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Global Tax Alert

US IRS proposes regulations implementing anti-hybrid mismatch rules and expanding scope of dual consolidated loss regulations

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Executive summary

On 20 December 2018, the United States (US) Internal Revenue Service (IRS) released proposed regulations (REG-104352-18) that would implement the anti-hybrid mismatch rules under Internal Revenue Code[1] (Code) Sections 245A(e) and 267A, which were enacted under the law known as the *Tax Cuts and Jobs Act* (TCJA). The proposed regulations also include rules under Sections 1503(d), 6038, 6038A, and 7701 (collectively, the Proposed Regulations).

Generally, the Proposed Regulations under Section 267A would deny a deduction for interest and royalty payments that meet the definition of a "disqualified related party amount" paid or accrued under a hybrid transaction or by, or to, a hybrid entity. Specifically, the Section 267A Proposed Regulations:

- Would clarify the scope of Section 267A as applying only to deductions of payments made to related parties, unless the deduction is under a "structured arrangement"
- Would limit Section 267A's application to deduction/no inclusion outcomes that result from hybridity
- Address when Section 267A applies to payments to a reverse hybrid
- Would exempt certain payments included in the income of a US tax resident or taken into account under the subpart F or global intangible low-taxed income (GILTI) rules

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- Define "royalty" by reference to the US Model Treaty and define "interest" expansively, similar to the regulations proposed under Section 163(j)
- Would generally apply to tax years beginning after 31 December 2017, but apply to tax years beginning on or after 20 December 2018, for certain payments

The Proposed Regulations also provide guidance on hybrid dividends for purposes of applying Section 245A(e). Specifically, the Proposed Regulations:

- Provide guidance on distributions of previously taxed income (PTI) by a first-tier controlled foreign corporation (CFC) to its US shareholder and tiered hybrid dividend payments of PTI (i.e., paid from a lower-tier CFC to an upper-tier CFC)
- Create the concept of a hybrid deduction account to ensure that dividends not out of PTI either result in subpart F income or are ineligible for the Section 245A dividends received deduction, regardless of whether the same payment gives rise to the dividend and the hybrid deduction
- Likely will be finalized by 22 June 2019, and apply to distributions made after 31 December 2017

This Alert provides a general overview of the Proposed Regulations.

Detailed discussion

Section 267A

Background

Section 267A, as enacted by the TCJA, disallows a deduction for interest or royalties paid or accrued in certain transactions involving a hybrid arrangement. According to the legislative history, Congress intended this provision to address cases in which the taxpayer is provided a deduction under US tax law, but the payee does not have a corresponding income inclusion under foreign tax law, known as a "deduction/no-inclusion" (D/NI) outcome. The Preamble notes that Section 267A and the Proposed Regulations are intended to be consistent with the approaches taken to address hybrid arrangements (or similar arrangements involving branches) under the Code, the Organisation for Economic Co-operation and Development (OECD) Base Erosion and Profit Shifting (BEPS) project, and income tax treaties, as well as other provisions in domestic and foreign law. The Proposed Regulations address only D/NI outcomes that result from hybridity (which would not include, for example, a D/NI outcome resulting from the lack of a corporate income tax in the recipient's jurisdiction), and do not provide rules for transactions that result in so-called double-deduction outcomes. The Preamble indicates these transactions are addressed through other provisions (or doctrines), such as the dual consolidated loss rules.

Prop. Reg. Sections 1.267A-1 through 1.267A-5 provide rules for when a deduction is disallowed under Section 267A for interest or royalties paid or accrued. Prop. Reg. Section 1.267A-6 provides examples illustrating application of these rules. Prop. Reg. Section 1.267A-7 provides applicability dates.

Prop. Reg. Section 1.267A-1: General rule

Prop. Reg. Section 1.267A-1(b) outlines the exclusive circumstances in which a deduction is disallowed under Section 267A. Generally, a specified party's deduction for any interest or royalty paid or accrued (the amount paid or accrued with respect to the specified party, a "specified payment") would be disallowed to the extent it produced a D/NI outcome as a result of (i) a hybrid or branch arrangement (a disqualified hybrid amount, as described in Prop. Reg. Section 1.267A-2); (ii) an offshore hybrid or branch arrangement being imported into the US tax system (a disqualified imported mismatch amount, as described in Prop. Reg. Section 1.267A-4); or (iii) a transaction whose principal purpose is to avoid the purposes of the regulations under Section 267A. The rules provide a de minimis exception to the extent the sum of a specified party's interest and royalty deductions (determined without regard to Section 267A) is less than US$50,000.[2]

A "specified party" is defined as a tax resident of the United States; a CFC with one or more US shareholders that own (within the meaning of Section 958(a)) at least 10% of the CFC's stock; and a US taxable branch, including a US permanent establishment (PE) of a tax treaty resident. A partner of a partnership may be a specified party, but not the partnership itself.

