13 April 2020

Global Tax Alert

US final and proposed regulations on hybrid mismatches, DCLs and conduit financing provide more certainty but some surprises

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In final regulations (TD 9896), the United States (US) Internal Revenue Service (IRS) and the Treasury Department implement hybrid mismatch rules under Internal Revenue Code[1] Sections 267A and 245A(e) and rules for dual consolidated losses (DCLs) and entity classifications (the "Final Regulations"). Sections 267A and 245A(e) were enacted under the *Tax Cuts and Jobs Act* (TCJA) and are aimed at certain hybrid arrangements, with Section 267A denying deductions for certain hybrid arrangements and Section 245A(e) denying a dividends-received deduction for certain hybrid dividends.

In accompanying proposed regulations (REG-106013-19), the IRS and the Treasury Department provide guidance on hybrid deduction accounts (HDAs) under Section 245A(e), conduit-financing rules involving equity interests, and the treatment of certain payments under the Global Intangible Low-Taxed Income (GILTI) provisions (the Proposed Regulations). The GILTI provisions in these Proposed Regulations are discussed in a separate EY Breaking Tax News, *New anti-abuse rule targeting certain "GILTI gap period" transactions included in proposed regulations on hybrid mismatch, DCL, conduit financing and GILTI rules*, dated 7 April 2020.

The Final Regulations generally adopt with some changes the proposed regulations under Sections 267A and 245A(e), and the DCL rules issued in December 2018 (the 2018 Proposed Regulations). For a discussion of the

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2018 Proposed Regulations see EY Global Tax Alert, *US IRS proposes regulations implementing anti-hybrid mismatch rules under Sections 245A and 267A and expanding scope of DCL regulations*, dated 4 January 2019.

The Final Regulations under Section 267 are generally effective for tax years ending on or after 20 December 2018. The Final Regulations under Section 245A(e) apply to distributions made after 31 December 2017, provided those distributions occur during tax years ending on or after 20 December 2018. For both Sections 267A and 245A(e), taxpayers may either apply the Final Regulations or the 2018 Proposed Regulations to earlier periods but must apply either set of regulations in their entirety. As discussed later, the Final Regulations under both Sections have special effective dates for certain rules.

The Proposed Regulations would expand the conduit financing regulations under Treas. Reg. 1.881-3 to treat certain instruments characterized as equity for US tax purposes, but as debt for foreign law purposes, as a financing transaction that can result in a conduit financing arrangement. The Proposed Regulations would apply to payments made on or after the date that final regulations are published.

Section 267A Final Regulations

1. Background

Section 267A generally disallows a deduction for interest or royalties paid or accrued in certain transactions involving a hybrid arrangement when US law allows a deduction, but the payee does not have a corresponding income inclusion under foreign tax law (deduction/no-inclusion (D/NI)). A deduction for any interest or royalty paid or accrued (a specified payment) is disallowed to the extent it is (1) a disqualified hybrid amount, as described in Treas. Reg. Section 1.267A-2 (hybrid and branch arrangements); (2) a disqualified imported mismatch amount, as described in Treas. Reg. Section 1.267A-4 (payments offset by a hybrid deduction); or (3) a specified payment for which the requirements of the anti-avoidance rule of Treas. Reg. 1.267A-5(b)(6) are satisfied. A specified party is generally a US person, a controlled foreign corporation (CFC) or a US taxable branch, and the payee must generally be related to the specified party.

The Final Regulations under Section 267A generally maintain the structure of the 2018 Proposed Regulations, adopting those rules with several clarifications and revisions discussed below.

2. Hybrid and branch arrangements

Within the hybrid and branch arrangements category, the Final Regulations retain the same subcategories:

- *Hybrid transaction*: Any transaction, series of transactions, agreement, or instrument having one or more payments that are treated as interest or royalties for US tax purposes but are not treated the same under the tax law of the specified recipient.
  - A specified payment made under a hybrid transaction is a disqualified hybrid amount to the extent that (i) a specified recipient of the payment does not include the payment in income (no-inclusion), and (ii) the no-inclusion results from the payment being made under the hybrid transaction.
- *Disregarded payment*: A specified payment to the extent that the recipient's tax law disregards the payment or the payment gives rise to a deduction or similar offset.
- *Deemed branch payment*: Interest or royalties deemed paid to the home office of a US permanent establishment (PE) of a treaty country, if the payment is disregarded or otherwise not taken into account under the home office's tax law.
- *Payments to reverse hybrid*: Payment made to a reverse hybrid (fiscally transparent under the tax law of the country in which it is created, organized, or otherwise established but not fiscally transparent under the tax law of an investor of the entity) to the extent the investor in the reverse hybrid does not include the payment in income and the no-inclusion resulted from the payment being made to the reverse hybrid.
- *Branch mismatch payment*: Specified payment that, under the home office's tax law, is treated as attributable to a branch of the home office and the branch, under its tax law, is treated as not having a taxable presence or not having income attributable to it.

a. Hybrid transaction – long-term deferral

Long-term deferrals of income inclusions may cause a D/NI outcome. In particular, a specified payment is deemed made under a hybrid transaction if the tax year in which a specified recipient recognizes the payment under its tax law ends more than 36 months after the end of the tax year in which a deduction for the payment would otherwise be allowed for US tax purposes. Thus, the inclusion of income must generally occur within 36 months after the end of the payor's tax year to be considered an inclusion under Section 267A.

