Preliminary highlights from the final anti-hybrid regulations and related proposed regulations

April 9, 2020

In brief

Treasury and the IRS on April 7, 2020 published regulations that finalize 2018 proposed regulations addressing anti-hybrid rules under Sections 245A(e), 267A, and 1503(d). On the same date, Treasury and the IRS issued additional proposed regulations under Sections 245A(e), 881 (with respect to the anti-conduit regulations), and 951A.

PwC is in the process of reviewing the final regulations in detail; some of the key highlights we have identified thus far are set forth below. An in-depth Insight on the final regulations will be published in the coming days. In addition, we will discuss the anti-hybrid guidance on a PwC webcast scheduled for April 17 at 2:00 pm ET.

In detail

Background

As noted in prior PwC Insights, Section 245A generally allows a 100% dividends received deduction (DRD) for the foreign-source portion of dividends received by a US corporation from foreign corporations with respect to which it is a 10% US shareholder. Section 245A(e), however, denies the DRD for any amount received by a US shareholder from a controlled foreign corporation (CFC) for which the CFC receives a deduction or other tax benefit for foreign income tax purposes (a hybrid dividend). If a CFC receives a hybrid dividend from another CFC, generally the dividend is treated as subpart F income and any US shareholder of both CFCs must include in gross income an amount equal to the shareholder's pro rata share of the dividend. The 2018 proposed regulations provided key guidance on mechanics for the application of Section 245A(e) and the application of Section 245A for hybrid dividends of tiered corporations, and provided for the establishment and maintenance of 'hybrid deduction accounts' with respect to shares of CFC stock.

Section 267A permanently disallows a deduction for interest and royalty amounts paid or accrued to a foreign related party of the payor if those payments are not included in the income of the recipient under its tax law and are paid pursuant to a hybrid arrangement (i.e., the recipient jurisdiction does not treat the payment as interest or royalties) or by or to a hybrid entity, unless the non-inclusion is not the result of hybridity. The 2018 proposed regulations set up a comprehensive framework for applying these rules, including providing rules that (1) limit the types of taxpayers subject to Section 267A, (2) provide when an amount is treated as not included in income by the recipient, (3) define disallowed hybrid deductions and the types of hybrid entity structures that are subject to disallowance, (4) apply Section 267A to certain branch mismatch structures, and (5) deny deductions for payments that are included in the recipient's income but are indirectly offset by hybrid deductions via an imported mismatch.

Section 951A requires a US shareholder to include in income the global intangible low-taxed income (GILTI) of its CFCs. While the full amount of GILTI is includible in the US shareholder's income, such GILTI inclusion is reduced through a 50% deduction in tax years beginning after December 31, 2017, and before January 1, 2026 (and a 37.5% deduction in tax years beginning after December 31, 2025). On June 14, 2019, Treasury and the IRS released the 2019 final sec. 951A regulations, which generally provided guidance relating to the mechanics of determining a US shareholder's GILTI inclusion, including CFCs held through partnerships, and determining a GILTI inclusion on a consolidated basis and certain anti-avoidance rules related to tax years of CFCs beginning before December 31, 2017 and ending after January 1, 2018.

Highlights from the final regulations

Hybrid dividends under Treas. Reg. sec. 1.245A(e)-1

The final sec. 245A(e) regulations, published April 7 retain the overall structure and basic approach of the 2018 proposed sec. 245A(e) regulations. While the preamble acknowledges various comments submitted by taxpayers, the majority of such comments were not adopted in the final sec. 245A(e) regulations.

The following summary is limited to discussing the provisions that were modified or revised by the final sec. 245A(e) regulations.

Note: A detailed discussion for any provision not covered in this Insight (because the final regulations adopted the 2018 proposed sec. 245A(e) regulations without change) can be found in our prior Insight discussing the 2018 proposed sec. 245A(e) regulations.