Prop. Reg. Section 1.267A-2: Hybrid and branch arrangements

Generally, the Proposed Regulations would treat a specified payment as a disqualified hybrid amount if the payment is made pursuant to a "hybrid transaction" and two requirements are met: first, the specified recipient of the payment does not include the payment in income, as determined under Prop. Reg. Section 1.267A-3(a) (a no-inclusion); second, the specified recipient's no-inclusion results from the payment being made pursuant to a hybrid

transaction. A "specified recipient" means, with respect to a specified payment, any tax resident that derives the payment under its tax law (determined under the principles of Reg. Section 1.894-1(d)(1), regardless of whether the country in question has an income tax treaty with the United States) or any taxable branch to which the payment is attributable under its tax law. A "tax resident" means: (i) a body corporate or other entity or body of persons liable for tax under the tax law of a country as a resident (which may be the case even if the country's tax law does not impose an income tax); or (ii) an individual that is liable for tax under the tax law of a country as a resident. Entities and individuals can be tax residents in more than one country.

A "hybrid transaction" means 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 so treated for purposes of the tax law of the specified recipient. For example, a hybrid transaction includes an instrument whose payments are treated as interest for US tax purposes but as distributions on equity under foreign tax laws. When a specified payment is made pursuant to a hybrid transaction, it generally is a disqualified hybrid amount to the extent that the specified recipient does not include the payment in income, and the no-inclusion results from the hybrid nature of the transaction. In addition, the Proposed Regulations would deem a specified payment as being made pursuant to a hybrid transaction if there were a long-term mismatch (more than 36 months) between the tax year in which the specified party is allowed a deduction for the payment under the US tax law and the tax year in which a specified recipient includes the payment in income under its tax law. This rule applies, for example, when a specified payment is made pursuant to an instrument viewed as debt under both US and foreign tax law and, due to a mismatch in tax accounting treatment, results in long-term deferral. In addition, special rules address payments made pursuant to securities lending transactions, sale-repurchase transactions, or similar transactions.

A specified recipient's no-inclusion would result from hybridity only to the extent that no-inclusion would not occur if the specified recipient's tax law treated the payment as interest or royalty, as applicable. For example, a royalty payment made to a hybrid entity in the United Kingdom (UK) qualifying for a low tax rate under the UK patent box regime could be denied a deduction in the US under the Section 267A statutory language. The low UK tax rate, however, results from the lower rate on patent box income and not from any hybrid arrangement. When no link exists between hybridity and the D/NI outcome, the deduction is not disallowed.

Disregarded payments would also be treated as disqualified hybrid amounts to the extent they exceeded dual inclusion income (as defined in Prop. Reg. Section 1.267A-2(b)(3)). A disregarded payment is a specified payment to the extent that, under foreign tax law, the payment is not regarded and, if the payment were regarded, the tax resident or taxable branch receiving the payment would include the payment in income. Such payments would generally give rise to a D/NI outcome because they are regarded under the payer's tax law and are therefore available to offset income not taxable to the payee, but are disregarded under the payee's tax law and therefore are not included in income. For example, a disregarded payment includes a specified payment made by a domestic corporation to its foreign owner if, under the foreign tax law, the domestic corporation is a disregarded entity and therefore the payment is not regarded by the foreign owner. Disregarded payments also include payments that give rise to deductions or similar offsets to a tax resident or taxable branch or a group of related entities under a foreign consolidation, fiscal unity, group relief, loss sharing or similar regime.

"Deemed branch payments" may also constitute disqualified hybrid amounts. The Proposed Regulations define a deemed branch payment as interest or royalties deemed paid by the US PE of a treaty country resident to its home office (or another branch of the home office) under the income tax treaty between the US and the home office country, and allowable as a deduction in computing the business profits of the US PE. When a specified payment is a deemed branch payment, it is a disqualified hybrid amount if the home office's tax law provides an exclusion or exemption from income attributable to the branch and does not otherwise take the deemed payment into account. In these cases, a deductible payment would be deemed made but that payment would not be taken into account under the home office's tax law, therefore giving rise to D/NI outcome.

