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Capital Structure Considerations

The US new Section 267A Proposed Regulations

With a UK and German Perspective

30 January 2019

Notices

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The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavor to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.

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Introduction

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Notes on CPE and polling questions

Continuing professional education (CPE) credits

North America

— We require that participants are registered, logged in and take part in at least four of the five polling questions and participate in at least 50 of the 60 minutes to qualify for CPE credits for today's webcast.

Outside North America

— We encourage you to participate in the questions, as you may be eligible for continuing education credits in your local jurisdiction.

Polling questions

— Polling questions will appear as we proceed through the presentation.

— As mentioned, in order to receive the CPE credit, we require that those participants take part in at least four of the five polling questions and participate in at least 50 of the 60 minutes to qualify for CPE credits for today's webcast.

Attendee questions

— You may submit questions in the *Ask a question* button on the left. We will answer as many questions as we can during Q&A. If we are unable to answer your question, someone from KPMG may reply via phone or email.

— For technical issues, please use the *Question Mark* button in the upper-right hand corner of the media player.

Your feedback

— When the webcast is over, the webcast player will automatically refresh to display an exit survey. Feel free to complete the survey, as your comments are very valuable to us.

Agenda

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- **The German Group (and ATAD) Perspective**
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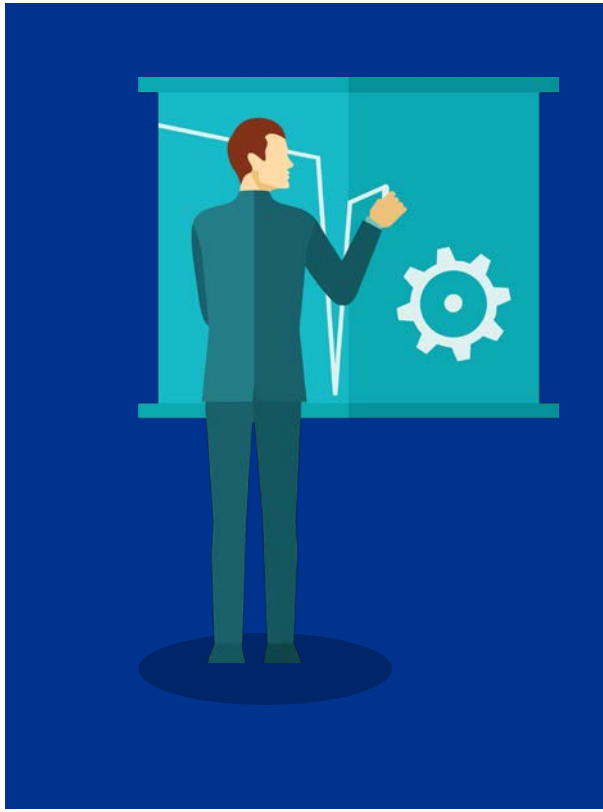
  - Disqualified imported mismatch amounts
  - Anti-avoidance rule
  - Applicability dates
- **Dual Consolidated Losses of Domestic Reverse Hybrid Entities**
- **Q&A**
- **Wrap-up**



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The UK Group Perspective

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The German Group (and ATAD) Perspective

Claus Jochimsen
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The New US Landscape

Jason Connery
KPMG in the US

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KPMG in the US

Section 267A – The Statute

No deduction is allowed for any **Disqualified Related Party Amount (or DRPA)**

- Any interest or royalty paid or accrued to a related party
- *To the extent* that the payment is either:
  - ***not included*** in the income of such related party ***under the tax law of the country*** of which such related party is a ***resident for tax purposes or is subject to tax***; or
  - such related party is ***allowed a deduction*** with respect to such amount under the tax law of such country
  - to the extent that the payment is not included in gross income of a US shareholder under section 951(a).