The Final Regulations retain the bright-line 36-month standard of the 2018 Proposed Regulations with some modifications. First, the Final Regulations establish a reasonable expectation standard based on whether, at the time of the specified payment, it is reasonable to expect that the payment will be taken into account and included in income within the 36-month period. If a specified payment will never be recognized under the tax law of a specified recipient (because, for example, the tax law does not impose an income tax), the Final Regulations clarify that the long-term deferral provision does not apply. Additionally, the Final Regulations treat a specified payment as included in income if the payment is included in income in a prior tax period.[2]

Basis or principal recovery can also give rise to long-term deferral and can thus create a D/NI. For example, if a specified payment is made under an instrument treated as debt for US tax purposes and equity for foreign law purposes, and the payment is treated as interest for US tax purposes and a recovery of basis under the foreign law, then the specified recipient may not have a taxable inclusion for an extended period. The Final Regulations clarify that a recovery of basis or principal can create a D/NI.[3]

The Final Regulations also include a special rule under which a specified recipient's no-inclusion of a specified payment is reduced by certain amounts that are repayments of principal for US tax purposes but included in income by the specified recipient.[4]

b. Hybrid transaction – hybrid sale/license

In response to certain comments on the definition of hybrid transactions, the Final Regulations add a rule exempting hybrid sale/license transactions from the hybrid transaction rule.[5] A hybrid sale/license transaction could occur, for example, when a specified payment is treated as a royalty for US tax purposes, and a contingent payment of consideration for the purchase of intangible property under the tax law of a specified recipient.

c. Hybrid transaction – interest-free loans (IFLs)

Under the Final Regulations, payments under IFLs and similar arrangements are deemed to be made under a hybrid transaction to the extent that a payment is imputed (for example, under Section 482 or 7872) and the tax resident or taxable branch to which the payment is made does not take the payment into account under its tax law because that tax law does not impute interest.[6] An IFL includes, for example, an instrument that is treated as debt under both US tax law and the holder's tax law but provides no stated interest. Such an instrument would give rise to a D/NI outcome to the extent the issuer is allowed an imputed deduction, but the holder is not required to impute interest income.

The IRS indicated its view that the 2018 Proposed Regulations covered IFLs. According to the Preamble, the disregarded-payment rule of the proposed regulations would treat the imputed interest as a disregarded payment because the imputed interest deduction on an IFL is not regarded under the tax law of the instrument's holder. The Preamble further states, "to more clearly address these transactions, the final regulations address imputed interest under the hybrid transaction rule."

The rule for IFLs and similar arrangements applies to payments made in tax years beginning on or after 20 December 2018.

d. Disregarded payments

Dual-inclusion income. The 2018 Proposed Regulations would treat a disregarded payment a disqualified hybrid amount to the extent it exceeded the specified party's dual-inclusion income. If a participation exemption regime or other relief regime applies to relieve double taxation (rather than create double non-taxation), the Final Regulations treat an income item of a specified party as dual-inclusion income even though the tax resident or taxable branch to which the disregarded payment is made does not include the item in income due to the participation exemption or other relief particular to a dividend.[7]

Coordination with deemed branch payments. The 2018 Proposed Regulations include a special rule to ensure that a specified payment is not a deemed branch payment to the extent the payment is otherwise taken into account under the home office's tax law so there is no mismatch. The 2018 Proposed Regulations, however, do not provide a similar rule in analogous cases involving disregarded payments. To provide symmetry between the disregarded payment rule and the deemed branch payment rule, the Final Regulations add a special rule to the disregarded payment rule. Under that special rule, a specified payment of a US taxable branch is not a disregarded payment to the extent that it is taken into account under tax law of the tax resident to which the payment is made.[8]

In addition, the Final Regulations require a US taxable branch to use a direct tracing approach to identify the person to whom interest described in Treas. Reg. Section 1.882-5(a)(1)(ii)(B) or -5(e) is payable. Additionally, similar to the tracing rules in the final Section 59A (Base Erosion and Anti-Abuse Tax – BEAT) regulations, the Final Regulations require foreign corporations to use US booked liabilities to identify the person to whom an interest expense is payable, without regard to which method the foreign corporation uses to determine its interest expense under Section 882(c)(1).[9]

The Preamble to Final Regulations notes that the Treasury Department and IRS determined that the deemed branch payment rule is not a treaty override and is consistent with US income tax treaty obligations.

e. Reverse hybrids

Expanded definition of fiscally transparent. A reverse hybrid is an entity that is fiscally transparent under the tax law of the country in which it is established but not under the tax law of an investor of the entity. A reverse hybrid can present D/NI outcomes because it is not a tax resident in the country where it is established, and an investor is not considered to derive the payment under its jurisdiction's tax law. A specified payment made to a reverse hybrid (provided relatedness requirements are satisfied) is generally a disqualified hybrid amount to the extent that an investor does not include the payment in income. While the 2018 Proposed Regulations would have limited the definition of "fiscally transparent" to the definition in the Section 894 regulations, the Final Regulations expand the definition to account for cases in which the Section 894 regulations might not consider an entity a reverse hybrid with respect to a payment it receives, because neither the entity nor its investor take the payment into income, resulting in a D/NI outcome.