In general, payments made to reverse hybrids would also be treated as disqualified hybrid amounts to the extent an investor in the reverse hybrid did not include the payment in income under its tax law and the investor's no inclusion resulted from the payment being made to the reverse hybrid. A reverse hybrid means an entity that is 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 in the entity. These payments may result in a D/NI outcome because the reverse hybrid is not a tax resident of the country in which it is established, and the investor in the reverse hybrid does not derive the payment under its tax law. Because this D/NI outcome may occur regardless of whether the establishment country is a foreign country or the US, the Proposed Regulations provide that both foreign and domestic entities may be reverse hybrids. While the Proposed Regulations use the principles of Reg. Section 1.894-1(d)(3) to determine whether an entity is fiscally transparent under its country's laws with respect to an item of income, the term "domestic reverse hybrid" in Reg. Section 1.894-1(d)(2)(i) is not the same as the term "reverse hybrid" in the Proposed Regulations; i.e., a "domestic reverse hybrid" for Section 894 purposes is a domestic entity that is treated as *not* fiscally transparent for US tax purposes but as fiscally transparent under the laws of the interest holder's country.

Similarly, branch mismatch payments can be characterized as a disqualified hybrid amount. A branch mismatch payment is a specified payment that, under the home office's tax law, is treated as attributable to a branch of the home office, and, under the tax law of the branch country, either (A) the home office does not have a taxable presence in the country (i.e., the branch is not a taxable branch), or (B) the specified payment is treated as attributable to the home office and not the branch. Such payments would give rise to a D/NI outcome due to differences between the home office's tax law and the branch's tax law regarding the allocation of items of income or the treatment of the branch. This could occur, for example, if the home office's tax law views a payment as income attributable to the branch and exempts the branch's income, but the branch's tax law does not tax the payment.

Example of a branch mismatch payment

FX, a country X resident, holds all the interests of US1, a US resident, and FZ, a country Z resident. FZ owns USB, a US branch that gives rise to a taxable presence in the United States under country Z tax law but not under US tax law. In Year 1, US1 pays $50x to FZ and this amount is treated as a royalty for US tax purposes and country Z tax purposes. Under country Z tax law, the $50x is treated as income attributable to USB and, as a consequence of country Z tax law exempting income attributable to a branch, is excluded from FZ's income.

US1's payment is a branch mismatch payment because country Z treats the payment as income attributable to USB, and USB is not a taxable branch (that is, under US tax law, USB does not give rise to a taxable presence). Further, FZ's $50x no-inclusion results from the payment being a branch mismatch payment because, were the payment not treated as income attributable to USB for country Z tax purposes, FZ would include $50x in income and, consequently, the no-inclusion would not occur. Thus, US1 is disallowed a deduction for the $50 payment under Section 267A.

The Proposed Regulations would treat a specified payment as a disqualified hybrid amount if a D/NI outcome occurred as a result of hybridity in *any* foreign jurisdiction, even if the payment were included in income in another foreign jurisdiction. Absent such a rule, an inclusion of a specified payment in income in a jurisdiction with a generally applicable low rate might discharge the application of Section 267A even though a D/NI outcome occurs in another jurisdiction as a result of hybridity. The Treasury Department and the IRS have requested comments on whether an exception should apply if the specified payment is included in income in any jurisdiction, taking into account accommodation transactions involving low-tax entities.

In determining whether a specified payment is a disqualified hybrid amount, the Proposed Regulations would generally only consider the tax laws of tax residents or taxable branches that are related to the specified party. Related status would be determined under the rules of Section 954(d)(3) (but without regard to downward attribution), and also include entities that are disregarded for US federal tax purposes. To prevent hybrid arrangements involving unrelated parties designed to give rise to D/NI outcomes, the Proposed Regulations generally provide that the tax law of an unrelated tax resident or taxable branch is taken into account for purposes of Section 267A if the unrelated party is a party to a structured arrangement (discussed later). The Proposed Regulations would impute an entity's participation in a structured arrangement to its investors, even if its investors have no knowledge of the structured arrangement; according to the Preamble, this means that, if a partnership is a party to a structured arrangement under which a specified payment is made, a tax resident that is a partner in that partnership is also a party to the structured arrangement.