Paid or accrued pursuant to a **Hybrid Transaction**, or by, or to, a **Hybrid Entity.**

Applies to tax years beginning after 31 December 2017

Section 267A – The Statute (continued)

Hybrid Transaction: any transaction, series of transactions, agreement, or instrument one or more payments with respect to which are treated as interest or royalties for US tax purposes and which are not so treated for purposes of the tax law of the foreign country of which the recipient of such payment is resident for tax purposes or is subject to tax.

Hybrid Entity: any entity which is either treated as:

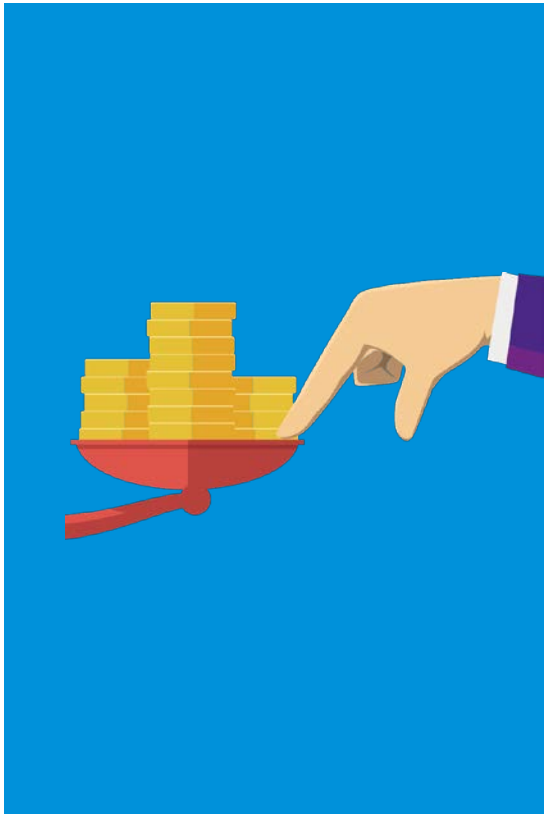
— fiscally transparent for US tax purposes but not for purposes of the tax law of the foreign country of which the entity is resident or subject to tax, or

— fiscally transparent for purposes of such tax law but not so treated for US tax purposes.

US Government has broad regulatory authority to issue guidance to carry out the purposes of the Statute

Section 267A – proposed regulations overview

- Sets forth the exclusive circumstances in which a deduction for interest or royalty is disallowed under section 267A
- A specified party's deduction for any interest or royalty, or structured payments (i.e. interest equivalents) paid or accrued is disallowed to the extent that the **specified payment** (i.e. the amount paid or accrued with respect to the **specified party**) is:
  - a disqualified hybrid amount
  - a disqualified imported mismatch amount; OR
  - subject to an anti-abuse rule.
- De minimis exception
  - Sum of specified party's interest/royalty deductions in a given tax year are less than US$50,000



Key definitions

- ***Interest*** — defined broadly
- ***Investor*** — with respect to an entity, any tax resident or taxable branch that directly or indirectly owns an interest in the entity
- ***Royalty*** — defined based on definition used in US income tax treaties
- ***Specified Party*:**
  - — a US tax resident
  - — a CFC with direct/indirect US shareholder(s) that own 10 percent or more of CFC stock directly/indirectly; or
  - — a US taxable branch (or US permanent establishment) of a foreign taxpayer.
- ***Specified Recipient*** — with respect to a specified payment, any tax resident that derives the payment under its tax law or any taxable branch to which the payment is attributable under its tax law.
  - — May be more than one specified recipient w/r/t a specified payment
- ***Tax resident*** — a body corporate or other entity or body of persons liable to tax under the tax law of a country as a resident.
  - — Includes entities incorporated in no tax jurisdictions

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Disqualified hybrid amounts

Disqualified hybrid amounts

Hybrids and branch transactions

- Hybrid Transactions (including repo transactions)
- Disregarded payments
- Deemed branch payments
- Payments to reverse hybrids
- Branch mismatch payments