Under the Final Regulations, an entity is fiscally transparent under the tax law of the country where it is established if it is considered fiscally transparent under the principles of Treas. Reg. Sections 1.894-1(d)(3)(ii) and (iii). In addition, the following special rules apply. First, an item of income is considered received by a fiscally transparent entity if the entity does not "take the item into account in its income" under the tax law of its country of organization, so its investor must take the item into account in its income as if the investor received the item directly, rather than through the entity. Second, a similar rule applies for purposes of determining whether the entity is fiscally transparent with respect to the payment under an investor's tax law. Third, the Final Regulations consider collective investment vehicles and similar arrangements as fiscally transparent under the tax law of the country where established if that tax law imposes a corporate income tax and neither the arrangement nor an investor must take the payment into account in income.[10]

Current-year distributions of all of reverse hybrid's income. The 2018 Proposed Regulations would generally treat a specified payment made to a reverse hybrid as a disqualified hybrid amount to the extent that an investor does not include the payment in income. Whether an investor includes the specified payment in income would be determined without regard to any subsequent distributions by the reverse hybrid. The Final Regulations soften this rule somewhat, but only when a reverse hybrid distributes **all** of its income during the tax year. In this case, to the extent an investor includes in income a current-year distribution (or distributions) from the reverse hybrid, the investor is treated as including in income a portion (or portions) of a specified payment that is made to the reverse hybrid during the year. That amount will not be treated as a disqualified hybrid amount.[11]

Multiple investors. When an investor of the reverse hybrid owns only a portion of the hybrid's interests and does not include in income its portion of a specified payment made to the reverse hybrid, the Final Regulations clarify that only the no-inclusion portion will give rise to a disqualified hybrid amount.[12]

f. Exceptions relating to disqualified hybrid amounts

Effect of inclusion in another foreign country. Under the 2018 Proposed Regulations, a specified payment generally would be 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 in another foreign country (i.e., a third country). Although commenters asked Treasury to remove the provision, or address it through general anti-avoidance rules, the Final Regulations retain the approach of the 2018 Proposed Regulations. According to the Preamble, that approach prevents the routing of a specified payment through a low-tax third country to avoid Section 267A, as well as the use of a hybrid or branch arrangement to place a taxpayer in a better position than it would have been absent the arrangement.

Amounts included or includible in income in the US. The Final Regulations revise the rule in the 2018 Proposed Regulations that would not treat a specified payment as a disqualified hybrid amount to the extent it is included in the income of a US person or a US branch, or is taken into account by a US shareholder under the subpart F or GILTI rules. The determination of amounts considered taken into account under the subpart F rules would be made without the earnings and profits limitation of Section 952. In a significant change from the 2018 Proposed Regulations, the Final Regulations reduce the determination of amounts considered taken into account under GILTI to correspond with the reduced rates on GILTI inclusions resulting from the Section 250(a)(1)(B) deduction.[13] Accordingly, more attention must be given to payments to CFCs.

3. Disqualified imported mismatch amounts

The imported mismatch rules are intended to prevent the effects of an offshore hybrid arrangement from being imported into the US through the use of a non-hybrid arrangement. A specified payment would generally be a disqualified imported mismatch amount to the extent the payment is (i) an imported mismatch payment and (ii) income attributable to the payment is directly or indirectly offset by a hybrid deduction of a tax resident or taxable branch. Under these rules, a hybrid deduction would offset income attributable to an imported mismatch payment only if the imported mismatch payment directly or indirectly funds the hybrid deduction. The Final Regulations retain the general approach of the imported mismatch rules, with some modifications that narrow the scope of the rules somewhat.

a. Imported mismatch payments

The Final Regulations revise the definition of an imported mismatch payment, which was defined under the 2018 Proposed Regulations as any specified payment to the extent it is not a disqualified hybrid amount. The Final Regulations only treat a specified payment as an imported mismatch payment to the extent that it is neither a disqualified hybrid amount nor included or includible in income in the US (as determined under the rules of Treas. Reg. Section 1.267A-3(b)) (e.g., as a subpart F inclusion).[14]

b. Hybrid deductions

An allowable deduction under a tax resident's or taxable branch's tax law is generally a hybrid deduction if the inclusion of rules substantially similar to Treas. Reg. Sections 1.267A-1 through 1.267A-3 and 1.267A-5 in that tax law would result in the deduction's disallowance. The Final Regulations clarify how this standard applies when the tax law of a tax resident or taxable branch contains hybrid mismatch rules. In those cases, the Final Regulations provide an exclusive list of deductions that constitute hybrid deductions. The list includes deductions for: (i) equity; (ii) interest-free loans and similar arrangements; and (iii) amounts that are not included in income in a third foreign country.[15] Thus, for a tax resident or taxable branch whose jurisdiction's laws include hybrid mismatch rules, only these types of arrangements need to be considered when determining whether the tax resident or taxable branch has hybrid deductions under the imported mismatch rule.