Prop. Reg. Section 1.267A-3: Income inclusions and amounts not treated as disqualified hybrid amounts

Prop. Reg. Section 1.267A-3 provides rules for determining the "no-inclusion" aspect of a D/NI outcome. Generally, for purposes of Section 267A, a tax resident or taxable branch includes in income a specified payment to the extent that, under the tax law of the tax resident or taxable branch, (i) it includes (or will include, during a tax year ending no more than 36 months after the end of the specified party's tax year) the payment in its income or tax base at the full marginal rate imposed on ordinary income; and (ii) 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 each type of payment (for example, a participation exemption, a dividends received deduction, or a deduction or exclusion for a particular category of income, such as a patent box regime). This rule is subject to both de minimis (10% or less) and deemed full (90% or greater) inclusion rules.[3]

Under Section 267A, a tax resident or taxable branch generally includes a specified payment in income to the extent that the applicable tax law requires the resident or branch to:

> Certain specified payments that would otherwise constitute disqualified hybrid amounts (tentative disqualified hybrid amounts) generally would be reduced to the extent (i) the specified recipient is a US tax resident or a US taxable branch and takes the tentative disqualified hybrid amount into account in its gross income; (ii) the amount is includible in subpart F income (determined without regard to properly allocable deductions of the CFC and qualified deficits under Section 952(c)(1)(B)); or (iii) the amount is included in a US shareholder's GILTI amount. These rules would ensure that a specified payment is not a disqualified hybrid amount to the extent it is included in the income of a tax resident of the US or US taxable branch, or taken into account by a US shareholder under the subpart F or GILTI rules.

Prop. Reg. Section 1.267A-4: Disqualified imported mismatch amounts

Deductions for specified payments that do not meet the definition of a disqualified hybrid amount may still be disallowed to the extent the payment is a disqualified imported mismatch amount. A specified payment is a disqualified imported mismatch amount to the extent that (under set-off rules described later) 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 making the payment (or that is a party to a structured arrangement under which the payment is made). The rule addresses "indirect" offsets to take into account, for example, structures involving intermediaries when the foreign tax resident receiving the specified payment differs from the foreign tax resident incurring the hybrid deduction.

A hybrid deduction means, with respect to a tax resident or taxable branch that is not a specified party, a deduction allowed to the tax resident or taxable branch under its tax law for an amount paid or accrued that is interest or a royalty under such law, to the extent that a deduction for the amount would be disallowed if that tax law contained rules substantially similar to those under the Proposed Regulations. It is not relevant for these purposes whether the amount is recognized as interest or a royalty under US law, or whether the amount would be allowed as a deduction under US law. For example, a royalty deduction under foreign tax law may constitute a hybrid deduction even though for US tax purposes the royalty is viewed as made from a disregarded entity to its owner, and therefore is not regarded. According to the Preamble, this requirement is intended to limit the application of the imported mismatch rule to cases in which, had the foreign-to-foreign hybrid arrangement instead involved a specified party, Section 267A would have applied to disallow the deduction. A hybrid deduction also means, with respect to a person that is not a "specified party" (i.e., not a US resident, a US taxable branch, or a CFC), a deduction allowed for equity, e.g., a notional interest deduction.

A hybrid deduction would directly or indirectly offset the income attributable to an imported mismatch payment to the extent the payment directly or indirectly funded the hybrid deduction. Special ordering rules would apply for purposes of determining the extent to which a hybrid deduction directly or indirectly offset income attributable to imported mismatch payments. For purposes of determining the extent that income attributable to an imported mismatch payment was directly or indirectly offset by a hybrid deduction, an amount paid or accrued by a tax resident or taxable branch that is not a specified party would be deemed to be an imported mismatch payment to the extent that (1) the tax law of such tax resident or taxable branch contained hybrid mismatch rules, and (2) the tax resident or taxable branch would be

denied a deduction for all or a portion of the amount under a provision of the hybrid mismatch rules substantially similar to this section.

Further, a hybrid deduction for a particular accounting period includes a loss carryover from another accounting period, to the extent that a hybrid deduction incurred in an accounting period beginning on or after 20 December 2018, comprises the loss carryover.

Example of an imported mismatch

FX, a country X resident, owns all the interests in FW, a Luxembourg resident, and FW owns all the interests in US1, a US resident. Each of FX, FW and US1 are classified as corporations for US tax purposes. FX holds instrument that is issued by FW and treated as equity for country X purposes, but as debt for Luxembourg purposes (the FX-FW instrument). FW holds an instrument that is issued by US1 and treated as debt for both Luxembourg and US tax purposes.

In Year 1, FW pays $100x to FX under the FX-FW instrument. The amount is treated as an excludible dividend for country X tax purposes (by reason of the country X participation exemption) and as interest for Luxembourg tax purposes. Also in Year 1, US1 pays $100x to FW under the FW-US1 instrument. The amount is treated as interest for Luxembourg and US tax purposes and is included in FW's income.