Relatedness or structured arrangement required

- Relevant parties must be related, OR
- If not related, rules apply to structured arrangements
  - hybrid mismatch is priced into the terms of the arrangement and the hybrid mismatch is a principal purpose of the arrangement

Disqualified hybrid amounts (continued)

Specified payment not treated as a disqualified hybrid amount to the extent it:

- is included in the income of a US tax resident or US taxable branch
- results in a subpart F inclusion by a US shareholder
- results in tested income being included by a US shareholder
- increases a US shareholder's pro rata share of tested income (or reduces a US shareholder's pro rata share of tested loss) under the GILTI rules.

Hybrid transactions

If a specified payment is made pursuant to a *hybrid transaction*, the payment is a disqualified hybrid amount to the extent that:

- a specified recipient does not include the payment in income (to such extent, a ***no-inclusion***); AND
- the specified recipient's no-inclusion is a result of the payment being made pursuant to a ***hybrid transaction***.
  - Would the no-inclusion not occur if the specified recipient's tax law were to treat the payment as interest or royalties?

"No-Inclusion" requirement

A recipient of a specified payment includes the payment in income if:

- it includes the payment in its income or tax base at the full marginal rate imposed on ordinary income; AND
  - must include the payment in income during a taxable year that ends no more than 36 months after the end of the specified party's taxable year in which it claims a deduction
- the payment is not reduced or offset by an exemption, exclusion, deduction, credit (other than for withholding tax imposed on the payment), or other similar relief particular to such payment)
  - examples: participation exemption, dividends received deduction, deduction or exclusion with respect to a particular category of income (such as patent box regime), and a credit for underlying taxes paid by a corporation from which a dividend is received.
  - payment will not be considered reduced or offset if it is offset by a generally applicable deduction or other tax attribute, such as depreciation or net operating losses carryforwards, even if it arises from a related transaction (e.g. back-to-back financing arrangement).

"No-Inclusion" requirement (continued)

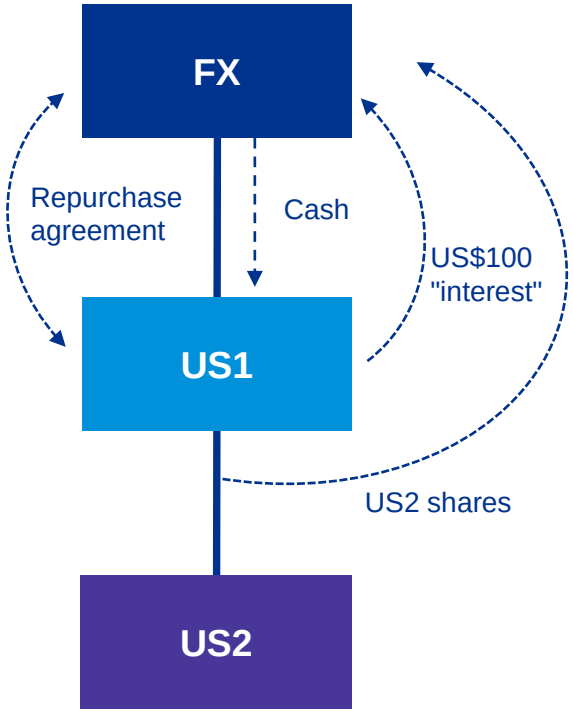
A recipient of a specified payment includes the payment in income if:

- coordination rule with other hybrid mismatch rules
  - no inclusion even if a recipient is required to include an amount in income under local country hybrid mismatch rules
- an investor in a reverse hybrid is determined to have an inclusion without regard to any distributions from the reverse hybrid (or right to distribution from the reverse hybrid triggered by the payment)
  - an income inclusion under the investor's CFC anti-deferral regime constitutes an inclusion for this purpose
- De minimis inclusions and deemed full inclusion rule.