NIDs. A hybrid deduction would include notional interest deductions (NIDs) allowed to a tax resident under its tax law. The Final Regulations clarify that an NID is a hybrid deduction only to the extent that the double non-taxation produced by the NID results from hybridity.[16] Only NIDs allowed to a tax resident under its tax law for accounting periods beginning on or after 20 December 2018, are hybrid deductions.[17]

Hybrid deductions of CFCs. In general, only a tax resident or taxable branch that is not a specified party would incur a hybrid deduction or would be considered to make a funded taxable payment. This approach was intended to prevent potential double taxation under Section 267A of specified payments involving CFCs, because payments made to CFCs would generally be includible in income in the United States, and payments by CFCs are subject to disallowance as disqualified hybrid amounts. To prevent the avoidance of the imported mismatch rule through the use of CFCs that are not wholly-owned by US tax residents, the Final Regulations permit CFCs to incur hybrid deductions and make funded taxable payments.[18] There is no hybrid deduction or funded taxable payment, however, if the amount is a disqualified hybrid amount or included or includible in US income. For a disqualified hybrid amount of a CFC that is only partially owned by US tax residents (or a disqualified hybrid amount for which a deduction would be allocated and apportioned to income not subject to US tax), only a portion of the disqualified hybrid amount prevents a CFC payment from giving rise to a hybrid deduction or a funded taxable payment. This is because disallowing the CFC a deduction for the disqualified hybrid amount will only partially increase the US tax base (or will not increase the US tax base at all).[19] The Final Regulations provide a new example illustrating these rules.[20]

c. Setoff rules

Subject to a set of ordering 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 under certain "funding" rules.

Funded taxable payments. For an imported mismatch payment to indirectly fund a hybrid deduction, the imported mismatch payee must directly or indirectly make a funded taxable payment to the tax resident or taxable branch that incurs the hybrid deduction. The Final Regulations clarify that a payment must be included in the income of a tax resident or taxable branch to be a funded taxable payment.[21]

Ordering rules. When there are multiple imported mismatch payments, a hybrid deduction is first considered to offset income attributable to the imported mismatch payment that has the closest nexus to the hybrid deduction. The Final Regulations retain this approach with two clarifications. First, an imported mismatch payment is a factually related imported mismatch (and given priority in terms of funding the hybrid deduction over other imported mismatch payments) only if a design of the plan or series of related transactions was for the hybrid deduction to offset income attributable to the payment.[22] Second, if there are multiple imported mismatch payments that indirectly connect to the tax resident or taxable branch incurring the hybrid deduction, then the hybrid deduction is first considered to offset income attributable to an imported mismatch payment that connects, through the fewest number of funded taxable payments, to the tax resident or taxable branch incurring the hybrid deduction.[23]

Relatedness requirement. A hybrid deduction offsets income attributable to an imported mismatch payment only if the tax resident or taxable branch incurring the hybrid deduction is related to the imported mismatch payer (or is a party to a structured arrangement under which the payment is made). For an imported mismatch payment to indirectly fund a hybrid deduction, the Final Regulations require the imported mismatch payee (and each intermediary tax resident or taxable branch) to be related to the imported mismatch payer (or a party to a structured arrangement under which the payment is made).[24]

d. Coordination with foreign imported mismatch rules

Certain payments deemed to be imported mismatch payments. The 2018 Proposed Regulations coordinate the US imported mismatch rule with foreign imported mismatch rules through a special rule under which certain payments by non-specified parties are deemed to be imported mismatch payments (the Deemed IMP Rule). The Deemed IMP Rule reduces the extent to which a payment of a specified party is considered to fund a hybrid deduction. The Final Regulations modify the Deemed IMP Rule so that it takes into account payments subject to disallowance under a foreign imported mismatch rule, rather than payments for which a deduction is actually denied under the foreign imported mismatch rule.[25]

Special rules for applying imported mismatch rule. When the US imported mismatch rule treats a deduction as a hybrid deduction, but a foreign imported mismatch rule does not, the Deemed IMP Rule could give rise to inappropriate results. Accordingly, the Final Regulations specify that the US imported mismatch rule is first applied by taking into account only certain hybrid deductions – that is, deductions that are unlikely to be treated as hybrid deductions for purposes of a foreign hybrid mismatch rule.[26] The Final Regulations provide an exclusive list of such hybrid deductions, which covers the hybrid deductions previously noted – (i) NIDs for equity, (ii) IFLs and similar arrangements, and (iii) amounts that are not included in income in a third foreign country. For purposes of applying the imported mismatch rule in this manner, the Deemed IMP Rule does not apply. For all other hybrid deductions, the imported mismatch rule applies by taking into account the Deemed IMP Rule.[27]