Definition of 'foreign deduction or other tax benefit'

Treasury and the IRS received various comments to the 2018 proposed sec. 245A(e) regulations with respect to the determination of whether, under foreign tax law, a 'foreign deduction or other tax benefit' was received by the relevant CFC and thus such amounts give rise to hybrid deductions. In addressing such comments, Treasury and the IRS clarified the following:

- *No limitation to current year.* Whether a given foreign deduction or other tax benefit is allowed to the relevant CFC (or related person) is not limited to the current tax year. Accordingly, foreign deductions or other tax benefits that are deferred may give rise to a hybrid deduction.
- *Foreign disallowance or limit based on percentage not relevant.* Foreign tax law may suspend or otherwise disallow a given deduction or other tax benefit under a thin capitalization rule or a rule similar to Section 163(j). The final sec. 245A(e) regulations provide that the determination of whether a foreign deduction or other tax benefit is allowed to a CFC (or related person) is made without regard to foreign rules that disallow or suspend deductions if a certain ratio or percentage is exceeded.
- *Foreign hybrid mismatch rules.* The final sec. 245A(e) regulations adopt a change to the 2018 proposed sec. 245A(e) regulations in order to more closely align with the OECD/G20 report on hybrid mismatches and to resolve potential circularity with foreign law. The final sec. 245A(e) regulations provide that the disallowance of a deduction under a foreign hybrid mismatch rule is not relevant for purposes of determining whether a CFC is allowed a deduction if there is close temporal proximity to the actual payment of a distribution. Specifically, the determination of whether foreign law

allows a deduction or other tax benefit is made without regard to the application of foreign hybrid mismatch rules if an amount gives rise to a dividend for US tax purposes or is reasonably expected to give rise to a dividend that will be paid within 12 months after the taxable period in which the deduction or other tax benefit is allowed.

- *Notional interest deductions (NIDs).* The final sec. 245A(e) regulations confirm that NIDs give rise to hybrid deductions, regardless of whether an actual payment, accrual or distribution occurs. However, the final sec. 245A(e) regulations provide for a delayed effective date such that only NIDs allowed to a CFC for tax years beginning on or after December 20, 2018 are hybrid deductions.
- *Subnational law may need to be considered.* The final sec. 245A(e) regulations provide that for purposes of determining the 'relevant foreign tax law', the tax law of a subnational authority (e.g., a state, province, or canton of the country) is treated as a relevant foreign tax law of a foreign country for purposes of Section 245A(e) if taxes imposed by the subnational authority are covered taxes under an income tax treaty with the United States.

Maintenance of hybrid deduction account

In general, the Treasury and IRS concluded that the hybrid deduction account approach under the 2018 proposed sec. 245A(e) regulations carries out the purpose of Section 245A(e) and prevents avoidance of Section 245A(e). However, Treasury and the IRS received various comments with respect to the maintenance of hybrid deduction accounts. In addressing such comments, Treasury and the IRS clarified the following:

- *No maintenance of hybrid deduction account for technical CFCs*. Treasury and the IRS have determined in situations where no domestic corporation owns, within the meaning of Section 958(a), stock in an upper-tier CFC (a 'Technical CFC'), a tiered hybrid dividend would result in no meaningful US tax consequence because no US shareholder would have a subpart F inclusion. The final sec. 245A(e) regulations provide that an upper-tier CFC is a specified owner of shares of lower-tier CFCs only if a domestic corporation that is a US shareholder owns, within the meaning of Section 958(a), stock in the upper tier CFC.
- *Section 355 transactions*. The final sec. 245A(e) regulations require the allocation of a shareholder's hybrid deduction account with respect to a distributing CFC in a manner consistent with how the earnings and profits of the distributing CFC are allocated between the distributing CFC and controlled CFC.
- *No succession to hybrid deduction accounts under Section 338(g)*. The final sec. 245A(e) regulations clarify that a new target does not succeed to a hybrid deduction account with respect to shares of stock in the old target because the new target does not inherit any of the earnings and profits of the old target. However, this rule does not apply with respect to carryover foreign target stock within the meaning of Treas. Reg. sec. 1.338-9(b)(3)(i).
- *Accounting for mid-year transfers of CFC stock.* The final sec. 245A(e) regulations provide additional guidance on how to account for mid-year transfers of CFC stock by using a proration approach based on the number of days in the pre-transfer period as compared to the total number of days in the CFC tax year.
- *No Subpart F inclusion for tiered hybrid dividend for individual.* The final sec. 245A(e) regulations confirm that a dividend from a lower-tier CFC to an upper-tier CFC only results in a tiered hybrid dividend with respect to a US domestic corporation.