Definition of hybrid transactions

- Definition of hybrid transaction is similar to that in section 267A
  - Includes repo arrangements
  - Includes instruments that provide long-term deferral
- a specified recipient recognizes the payment as income under its tax law *more than 36 months* after the end of the taxable year in which the specified party is allowed the deduction

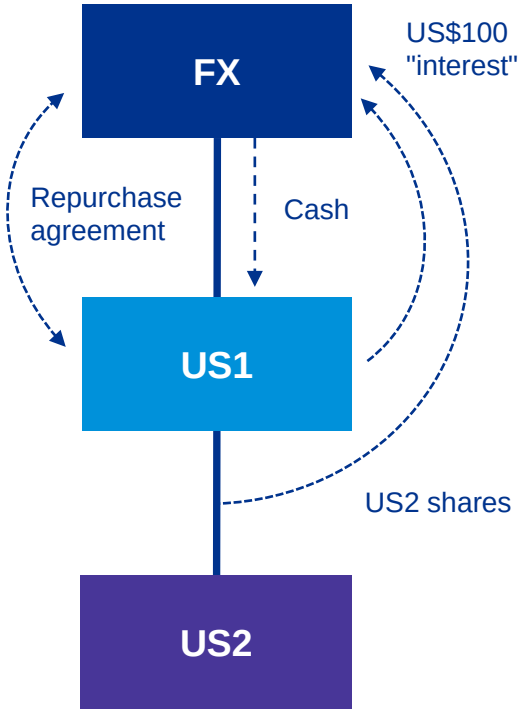
Example 2 – Inbound repo transaction (tax credit regime)



Facts

- US1 sells US2 preference shares to FX in exchange for cash
- Simultaneously, US1 enters into a forward share purchase agreement to repurchase the preferred shares from FX at a slightly higher price that provides FX with an interest-like return on its investment.
- For US tax purposes, the sale/repurchase agreements are collapsed and treated as a secured loan from FX to US1.
- For Country X tax purposes, the transaction's form is respected and payments received on the US2 preference shares are treated as dividends.
  - Under Country X tax law, dividends are subject to tax at the full marginal tax rate for ordinary income (25 percent) and a credit for underlying foreign taxes paid associated with the "dividend" income is provided.
- For Country X tax purposes, FX receives a US$100 dividend from US2 and is eligible to claim US$10 tax credit.
  - FX would not be eligible to claim a tax credit if the dividend income were instead treated as interest.

Example 2 – Inbound repo transaction (tax credit regime)

