In response to comments, the Final Regulations replace the subjective "a principal purpose" standard with an objective design test and reason to know standard, and incorporate the pricing test into the design test. As modified under the Final Regulations, the structured arrangement rule for section 267A purposes is more closely aligned to the BEPS definition of a structured arrangement.

- The "reverse hybrid rule" is retained, subject to limited modifications that expand the definition of the term "fiscally transparent" to include certain collective investment vehicles and particular types of trusts. Treasury provided limited taxpayer relief in response to comments by providing that current year distributions from a reverse hybrid entity to its owner may be taken into accounts when determining the extent of such owner's income inclusion, but only if the reverse hybrid entity distributes **all** of its current year income.

- The "disregarded payment and deemed branch payment rules" are retained, subject to limited modifications. The "branch mismatch payment rule" also is retained.

- The rule treating a long-term (36-month) deferral of income as if it were an exclusion is retained (with limited modifications).

- Effect on earnings and profits ("E&P"). The 2018 Proposed Regulations provided that the computation of a specified party's E&P would not be affected by the operation of the section 267A deduction disallowance rules. The Final Regulations broadly retain this rule, unless a principal purpose of the transaction pursuant to which the payment is made is to reduce or limit the a CFC's subpart F income by reason of section 952(c).

- The "General Anti-Avoidance Rule" is retained. The 2018 Proposed Regulations include a "General Anti-Avoidance Rule" that provides that a specified party's deduction for a specified payment is disallowed to the extent that it gives rise to a D/NI outcome and "a" principal purpose of the plan or arrangement is to avoid the purposes of the regulations under section 267A. The Final Regulations retain the General Anti-Avoidance Rule, but the preamble clarifies that the rule shall only apply to the extent that the D/NI outcome produced is a result of a hybrid or branch arrangement. The language of the General Anti-Avoidance Rule's "a" principal purpose test prong has been amended to reflect that

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the focus of the rule is on the plan or arrangement's terms or structure.

- The broad definition of "interest" in the 2018 Proposed Regulations has been slightly narrowed in the Final Regulations, presumably to align with what many anticipate will be a scaled-back definition of interest in the yet-to-be released final section 163(j) regulations.

Applicability dates

- Section 267A generally applies to tax years ending on or after December 20, 2018, provided that such tax years begin after December 31, 2017 (i.e., for a calendar year taxpayer effective date is January 1, 2018). However, taxpayers with short tax years beginning after December 31, 2017, and ending before December 20, 2018, may apply the 267A Final Regulations in their entirety for such period.

- The majority of the provisions contained in the Final Regulations, however, are subject to special applicability date rules. For example, the following rules generally do not apply until tax years beginning on or after December 20, 2018:
    - Interest-free loans and similar arrangements
    - Disregarded payments
    - Deemed branch payments
    - Branch mismatch payments
    - Disqualified imported mismatch amounts rules
    - Structured payments (i.e., interest equivalents), and
    - Structured arrangements (unless the structured arrangement was entered into pre-TCJA, in which case the effective date applies to tax years beginning after December 31, 2020)

- Lastly, the rules regarding swaps with significant nonperiodic payments only apply to notional principal contracts entered into on or after April 8, 2021, unless the taxpayer exercises his / her discretion to apply such rules to pre-April 8, 2021 notional principal contracts.

The final DCL rules

- The Final Regulations retain, without any modification, the rule that requires taxpayers to treat domestic reverse hybrid (DRH) entities as dual resident corporations that are subject to the DCL rules, as a pre-condition to electing corporate status for the entity under the "check-the-box" regulations, when there are related foreign persons who would take the DRH's items into account on a pass-through basis under foreign law.

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