Under the imported mismatch rule, US1's $100x payment is a disqualified imported mismatch payment to the extent that the income attributable to the payment is directly or indirectly offset by a hybrid deduction. Under the Proposed Regulations, US1's $100x payment would be treated as directly funding FX's hybrid deduction because FW incurs at least $100x of hybrid deduction. Accordingly, the entire $100x payment is a disqualified imported mismatch and, as a result, US1's deduction for the payment is disallowed under Section 267A.

The Proposed Regulations reach this result regardless of whether the FX-FW instrument was entered into under the same plan or series of related transactions under which the FW-US1 instrument was entered into.

Prop. Reg. Section 1.267A-5: Definitions and special rules

The Preamble to the Proposed Regulations acknowledges that no generally applicable regulations or statutory provisions exist addressing when financial instruments are treated as debt for US federal income tax purposes, or when a payment is interest. Instead, the Preamble refers to the general debt-equity factors in Notice 94-47, 1994-1 C.B. 357, and reverts to the traditional definition of "interest" as compensation for the use or forbearance of money. The Proposed Regulations themselves, however, further define "interest" in a manner consistent with the definition used in Prop. Reg. Section 1.163(j)-1(a)(20), in part to address instruments that the Preamble references as indebtedness "in substance although not form."

Similarly, Section 267A does not define the term "royalty" and there is no universal definition under the Code. To provide certainty on the application of Section 267A to these payments, the Proposed Regulations provide a definition of "royalty" that generally is based on the definition used in tax treaties and, in particular, the definition incorporated into Article 12 of the 2006 US Model Income Tax Treaty.

Prop. Reg. Section 1.267A-5 also coordinates the application of Section 267A with other provisions of the Code and regulations that affect the deductibility of interest and royalties, generally providing that Section 267A applies after the application of other provisions of the Code and regulations. For example, an amount deferred under Section 267(a)(3) is tested for disallowance under Section 267A in the tax year in which the amount is paid and thus would otherwise be allowable under Section 267(a)(3). Conversely, Section 267A would apply before determining whether any interest payment is deductible under Section 163(j).[4]

The Proposed Regulations would also treat a US taxable branch (including a PE of a foreign person) as a specified party, and provide rules regarding interest or royalties considered paid or accrued by a US taxable branch, solely for purposes of Section 267A. Under this approach, interest or royalties considered paid or accrued by a US taxable branch would be specified payments subject to the Proposed Regulations.

In addition, the Proposed Regulations provide that foreign currency gain or loss recognized under Section 988 is not separately taken into account under Section 267A. Instead, such gain or loss would be taken into account under Section 267A only to the extent that the specified payment is in respect of accrued interest or an accrued royalty for which a deduction is disallowed under Section 267A. Thus, for example, a Section 988 loss recognized with respect to a specified payment of interest is not separately taken into

account under Section 267A. In addition, disallowance of a deduction under Section 267A does not affect whether or when the amount paid or accrued reduces earnings and profits.

The Proposed Regulations define a "structured arrangement" as an arrangement in which one or more specified payments would be a disqualified hybrid amount if the payment were analyzed without regard to whether it is made between related parties, if either (1) the hybrid mismatch is priced into the terms of the arrangement, or (2) based on all the facts and circumstances, the hybrid mismatch is a principal purpose of the arrangement.[5]

Finally, the Proposed Regulations contain an anti-avoidance rule under which a deduction for a "structured payment" (certain interest equivalent payments, such as debt-issuance costs) will be disallowed to the extent the payment (or income attributable to the payment) is not included in the income of a tax resident or taxable branch, and a principal purpose of the plan or arrangement is to avoid the purposes of the Proposed Regulations.

Prop. Reg. Section 1.267A-7: Applicability dates

The Proposed Regulations under Section 267A would generally apply to tax years beginning after 31 December 2017. The following provisions, however, would apply to tax years beginning on or after 20 December 2018: (1) Prop. Reg. Section 1.267A-2(b) (disregarded payments), (c) (deemed branch payments), and (e) (branch mismatch payments); (2) Prop. Reg. Section 1.267A-4 (disqualified imported mismatch amounts); and (3) Prop. Reg. Section 1.267A-5(b)(5) (application to structured payments). In addition, Prop. Reg. Section 1.267A-5(a)(20) (defining structured arrangements), as well as the portions of Prop. Reg. Sections 1.267A-1 through 1.267A-3 that relate to structured arrangements, would apply to tax years beginning on or after 20 December 2018. Thus, certain portions of the regulations may not apply to a calendar-year taxpayer's 2018 tax year.