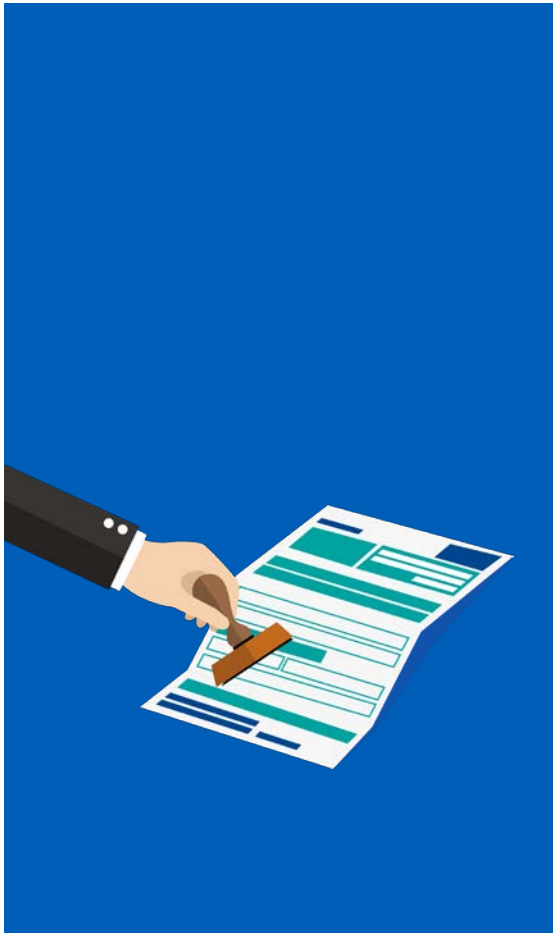


Analysis

- US1's interest payment is made pursuant to a hybrid transaction and US1's interest expense is a disqualified hybrid amount and disallowed under the proposed regulations to the extent of FX's no-inclusion.
  - US1 is a specified party.
  - The US1 payment is a "specified payment" -- although the payment from US1 to FX is not regarded for Country X tax purposes, a connected amount (the US2 pref dividend) is treated as derived by FX.
  - The payment is made pursuant to a hybrid transaction because the payment is treated as interest for US tax purposes but not for Country X tax purposes.
  - Although FX includes the US$100 connected amount in its taxable income, the portion of FX's tax liability that is reduced by reason of FX's tax credit constitutes the "no-inclusion" amount.
    - FX's no inclusion with respect to US1's interest payment is US$40 (US$10 credit/25 percent tax rate = US$40).
  - FX's no-inclusion is a result of the payment being made pursuant to a hybrid transaction because FX's no-inclusion would not occur if the US$100x payment were treated as interest for Country X purposes.
- Result: US$40 of US1's interest expense deduction is denied

Disregarded payments

- Excess of the sum of a specified party's **disregarded payments** for a taxable year over its **dual inclusion income** for the taxable year
- Disregarded payment is:
  1. A specified payment to the extent that, under the tax law of a tax resident or taxable branch, the payment is not regarded; and
  2. Were the payment to be regarded (and treated as interest or royalty) under such tax law, the tax resident or taxable branch would include the payment in income.
- Disregarded payment may also be a specified payment that, under the tax law of the tax resident or taxable branch to which the payment is made, is a payment that gives rise to a deduction or similar offset allowed to the tax resident or taxable branch under a foreign consolidation, fiscal unity, group relief, loss sharing, or any similar regime.
- Does not include:
  - Deemed branch payment
  - Repo transaction



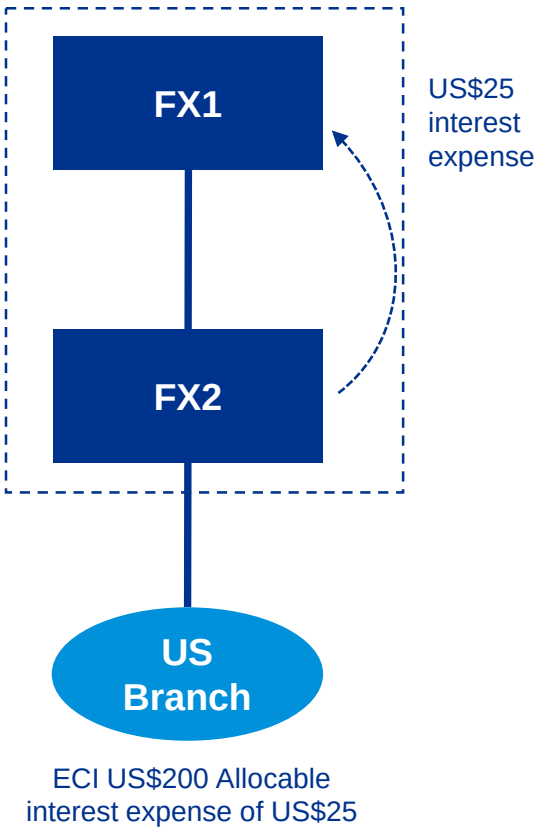
Disregarded payments (continued)

Dual inclusion income is the excess of:

1. Sum *of specified party's items of income or gain for US tax purposes*, to the extent the items of income or gain are included in the income of the tax resident or taxable branch to which the disregarded payments are made (by treating the disregarded payments as the specified payment); over

2. Sum of the *specified Items of deduction or loss for US tax purposes* (other than deductions for disregarded payments) to the extent the items of deduction or loss are allowable under the tax law of the tax resident or taxable branch to which the disregarded payments are made.