4. Other issues

a. Definition of Interest

The definition of interest in the 2018 Proposed Regulations is based on the definition of interest in the proposed regulations under Section 163(j). Although no comments were received on the definition of interest under the hybrid regulations, numerous comments were received on the definition of interest in the proposed regulations under Section 163(j). The Final Regulations modify the definition of interest for Section 267A purposes in light of these comments. The Final Regulations do not include the rules requiring adjustments to the amount of interest expense to reflect the impact of derivatives that alter a taxpayer's effective cost of borrowing.[28] For swaps with nonperiodic payments, the Final Regulations provide exceptions for cleared swaps and for non-cleared swaps subject to margin or collateral requirements.[29]

b. Structured payments treated as interest

Structured payments are treated as specified payments and subject to Section 267A. Structured payments include certain payments related to, or predominantly associated with, the time value of money, and adjustments affecting the effective cost of funds.

The Final Regulations treat structured payments as identical to interest for purposes of Section 267A.[30] The Final Regulations also modify the definition of a structured payment in light of comments received on the definition of interest under the Section 163(j) proposed regulations.

The Final Regulations do not specifically include certain amounts that are closely related to interest and that affect the economic cost of funds, such as commitment fees, debt issuance costs and guaranteed payments, in the definition of structured payments. The Final Regulations instead provide an anti-avoidance rule pursuant to which any expense or loss that is economically equivalent to interest is treated as a structured payment for purposes of Section 267A if a principal purpose of structuring the transaction is to reduce an amount that would have been treated as interest or as a structured payment.[31] Additionally, the Final Regulations provide that a substitute interest payment, as defined in Treas. Reg. Section 1.861-2(a)(7), is a structured payment for purposes of Section 267A, unless the payment relates to a sale-repurchase agreement or securities lending transaction that is entered into by the payor in its ordinary course of business.[32]

c. Coordination rules, including with capitalization and recovery provisions and Section 163(j)

Section 267A generally applies to a specified payment after applying other applicable provisions of the Code. The Final Regulations, however, require Section 267A to be applied before capitalization provisions. For example, the payment is not capitalized and included in inventory cost or added to basis under Section 263A to the extent that Section 267A disallows a deduction.[33]

Additionally, the Final Regulations clarify that Section 267A applies to a specified payment before Section 163(j). To the extent a specified payment is not described in Treas. Reg. Section 1.267A-1(b) at the time it is subject to Section 267A, the payment is not subject to Section 267A at a later time.[34]

d. Structured arrangements

A structured arrangement is an arrangement for which one or more specified payments would be a disqualified hybrid amount or a disqualified imported mismatch amount if the specified payment were analyzed without regard to the relatedness limitations (i.e., payments to third parties). Under the 2018 Proposed Regulations, an arrangement is a structured arrangement if either (i) a pricing test is satisfied (i.e., a hybrid mismatch is priced into the terms of the arrangement), or (ii) a principal purpose test is satisfied (i.e., a hybrid mismatch is a principal purpose of the arrangement based on all the facts and circumstances). In response to comments, the Final Regulations provide a somewhat more objective test (including a pricing component) to determine whether the arrangement was designed to produce the hybrid mismatch and incorporate a reason-to-know standard.[35]

To facilitate restructurings intended to eliminate or minimize hybridity for structured arrangements entered before 22 December 2017, the Final Regulations apply to specified payments made under a structured arrangement only for tax years beginning after 31 December 2020.[36]

e. Tax law of a country

The Final Regulations define the tax law of a country as including the tax law of a political subdivision or other local authority, provided that an income tax treaty between that country and the US covers income taxes imposed under such a subnational tax law.[37] For example, taxes imposed by states or jurisdictions, such as a cantonal tax, would be subject to Section 267A.

f. Specified parties

The Final Regulations treat a CFC as a specified party only if a US tax resident, for purposes of Sections 951 and 951A, owns at least 10% of the CFC's stock.[38]

g. Anti-avoidance rule

The Final Regulations retain a general anti-avoidance rule but clarify it to focus on the terms or structure of an arrangement. They also require the D/NI outcome to result from a hybrid or branch arrangement.[39]

h. Effect of disallowance on earnings and profits

Under the 2018 Proposed Regulations, the disallowance of a deduction under Section 267A would not affect a corporation's earnings and profits. The Final Regulations retain this rule but include an anti-abuse rule. Under that rule, a specified payment for which a deduction is disallowed under Section 267A does not reduce a CFC's earnings and profits under Section 952(c)(1) and Treas. Reg. Section 1.952-1(c), if reducing or limiting the CFC's subpart F income is a principal purpose of the transaction under which the payment is made.

Section 245A(e) Final Regulations

1. Section 245A(e)

Section 245A(e) disallows a DRD for dividends received by a US shareholder from a CFC if the dividend is a "hybrid dividend." A hybrid dividend is an amount received from a CFC for which a Section 245A DRD would otherwise be allowed, and for which the CFC received a deduction (or other tax benefit) with respect to any income, war profits or excess profits taxes imposed by any foreign country or US possession.