Section 245A(e)

The TCJA added Section 245A(e) to the Code to address issues of hybridity by introducing a hybrid dividends provision, which disallows a dividend received deduction (DRD) for any dividend 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 allowable, and for which the CFC received a deduction (or other tax benefit) for any income, war profits, or excess profits taxes imposed by any foreign country or US possession. The Proposed Regulations provide rules for identifying and tracking such hybrid dividends, and set forth common standards for identifying hybrid deductions.

The Proposed Regulations define "hybrid dividend" consistent with the statute, but introduce the concept of "hybrid deduction accounts." Generally, the amount of any hybrid dividend would be limited to the sum of a US shareholder's hybrid deduction accounts for each share of the CFC's stock. The hybrid deduction account for the share would generally reflect the amount of hybrid deductions of the CFC allocated to the share.

A "hybrid deduction" of a CFC means a deduction or other tax benefit that is allowed to the CFC or to a person related to the CFC under a relevant foreign tax law, and the deduction or other tax benefit relates to or results from an amount paid, accrued, or distributed with respect to an instrument issued by the CFC and treated as stock for US tax purposes. Thus, there must be a connection between the deduction or other tax benefit under the relevant foreign tax law and the instrument that is stock for US tax purposes. Accordingly, a hybrid deduction includes an interest deduction under a relevant foreign tax law with respect to a hybrid instrument (e.g., stock for US tax purposes, indebtedness for foreign tax purposes). It does not include, for example, an exemption provided to a CFC under its tax law for certain types of income, because no connection exists between the tax benefit and the instrument that is stock for US tax purposes. In addition, the deduction must be "allowed" under the foreign tax law. Accordingly, if the relevant foreign tax law contained hybrid mismatch rules under which a CFC would be denied a deduction for an amount of interest paid with respect to a hybrid instrument, then the payment of interest would not give rise to a hybrid deduction.

Hybrid deductions would be allocated to a share of CFC stock to the extent that the hybrid deduction related to an amount paid, accrued or distributed by the CFC with respect to the share. Hybrid deductions with respect to equity, however, such as notional interest deductions, would be allocated to all shares of the CFC pro-rata, based on the value of the shares. Certain rules would apply to maintain the hybrid deduction account. In addition, special rules would apply to acquisitions of CFC stock to which hybrid deduction accounts were attributable, including exchanges to which Sections 354 or 356 applied, Section 332 liquidations, and

certain recapitalizations under Section 368(a)(1)(E). Hybrid deduction accounts generally would be maintained in the CFC's functional currency.

Special rules would apply for certain dividends attributable to earnings of lower-tier foreign corporations. For purposes of Section 245A(e), the Proposed Regulations would treat gain that a domestic corporation recognized as a dividend under Section 1248 from a sale or exchange of foreign corporation stock as follows:

- The earnings and profits would be treated as a dividend distributed by the lower-tier CFC directly to the domestic corporation to the extent the lower-tier CFC's earnings and profits gave rise to a dividend under Section 1248
- The hybrid deduction accounts for shares of the lower-tier CFC that were indirectly held by the domestic corporation would be treated as belonging to the domestic corporation

Amounts received by a US shareholder from a CFC would be accounted for under Section 245A(e) in the order in which they were received.

In addition, the Proposed Regulations provide guidance on hybrid dividends of tiered corporations (tiered hybrid dividends). A tiered hybrid dividend means an amount received by a CFC from another CFC to the extent that the amount would be a hybrid dividend under the Proposed Regulations. The amount would have to be treated as a dividend under US tax law to be treated as a tiered hybrid dividend. In general, if a CFC (the receiving CFC) received a tiered hybrid dividend from another CFC, and a domestic corporation were a US shareholder in both CFCs, then the tiered hybrid dividend would be treated as subpart F income of the receiving CFC, the US shareholder would have to include in gross income an amount equal to its pro rata share of the subpart F income, and the rules of Section 245A(d) would apply to disallow associated foreign tax credits or deductions.

The Proposed Regulations also provide guidance on distributions of PTI by a first-tier CFC to its US shareholder, and to tiered hybrid dividend payments of PTI. Generally, distributions of PTI are excluded from gross income of a US shareholder when distributed under Section 959(a). As a result, distributions from a CFC to its US shareholder out of PTI are not eligible for the Section 245A DRD. Accordingly, Section 245A(e) does not apply. Similarly, distributions of PTI from a lower-tier CFC to an upper-tier CFC are excluded from gross income of the upper-tier CFC under Section 959(b), but only for purposes of Section 951(a), and such amounts continue to be treated as dividends under Section 959(d). Thus, absent the Proposed Regulations, these dividends could be treated as tiered hybrid dividends resulting in an income inclusion for the US shareholder. To prevent this result, the Proposed Regulations provide that a tiered hybrid dividend does not include amounts described in Section 959(d).