Ex. 4 – Payment allocable to a US taxable branch (simplified)



Facts

- FX1 and FX2 file a consolidated return under Country X tax law resulting in the interest on the loan issued by FX2 to FX1 being disregarded
- FX2 has US$200 of gross income that is treated as ECI
- FX2 allocates US$25 of interest expense against its ECI under regulations section 1.882-5
- Under Country X tax law, the FX Group does not include US Branch's US$200 of gross income in its taxable income because Country X tax law exempts income attributable to an offshore branch

Analysis

Identify specified party/specified payment/specified recipient

- US Branch is a specified party
- US$25 of allocable interest expense is a specified payment
- US$25 is treated as paid by US Branch to FX1, a specified recipient

Determine the disqualified hybrid amount

- USB's US$25 specified payment is a disregarded payment under proposed regulations section 1.267A-2(b) because (i) the US$25 payment is not regarded as a result of the application of the Country X consolidated tax regime and (ii) if US$25 were regarded as interest, FX1 would include such amount in income. Also, there is no dual inclusion income.
- US$25 is a disqualified hybrid amount

Result: US$25 interest expense deduction is denied

Deemed branch payments

— A **deemed branch payment** is a disqualified hybrid amount if the tax law of the home office provides an exclusion or exemption for the income attributable to the branch.

— Deemed branch payment means, with respect to a US taxable branch that is a US permanent establishment of a treaty resident eligible for benefits under an income tax treaty between the US and the treaty country, any amount of interest or royalties allowable as a deduction in computing the business profits of the US permanent establishment to the extent the amount is deemed paid to the home office and is not regarded (or otherwise taken into account) under the home office's tax law.

Payments to reverse hybrids

- Specified payment to a reverse hybrid may constitute disqualified hybrid amounts to the extent that —
  1. An investor of the reverse hybrid does not include the payment in income (**no-inclusion**); and
  2. Investor's no-inclusion is a result of the payment being made to the reverse hybrid.
     - Will be considered to be a result of the reverse hybrid to the extent that the no-inclusion would not occur were the investor's tax law to treat the reverse hybrid as fiscally transparent (and treat the payment as interest or royalty).
- Reverse hybrid means:
  - a domestic or foreign entity that is fiscally transparent under the tax law of the country in which is it created, organized, or otherwise established but not fiscally transparent under the law of an investor of the entity.

Branch mismatch payments

Branch Mismatch Payment is a Disqualified Hybrid Amount to the extent that:

- A home office, the tax law of which treats the payment as income attributable to a branch of the home office, does not include the payment in income; and
- The home office's no-inclusion is a result of the payment being a branch mismatch payment
  - Linkage occurs to the extent that the no-inclusion would not occur were the home office's tax law to treat the payment as income that is not attributable to a branch of the home office.

Branch mismatch payment exists if:

- Under the home office's tax law, the payment is treated as income attributable to the branch of the home office; and
- Either:
  - The branch is not a taxable branch; or
  - Under the branch's tax law, the payment is not treated as income attributable to the branch.

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Disqualified imported mismatch amounts

Disqualified imported mismatch amounts

- Specified payment is a “disqualified imported mismatch amount” to the extent that, under the “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 is a party to a structured arrangement).
  - Specified payment is an “imported mismatch payment”
  - Specified party is the “imported mismatch payer”
  - Tax resident or taxable branch that includes the imported mismatch payment in income is the “imported mismatch payee”

Hybrid deduction

— **Hybrid deduction** means, with respect to a tax resident or taxable branch that is not a specified party:

1. A deduction allowed to the tax resident or taxable branch under its tax law for an amount paid or accrued that is interest or royalty under its tax law.
2. To the extent that a deduction for the amount would be disallowed if such tax law contained rules substantially similar to those under proposed regulations sections 1.267A-1 through 1.267A-3 and 1.267A-5.