The 2018 Proposed Regulations provide rules for identifying and tracking hybrid dividends and set forth standards for identifying hybrid deductions. The 2018 Proposed Regulations would treat a dividend as a hybrid dividend to the extent paid out of a "specified owner's" "[HDAs]." Generally, the amount of any hybrid dividend is the sum of a specified owner's HDAs for each share of CFC stock. The hybrid deduction account for the share generally reflects the amount of the CFC's hybrid deductions allocated to the share. A specified owner includes a domestic corporation that is a US shareholder of a CFC, an upper-tier CFC that would be a US shareholder of the CFC if the upper-tier CFC were a domestic corporation and certain other indirect owners of CFCs.

2. Section 245A(e) Final Regulations and Proposed Regulations

The Final Regulations generally retain the approach of the 2018 Proposed Regulations but make several notable changes. The Proposed Regulations would reduce a hybrid deduction account with respect to a share of CFC stock by an "adjusted subpart F inclusion" or an "adjusted GILTI inclusion" (or both) with respect to the share. These Proposed Regulations are proposed to apply to tax years ending on or after the date those regulations are published as final. Taxpayers may apply these rules to tax years ending before that date, provided they apply them consistently.[40]

3. Hybrid deductions

The Final Regulations make several changes and clarifications to the definition of "hybrid deduction."

First, the Final Regulations contain an "anti-duplication" rule. This rule is intended to address cases in which the upper-tier CFC and lower-tier CFC have issued "mirror" hybrid instruments. For example, the lower-tier CFC issues a hybrid instrument to the upper-tier CFC and the upper-tier CFC issues a hybrid instrument with substantially similar terms to its corporate US shareholder. Under the anti-duplication rule, the lower-tier CFC's deduction is not a hybrid deduction, but the upper-tier CFC's deduction is a hybrid deduction.[41]

Second, the Final Regulations clarify that a deduction or other tax benefit may be a hybrid deduction, regardless of whether the deduction is used currently to reduce foreign tax liability. In determining whether a deduction or other tax benefit is allowed, taxpayers are to disregard whether the deduction is disallowed or deferred under the relevant foreign law (for example, a rule similar to Section 163(j)). They also are to disregard whether any foreign hybrid mismatch rules apply, if the amount gives rise, or is reasonably expected to give rise, to a dividend for US tax purposes and will be paid within 12 months after the tax period in which the deduction or other tax benefit would otherwise be allowed.[42]

Third, while retaining the approach in the 2018 Proposed Regulations by treating a deduction for equity, like a NID, as a hybrid deduction, the final regulations treat only NIDs allowed to a CFC for tax years beginning on or after 20 December 2018, as hybrid deductions.[43]

4. Hybrid deduction accounts

Under the 2018 Proposed Regulations, a dividend received by a US shareholder generally is a hybrid dividend to the extent of the shareholder's HDAs for the shares of CFC stock, even if the dividend was paid with respect to a share that did not have hybrid deductions allocated to it. While generally retaining this approach, the Final Regulations make some changes.

a. Exception for certain upper-tier CFCs

The Final Regulations acknowledge that there is no need in some cases for an upper-tier CFC to maintain HDAs with respect to shares of its lower-tier CFC. For example, if the upper-tier CFC is a CFC solely because of the repeal of the limitation on the "downward" attribution rule under Section 958(b)(4), Section 245A(e)(2) would not apply to a dividend received by the upper-tier CFC from the lower-tier CFC.[44]

b. Exception for Section 355 distributions and Section 338(g) elections

The Final Regulations also address adjustments to hybrid deductions accounts for a Section 355 distribution or a Section 338(g) election. For a Section 355 distribution, the hybrid deduction account with respect to the stock of the distributing CFC is allocated in a manner consistent with how earnings and profits of the distributing CFC are allocated between the distributing CFC and the controlled CFC. If a Section 338(g) election is made, a hybrid deduction account with respect to the old target's stock generally does not carry over to the new target's stock.[45]

c. Reductions to HDAs for previously included amounts

The Proposed Regulations provide rules that reduce HDAs for three amounts:

1. An adjusted subpart F inclusion amount
2. An adjusted GILTI inclusion amount
3. Section 956 income inclusions resulting from a hypothetical distribution not qualifying for the Section 245A DRD by reason of Section 245A(e)'s application

Treasury and the IRS proposed these rules because they believe Section 245A(e) is generally intended to ensure that CFC earnings and profits that have not been subject to foreign tax because of certain hybrid arrangements are subject to US tax when distributed. This safeguard is not needed, however, if those earnings and profits are included in the gross income of a CFC's US shareholder by other means, such as under the subpart F or GILTI regimes.

The regulations provide a three-step process for determining the appropriate adjustment for each of these two categories. The ultimate objective of these steps is to reflect, on a share-by-share basis (when relevant), the adjusted amount of subpart F and tested income amounts that would be subject to the full corporate income tax in the US. For example, the adjusted GILTI inclusion amount takes into account both the Section 250 deduction and the applicable foreign tax credit rules (including the inclusion percentage, the 80% percent limit and the Section 78 gross-up amount).