The Proposed Regulations would permit the IRS to make appropriate adjustments, including adjustments that would disregard the transaction or arrangement, if a transaction or arrangement were undertaken with a principal purpose of avoiding the purposes of Section 245A(e). For example, if a transaction or arrangement is undertaken to affirmatively fail to satisfy the holding period requirement under Section 246(c)(5), with a principal purpose of avoiding the tiered hybrid dividend rules, the transaction or arrangement may be disregarded.

The Proposed Regulations under Section 245A(e) would generally apply to distributions made after 31 December 2017.

Information reporting under Section 6038, 6038A, and 6038C

The Proposed Regulations would require a specified payment for which a deduction is disallowed under Section 267A, as well as hybrid dividends and tiered hybrid dividends under Section 245A, to be reported on the appropriate reporting form in accordance with Sections 6038 and 6038A. These rules would apply to information for annual accounting periods or tax years, as applicable, beginning on or after 20 December 2018.

Section 1503(d) and 7701

Section 1503(d) and its regulations generally provide that, subject to certain exceptions, a dual consolidated loss of a corporation cannot reduce the taxable income of a domestic affiliate (a domestic use). The general prohibition against the domestic use of a dual consolidated loss does not apply if, under a "domestic use election," the taxpayer certifies that there has not been and will not be a "foreign use" of the dual consolidated loss during a certification period. A foreign use occurs when any portion of the dual consolidated loss is made available to offset the income of a foreign corporation or the direct or indirect owner of a hybrid entity.

Entities classified as domestic reverse hybrids were not subject to limitations under Section 1503(d) because a domestic reverse hybrid is neither (1) a dual resident corporation, nor (2) a separate unit of a domestic

corporation. These structures were used to produce double-deduction outcomes because deductions incurred by the domestic reverse hybrid could be used (1) under US tax law to offset income that is not subject to tax in the foreign parent's country, and (2) under the foreign parent's tax law to offset income not subject to US tax.

The Treasury Department and the IRS determined that these structures are inconsistent with the principles of Section 1503(d). Accordingly, the Proposed Regulations include rules under Sections 1503(d) and 7701 to prevent the use of these structures to obtain a double deduction. Specifically, the Proposed Regulations would require, as a condition to a domestic entity electing to be treated as a corporation under Reg. Section 301.7701-3(c), that the domestic entity consent to be treated as a dual resident corporation for purposes of Section 1503(d) for tax years in which two requirements are satisfied: (1) a "specified foreign tax resident" (generally, a body corporate that is a tax resident of a foreign country) under its tax law derives or incurs items of income, gain, deduction, or loss of the domestic consenting corporation, and (2) the specified foreign tax resident is related to the domestic consenting corporation (as determined under Sections 267(b) or 707(b)).

Modified example from Proposed Regulations

FZ, a country Z resident, owns all the interest in DCC, a US entity that is classified as a corporation for US tax purposes and is fiscally transparent for country Z tax purposes. In Year 1, DCC's only item of income, gain, deduction and loss is a loss of $100, and FZ's only item of income, gain, deduction, or loss, other than the $100x loss attributable to DCC, is $60x of operating income.

DCC is a domestic consenting corporation because, by electing to be classified as an association, it consents to be treated as a dual resident corporation for purposes of Section 1503(d). Further, because FZ derives items of income, gain, deduction and loss of DCC, DCC is treated as dual resident corporation in Year 1. Thus, DCC has a $100x dual consolidated loss for Tax Year 1 and, because the loss is available to, and in fact does, offset income of FSZ1 under Country Z tax law, there is a foreign use of the dual consolidated loss in Year 1.

The Proposed Regulations treating "domestic consenting corporations" as dual resident corporations would apply to tax years ending on or after 20 December 2018. The proposed amendments to Reg. Sections 301.7701-3(a) and (c)(3) would 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). The Proposed Regulations provide a transition rule for domestic eligible entities that existed before the publication of the Proposed Regulations. Such domestic eligible entities would be deemed to consent to be treated as a dual resident corporation for tax years beginning after 20 December 2019.