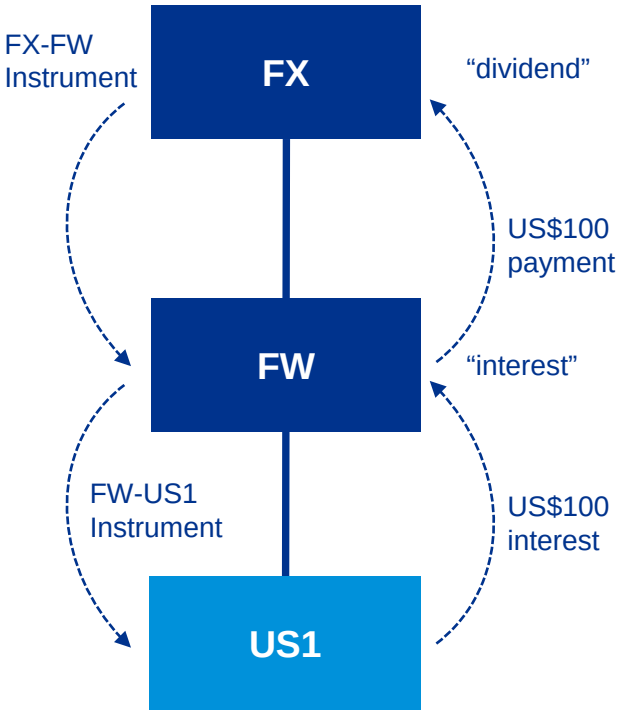
— Includes a deduction allowed with respect to equity, such as a notional interest deduction

— Includes NOLs if the NOLs are attributable to a hybrid deduction

Set-off rules

- A hybrid deduction directly or indirectly offsets the income attributable to an imported mismatch payment to the extent that the payment directly or indirectly funds the hybrid deduction.
- Ordering rules:
  1. A “factually-related imported mismatch payment” is an imported mismatch payment that is made pursuant to a transaction, agreement, or instrument entered into pursuant to the same plan or series of related transactions that includes the transaction, agreement, or instrument pursuant to which the hybrid deduction is incurred.
  2. Remaining amount if offsets income attributable to an imported mismatch payment that directly funds the hybrid deduction.
  3. Any remaining amount that indirectly funds the hybrid deduction.
- Funding rules:
  - Imported mismatch payment is considered to directly fund to the extent that the imported mismatch payee incurs the deduction
  - Indirectly funds to the extent that imported mismatch payee is allocated the deduction

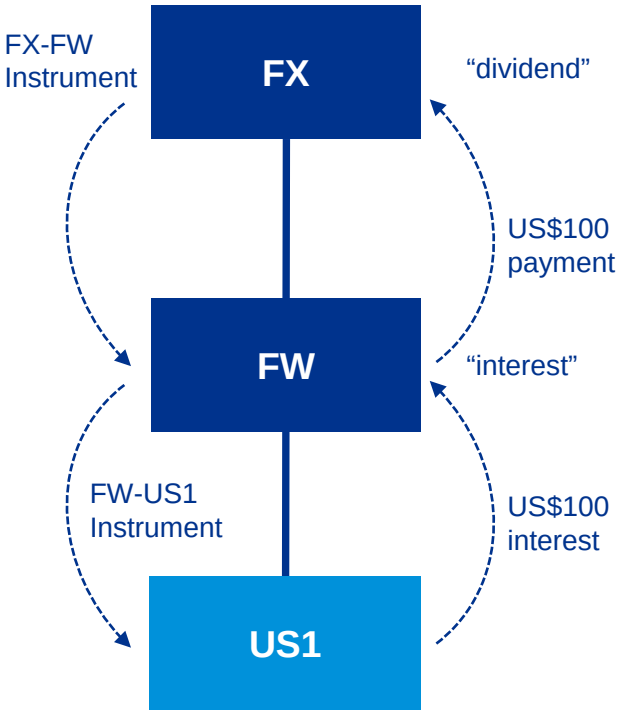
Ex. 8 – Imported Mismatch (direct offset)