Conversely, because no foreign tax credits are deemed paid with respect to a Section 956 inclusion and no deduction is allowed for that inclusion, a Section 956 inclusion reduces an HDA dollar-for-dollar. In any given year, the reduction to the HDA balance cannot exceed the hybrid deductions (for the year) allocated to each of the CFC's share(s) multiplied by the ratio of the subpart F income (or tested income) to the CFC's taxable income in that tax year. The Preamble to the Proposed Regulations explains that this limiting rule is intended to ensure that a subpart F inclusion in a current tax year does not reduce or deplete hybrid deductions that occurred and were added to the HDA's balance in a prior tax year, thus sheltering income that has technically never been subject to foreign tax.

5. Anti-avoidance rule

The 2018 Proposed Regulations include an anti-avoidance rule that would require appropriate adjustments to be made, including adjustments that would disregard a transaction or arrangement, if a taxpayer engages in the transaction or arrangement with a principal purpose of avoiding the purposes of the proposed regulations. The Final Regulations retain this rule, but also provide that the rule does not apply to disregard the elimination of a hybrid arrangement or the conversion of the arrangement into a non-hybrid arrangement.[46]

Final DCL Regulations

As in the 2018 Proposed Regulations, the Final Regulations require a domestic entity electing to be treated as a corporation under Treas. Reg. Section 301.7701-3(c) to consent to be treated as a dual-resident corporation under Section 1503(d) for tax years in which (1) a "specified foreign tax resident" (generally, a foreign corporation that is a tax resident) derives or incurs under its tax law the domestic consenting corporation's items of income, gain, deduction, or loss, and (2) the specified foreign tax resident is related to the domestic consenting corporation (as determined under Sections 267(b) or 707(b)).

The Final Regulations treating "domestic consenting corporations" as dual-resident corporations apply to tax years ending on or after 20 December 2018. The amendments to Treas. Reg. Section 301.7701-3(a) and (c)(3) apply to domestic eligible entities that, on or after 20 December 2018, file an election to be classified as an association (regardless of whether the election is effective before that date).[47] The Final Regulations provide a transition rule for domestic eligible entities that existed before the publication of the proposed regulations. They would be deemed to consent to be treated as a dual-resident corporation for tax years beginning after 20 December 2019.[48]

New Proposed Conduit Regulations

1. Conduit regulations generally

The conduit regulations allow the IRS to disregard a conduit entity in a conduit "financing arrangement" so that the financing arrangement is a transaction directly between the remaining parties. These rules are meant to prevent the use of a multiple-party financing transaction to avoid withholding tax. Under the current conduit financing regulations, an instrument that is treated as equity for US tax purposes will generally not result in a financing transaction, even if the instrument is treated as debt for foreign law purposes.[49] The Treasury Department and the IRS determined that these types of instruments could be used inappropriately to avoid the application of the conduit financing regulations and raised similar D/NI concerns as those addressed by Sections 267A and 245A(e). The Proposed Regulations were issued to address these concerns.

2. Proposed Regulations

The Proposed Regulations would expand the types of equity interests treated as financing transactions to include stock or a similar interest if the tax laws of a foreign country where the issuer is resident allow the issuer to take a deduction or other tax benefit for an amount paid, accrued or distributed with respect to the stock or similar interest. Similarly, if the issuer maintains a taxable presence (PE) in a country that allows a deduction (including a notional deduction) for an amount paid, accrued or distributed with respect to the PE's deemed equity or capital, then the amount of the deemed equity or capital would be treated as a financing transaction.[50] The Proposed Regulations would also treat equity as a financing transaction if a person related to the issuer is entitled to a refund (including a credit) or similar tax benefit for taxes paid by the issuer.[51] If an equity interest constitutes a financing transaction because the issuer is allowed a NID, the Proposed Regulations would limit the portion of the financed entity's payment that is recharacterized under Treas. Reg. Section 1.881-3(d)(1)(i). The recharacterized portion would equal the financing transaction's principal amount as determined under Treas. Reg. Section 1.881-3(d)(1)(ii), multiplied by the applicable rate used to compute the issuer's NID in the year of the financed entity's payment.[52] These regulations will apply to payments made on or after the date that the final regulations are published.

Implications

The Section 267A Final Regulations provide some much-needed clarity, especially on what constitutes a hybrid deduction for purposes of the imported mismatch rules and what constitutes interest for purposes of Section 267A. Additionally, the rules narrowing the definition of interest may indicate the direction of the yet-to-be published final Section 163(j) regulations.

While the inclusion of IFLs in the Section 267A Final Regulations may not come as a surprise to some taxpayers, the effective date of these rules might, as they apply for tax years beginning on or after 20 December 2018. Accordingly, taxpayers should review their capital structures to determine whether certain deductions are disallowed under this rule. The rules requiring GILTI inclusions (which are not disqualified hybrid amounts under Section 267A) to be reduced to take into account the Section 250(a)(1)(B) deduction will require taxpayers to more carefully consider the impact of Section 267A on payments to CFCs.