Anti-hybrid Rules under Treas. Reg. Secs. 1.267A-1 through 1.267A-7

The final sec. 267A regulations retain the framework of the proposed sec. 267A regulations, but make numerous changes in response to comments. Each of the categories of payments that give rise to disallowance under the proposed rules is retained.

General definitions of hybrid and branch arrangements (Treas. Reg. sec. 1.267A-2)

The final sec. 267A regulations retain the general approach under the proposed sec. 267A regulations defining the various arrangements that give rise to a disqualified hybrid amount. The modifications made under the final sec. 267A regulations, among others, notably include several taxpayer-favorable rules.

- *Reasonable expectation standard for long-term deferral.* The proposed sec. 267A regulations generally treat an income inclusion that is deferred for more than 36 months as a no-inclusion result and a hybrid transaction (the 'long-term deferral' rule). The final sec. 267A regulations modify this rule such that whether long-term deferral exists may be determined on the basis of when the payment is reasonably expected to be included in the specified recipient's income at the time the payment is made.
- *Exemption for sale/license transactions.* The final sec. 267A regulations generally exempt a specified payment treated as a royalty for US tax purposes, but as consideration for the purchase of property for purposes of the tax law of the specified recipient, from giving rise to a hybrid transaction.
- *Certain exempt dividends treated as dual inclusion income.* For purposes of the definition of disregarded payments, the final sec. 267A regulations provide that an item of income does not fail to be dual inclusion income if, under the tax law of the recipient, the item is a dividend that is exempted from income inclusion by a relief particular to such an item (provided that the payor is not allowed a deduction for it under its tax law). A similar rule is provided with respect to dividends eligible for a dividend received deduction under the tax law of the payor.
- *Current-year distributions of a reverse hybrid.* The final sec. 267A regulations take into account current-year distributions for determining whether an investor in a reverse hybrid includes in income a payment made to the reverse hybrid, but only if the reverse hybrid distributes all of its income during the tax year.
- *Inclusion by taxable branch in the reverse hybrid's country.* For purposes of the reverse hybrid rule under Treas. Reg. sec. 1.267A-2(d), the final sec. 267A regulations provide relief with respect to payments made to a reverse hybrid that are included in the income of a taxable branch located in the country in which the reverse hybrid is created and the activities of which are carried on by one or more investors of the reverse hybrid.

Determination of whether an item is included in income (Treas. Reg. sec. 1.267A-3)

Section 267A generally only applies when a deductible item is not included in income by the recipient (D/NI), as determined under Treas. Reg. sec. 1.267A-3. Modifications in the final sec. 267A regulations modifications include the following:

- Clarified that a specified payment that constitutes, under the tax law of the specified recipient, a recovery of (i) basis with respect to stock or (ii) principal with respect to indebtedness can create a D/NI outcome.
- Provided a special rule pursuant to which a specified recipient's no-inclusion with respect to 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.
- Expanded on the rules providing that certain payments included in income under Sections 951 and 951A do not lead to a D/NI outcome, as well as added a new exception for specified payments received by a qualified electing fund (QEF) and taken into account by a US tax resident under Section 1293.

Imported mismatch rules (Treas. Reg. sec. 1.267A-4)

The imported mismatch rules address offshore hybrid arrangements that are funded by or connected to an otherwise deductible payment arising within the United States. The rules are intended to prevent a hybrid arrangement from being imported into the United States through the use of non-hybrid arrangements.

The final sec. 267A regulations retain the framework of the imported mismatch rules under the proposed sec. 267A regulations but provide a number of clarifications to facilitate compliance and administration of this complex set of rules.