FACTS

- FX wholly-owns FW, and FW wholly-owns US1
- FX holds a hybrid financial instrument issued by FW that is treated as debt for Country W purposes and equity for Country X purposes (the "FX-FW Instrument")
- FW holds an instrument of indebtedness due from US1 that is treated as debt for Country W and US tax purposes (the "FW-US1 Instrument")
- In Year 1, FW pays US$100 to FX on the FX-FW Instrument
  - For Country W purposes, the payment is treated as interest
  - For Country X purposes, the payment is treated as an excludable dividend
- Also, US1 pays US$100 interest to FW in Year 1, which FW includes in its taxable income as interest
- 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

Ex. 8 – Imported Mismatch (direct offset)



ANALYSIS

- US1 is a specified party and thus a deduction for its US$100 specified payment is subject to disallowance under section 267A to the extent it is, e.g., a "disqualified imported mismatch amount".
- US1's interest payment is a "disqualified imported mismatch amount" because the income attributable to US1's US$100 interest payment (an "imported mismatch payment") is directly offset by a "hybrid deduction".

1 FW's US$100x deduction is a "hybrid deduction" because it is a deduction allowed to FW (not a specified party) that:

  - Results from a payment of interest under Country W's tax law, and
  - If Country W [Ex. refers to Country X] had had rules substantially similar to those under proposed regulations sections 1.267A-1 thru -3 and -5, FW's deduction would be disallowed (here, because it is pursuant to a "hybrid transaction" under proposed regulations section 1.267A-2(b)).

2 Under proposed regulations section 1.267A-4(c)(1), the US$100 hybrid deduction directly offsets the income attributable to US1's imported mismatch payment because the entire US$100 of US1's payment directly funds FW's "hybrid deduction".

  - FW (the "imported mismatch payee") incurs at least US$100 of a hybrid deduction on its payment under the FX-FW Instrument.

- Result: US1's entire US$100 payment is a disqualified imported mismatch amount and, as a result, a deduction for the entire payment is disallowed

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Anti-avoidance rule

Anti-avoidance rule

Specified party's deduction for a specified payment is disallowed to the extent that:

The payment (or income attributable to the payment) results in a no inclusion

— Without regard to the de minimis and full inclusion rules

A principal purpose of the plan or arrangement is to avoid the purposes of the regulations

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Applicability dates

Applicability Dates

Generally apply to taxable years beginning after 31 December 2017

For taxable years beginning on or after 20 December 2018

- Disregarded payments
- Deemed branch payments
- Branch mismatch payments
- Imported mismatch amounts
- Application to structured arrangements

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Dual consolidated losses (DCLs) and domestic reverse hybrid entities (DRHs)

DCLs and DRHs

- Proposed regulation package includes proposed regulations that would require DRHs to consent to be subject to the US dual consolidated loss rules as dual resident corporations.
  - Address a double-deduction outcome
  - Would turn off the mirror legislation rule to DCLs of a domestic consenting entity

- DRH must have a related "specified foreign tax resident" owner that incurs or derives items of income, gain, deduction or loss of the DRH under the tax laws where such specified foreign tax resident is tax resident (e.g., treats the DRH as pass-through for the owner's local tax purposes).

- Effective date
  - Applies to any US check the box election made by an entity to be treated as a DRH post — 20 December 2018, regardless of whether the election is effective before 20 December 2018.
  - Previously formed DRHs are deemed to have consented, effective for their first tax year beginning post — 20 December 2019, unless they elect back into pass-through status for US tax purposes before then.

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