Certain other changes to the dual consolidated loss regulations, in particular some relief under the mirror rule and for triggering events for compulsory transfers, are proposed. In addition, the Preamble to the Proposed Regulations indicates that Treasury and the IRS are considering further changes to the dual consolidated loss regulations and, in particular, whether payments that are disregarded for US tax purposes should be brought within the scope of the regulations, giving the fact pattern in Example 23 at Treas. Reg. 1.1503(d)-7(c) as an example of their concern.

Implications

These Proposed Regulations are the first guidance issued under new Sections 245A and 267A. In addition to providing necessary definitions and mechanical rules, they provide directional guidance as to how broadly the IRS and Treasury intend to view the grant of regulatory authority provided in Section 267A(e) (in some cases, such as the definition of interest, quite broadly).

Helpfully, the Proposed Regulations would clarify that GILTI-tested income will be exempt from the definition of disqualified related party amount to the same extent as other subpart F inclusions. For hybrid arrangements with a D/NI outcome, the Proposed Regulations would clarify that denial of an interest or royalty deduction depends on whether the outcome results from hybridity rather than a general feature of a country's tax laws.

For example, the Preamble states that a royalty payment to a hybrid entity qualifying for a low rate under the UK patent box regime would not be disallowed under Section 267A since it is the patent box regime that yields the D/NI outcome and the low UK rate is available to taxpayers regardless of whether they are organized as hybrid entities.

Also helpful is the clarification that a payment to a foreign reverse hybrid would not be within scope to the extent the item is taken into account under 894 principles (some had been concerned that any payment to a related foreign

reverse hybrid could be problematic because, under the statutory language, the reverse hybrid would not itself include the payment in income, although in many cases its investors would). Less helpful is the definition of "structured transaction," which, while providing some clarity to a previously undefined term, adds uncertainty for taxpayers by including a principal purpose test (one among several issued under TCJA proposed regulations), and imputes structured arrangement treatment to an entity's investors even when they lack knowledge of the structured arrangement.

Other areas of uncertainty include the scope of the imported mismatch rules, which, while modeled on the imported mismatch rule in Action 2 of OECD's BEPS project, require a detailed understanding of foreign tax law as well as what would be considered "substantially similar" to the rules of Section 267A.

The tracking required by the new hybrid deduction account rules would add significant complexity to the application of Section 245A(e). Notably, this approach differs from what was suggested in Action 2 of the BEPS project, which would mandate an income inclusion to the US parent corporation at the time the deduction is permitted under foreign law.

The inclusion of the new proposed DCL regulations in this package was not entirely unexpected, given the language in the Preamble of the 2007 DCL regulations identifying the ability to use domestic reverse hybrids to achieve deductions in two jurisdictions; interestingly, these Proposed Regulations would use the entity classification election rules to achieve a result that, according to prior guidance, Section 1503(d) alone could not. The proposed changes to the mirror legislation rules are helpful in light of other jurisdictions, such as the UK, that have recently implemented their own anti-hybrid provisions; however, that the IRS and Treasury are considering changing the treatment of disregarded payments for DCL purposes is an issue that warrants close attention.

Comments are requested on various aspects of the Proposed Regulations, including (1) whether Section 267A should not apply if a specified payment is included in income in any foreign jurisdiction, taking into account accommodation transactions involving low-tax entities, (2) whether there should be special rules under Section 267A when withholding taxes are imposed in connection with a specified payments, (3) the definition of interest and royalty for purposes of Section 267A, (4) whether a different threshold for the de minimis exception in Section 267A is more appropriate, and (5) the treatment of disregarded payments under the dual consolidated loss regulations. Comments must be received by 26 February 2019 (i.e., 60 days after the date the proposed regulations were published in the Federal Register).

Endnotes

1 All "Section" references are to the Internal Revenue Code of 1986, and the regulations promulgated thereunder.

2. Currency references in this Alert are to US$.

3. Specifically, Prop. Reg. Section 1.267A-3(a)(4) considers a preferential rate, exemption, exclusion, deduction, credit, or similar relief particular to a type of payment that reduces or offsets 90% or more of the payment to reduce 100% of the payment. Such items that reduce or offset 10% or less of the payment are considered to reduce or offset none of the payment.

4. The proposed regulations under Section 163(j) do not consider interest that is permanently disallowed under Section 267A as "business interest expense" for Section 163(j) purposes.

5. The Proposed Regulations include a non-exclusive list of facts and circumstances indicative of a principal purpose: marketing the arrangement as tax-advantaged, features altering the return on the arrangement if the hybrid mismatch ceases to be available, or a below-market return absent the benefits of the hybrid mismatch.

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