- *Modification to the definition of imported mismatch payments*. The final sec. 267A regulations provide that a payment is an imported mismatch payment only if it is neither a disqualified hybrid amount nor included in income in the United States. The effect of this modification is that the subpart F, GILTI, or QEF exception could apply to exempt a payment from the imported mismatch rules.

- *Foreign hybrid mismatch rules.* The imported mismatch rules take into account a hybrid deduction outside of the United States only if such deduction would be disallowed if the relevant foreign tax law contained rules substantially similar to the Section 267A regulations. The final sec. 267A regulations prescribe an exclusive list of deductions that could constitute hybrid deductions when a foreign country has implemented its own hybrid mismatch rules, generally representing deductions that would be disallowed under Section 267A but may be allowed under the foreign law (e.g., deductions with respect to equity and interest-free loans).
- *Notional interest deductions (NIDs).* The final sec. 267A regulations retain the general approach under the proposed sec. 267A regulations with respect to NIDs (i.e., NIDs may constitute a hybrid deduction) but provide that the regulations only apply to NIDs allowed for an accounting period beginning on or after December 20, 2018. The final sec. 267A regulations also provide that NIDs are hybrid deductions only to the extent that the resulting double non-taxation is a result of hybridity, consistent with other aspects of the Section 267A regulations.
- *Dual inclusion income standard for certain deemed branch payments. The* imported mismatch rules under the final sec. 267A regulations apply the dual inclusion income standard used in Treas. Reg. sec. 1.267A-2(b) (regarding disregarded payments) to deemed branch payments in cases in which the tax law of the taxable branch permits a loss to be shared with a tax resident or another branch.
- *Hybrid deductions incurred by CFCs.* The final sec. 267A regulations provide that CFCs may incur hybrid deductions and make funded taxable payments, but generally carve out any payment that increases the US tax base (i.e., an amount that is a disqualified hybrid amount or included in income in the United States).
- *Setoff rules*. The final sec. 267A regulations contain several clarifications to the setoff rules that determine whether and to what extent an imported mismatch payment is considered as directly or indirectly funding a hybrid deduction. The modifications provide that, for purposes of the rule treating a hybrid deduction as first offsetting a factually related imported mismatch payment, factual relatedness exists only if a design of the plan or series of related transactions was for the hybrid deduction to offset the imported mismatch payment. In addition, in the context of multiple imported mismatch payments that are indirectly connected to a hybrid deduction, priority is given to the imported mismatch payment that is connected through the fewest number of funded taxable payments to the hybrid deduction. Further, the final sec. 267A regulations clarify that a payment is treated as a funded taxable payment only if it is included in the income of a tax resident or taxable branch.
- *Coordination with foreign imported mismatch rules.* The proposed sec. 267A regulations contain a deemed imported mismatch payment (deemed IMP) rule to coordinate with foreign imported mismatch rules to prevent the same hybrid deduction from causing the disallowance of a deduction in multiple jurisdictions. The final sec. 267A regulations make certain modifications to the application of the deemed IMP rule to ensure that a foreign imported mismatch rule does not turn off the US imported mismatch rule in cases in which the foreign rule is unlikely to apply to the hybrid deduction in question.

Treas. Reg. sec. 1.267A-5

Treas. Reg. sec. 1.267A-5 provides the definitions applicable to Section 267A, as well as certain special rules. Significant changes to the proposed regulations include the following:

- The definition of interest in the proposed sec. 267A regulations included not just interest, original issue discount, and other similar items, but broadly included any payment that could be treated as economically similar to interest or affecting the cost of borrowing, such as commitment fees paid to lenders, guarantee fees, or guaranteed payments. The final sec. 267A regulations provide a narrower definition of interest that excludes certain of these payments, subject to an anti-abuse rule.
- Section 267A generally requires that the specified party subject to Section 267A disallowance and any relevant specified recipient, branch, or investor be related or be party to a 'structured arrangement,' which was defined in the proposed sec. 267A regulations as an arrangement where the payment would be subject to disallowance if the parties were related and the arrangement is structured with a principal purpose of benefiting from the hybridity of the

arrangement. The final sec. 267A regulations clarify the definition of a structured arrangement and replace the principal purpose test with a test that asks whether the arrangement is designed to produce the hybrid mismatch. However, the final sec. 267A regulations also delay the effective date of disallowances in structured arrangements to tax years beginning after December 31, 2020.