Regarding Section 245A(e), the Final Regulations provide a mixed bag for taxpayers. On the one hand, the changes to the rules for HDAs, including the anti-duplication rule and the delayed effective dates for certain transactions, will be welcome. Additionally, the rules in the Proposed Regulations reducing the HDAs for subpart F income and GILTI provide some needed relief. On the other hand, Treasury rejected most comments requesting relief from some provisions of regulations that were not contemplated by the statute and the anti-avoidance rule remains quite vague.

The New Proposed Regulations under the conduit rules may take some taxpayers by surprise. By expanding the conduit financing rules to capture certain hybrid equity arrangements, the rules could have broad implications. Moreover, considering that these rules apply to payments made on or after the date those regulations are finalized, taxpayers should be currently reviewing their capital structures to determine if they could be affected by these new rules.

Endnotes

1. All "Section" references are to the Internal Revenue Code of 1986, and the regulations promulgated thereunder.
2. Treas. Reg. Section 1.267A-2(a)(2)(ii)(A); -3(a)(1)(i).
3. Treas. Reg. Section 1.267A-3(a)(1).
4. Treas. Reg. Sections 1.267A-3(a)(4); -6(c)(1)(vi).
5. Treas. Section 1.267A-2(a)(2)(ii)(B).
6. Treas. Reg. Section 1.267A-2(a)(4).
7. Treas. Reg. Sections 1.267A-2(b)(3)(ii) and -6(c)(3)(iv).
8. Treas. Reg. Section 1.267A-2(b)(2)(ii)(B).
9. Treas. Reg. Section 1.267A-5(b)(3)(ii)(A).
10. Treas. Reg. Section Treas. Reg. 1.267A-5(a)(8)(i) - (iii).
11. Treas. Reg. Section 1.267A-3(a)(3).
12. Treas. Reg. Sections 1.267A-2(d) and -6(c)(5)(iv).
13. Treas. Reg. Section 1.267A-3(b)(3)-(5).
14. Treas. Reg. Section 1.267A-4(a)(2)(v).
15. Treas. Reg. Section 1.267A-4(b)(2)(i).
16. Treas. Reg. Section 1.267A-2(b)(1)(ii).
17. Treas. Reg. Section 1.267A-4(b)(2)(iii).
18. Treas. Reg. Sections 1.267A-4(b)(1) and (c)(3)(v).
19. Treas. Reg. Section 1.267A-4(g).
20. Treas. Reg. Section 1.267A-6(c)(11).
21. Treas. Reg. Section 1.267A-4(c)(3)(v)(B).
22. Treas. Reg. Section 1.267A-4(c)(2)(i).
23. Treas. Reg. Section 1.267A-4(c)(3)(vii) and (viii).
24. Treas. Reg. Section 1.267A-4(c)(3)(ii) and (iv).
25. Treas. Reg. Section 1.267A-4(f)(2).
26. Treas. Reg. Section 1.267A-4(f)(1).
27. Treas. Reg. Section 1.267A-4(f)(2).
28. Treas. Reg. Section 1.267A-5(a)(12).
29. Treas. Reg. Section 1.267A-5(a)(12)(ii).
30. Treas. Reg. Section 1.267A-5(b)(5)(i).
31. Treas. Reg. Section 1.267A-5(b)(5)(ii)(B).
32. Treas. Reg. Section 1.267A-5(b)(5)(i).
33. Treas. Reg. Section 1.267A-5(b)(1)(iii).
34. Treas. Reg. Section 1.267A-5(b)(1)(i).
35. Treas. Reg. Section 1.267A-5(a)(20).
36. Treas. Reg. Section 1.267A-7(b)(2).
37. Treas. Reg. Section 1.267A-5(a)(21).
38. Treas. Reg. Section 1.267A-5(a)(17).
39. Treas. Reg. Section 1.267A-5(b)(6).
40. Prop. Reg. Section 1.245A(e)-1(h)(2).
41. Treas. Reg. Section 1.245A(e)-1(d)(2)(iii).
42. Treas. Reg. Section 1.245A(e)-1(d)(2).
43. Treas. Reg. Section 1.245A(e)-1(d)(2)(iv).
44. Treas. Reg. Section 1.245A(e)-1(f)(6).
45. Treas. Reg. Section 1.245A(e)-1(d)(4)(iii)(B)(4).
46. Treas. Reg. Section 1.245A(e)-1(e).
47. Treas. Reg. Sections 1.1503(d)-8(b)(6) and 301.7701-3(c)(3)(iii).
48. Treas. Reg. Section 301.7701-3(c)(3)(ii).
49. Treas. Reg. Section 1.881-3(a)(2)(ii).
50. Prop. Reg. Section 1.881-3(a)(2)(ii)(B)(1)(iv).
51. Prop. Reg. Section 1.881-3(a)(2)(ii)(B)(1)(v).
52. Prop. Reg. Section 1.881-3(d)(1)(ii).

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EYG no. 002058-20Gbl

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