- The final sec. 267A regulations clarify the coordination of Section 267A with other provisions of the Code that disallow or defer deductions, and provide that if a specified payment that would normally be capitalized and recovered through depreciation or amortization, cost of goods sold, or similar provisions is disallowed under Section 267A, such amount will not be included in basis or cost of goods sold.

Highlights from the proposed regulations

In addition to the final regulations described above, Treasury and the IRS released proposed regulations addressing (1) certain adjustments to hybrid deduction accounts for purposes of applying Section 245A(e), (2) certain anti-conduit rules under section 881, and (3) certain rules with respect to the allocation of deductions associated with 'gap' period prepayments in the computation of tested income under Section 951A.

Adjustments to hybrid deduction accounts under Prop. Reg. sec. 1.245A(e)-1

The 2020 proposed sec. 245A(e) regulations provide taxpayers a mechanism to reduce hybrid deduction accounts with respect to stock of a CFC to the extent that the earnings and profits of the CFC that were not subject to foreign tax (as a result of certain hybrid arrangements) are included in income (i.e.,not offset by a deduction or credit particular to the inclusion) under the anti-deferral provisions of subpart F, GILTI, or Section 956. Specifically, the hybrid deduction account with respect to a share of stock of a CFC is reduced by the following:

- *Adjusted subpart F inclusion*. Equal to the excess of (1) the sum of the pro rata share of subpart F income assigned to the share of stock and the current foreign income taxes allocable to the subpart F income grouping of the CFC, over (2) the current foreign income taxes allocable to the subpart F income groupings of the CFC divided by the US corporate income tax rate (21 percent).
- *Adjusted GILTI inclusion.* computed in a similar manner to the adjusted subpart F inclusion with adjustments to reflect the available Section 250 deduction with respect to GILTI inclusions, the 20% haircut for tested taxes under Section 960(d)(1), and adjustments to reflect the GILTI inclusion percentage described in Section 960(d)(2).
- *Section 956 inclusions.* Amounts included in the gross income of a domestic corporation under Section 956 by reason of the application of Section 245A(e) and the hypothetical distribution described in Treas. Reg. sec. 1.956-1(a)(2).

These rules generally apply, upon finalization, to tax years ending on or after the date of publication of the final regulations in the federal register. However, a taxpayer may apply the 2020 proposed sec. 245A(e) regulations to tax years before finalization of the regulations provided the rules are applied consistently in those taxable years.

Anti-conduit rules under Section 881

As a general matter, holding an equity interest does not constitute a financing transaction for purposes of the anti-conduit rules under Treas. Reg. sec. 1.881-3 unless such equity qualifies as 'Debt-Like Stock' under Treas. Reg. sec. 1.881-3(a)(2)(ii)(B)(1) - that is, as stock in a corporation (or a similar interest in a partnership, trust, or other person) that is subject to certain redemption, acquisition, or payment rights or requirements.

The proposed sec. 881 regulations create two new categories of equity that constitutes a financing transaction: (i) the issuer is allowed a tax benefit (i.e., a deduction) for an amount paid, accrued or distributed with respect to such interest (or deemed paid, such as under a NID) either under the laws of the issuer's country of residence or a country in which the issuer has a taxable presence (e.g., a permanent establishment); or (ii) a person related to the issuer is allowed a refund (including a credit) or similar tax benefit for taxes paid by the issuer to its country of residence, without regard to the related person's tax liability under the laws of the issuer.

The preamble makes clear that even if these rules cause an entity to be treated as an intermediate entity in a financing arrangement, the intermediate entity will not be a conduit entity unless the tests provided under Treas. Reg. sec. 1.881-3(a)(4)(i) (e.g., tax reduction test, tax avoidance plan test) also are satisfied.

The provisions under the proposed sec. 881 regulations apply to payments made on or after the date of publication of the final regulations.

Allocation of certain deductions related to 'gap' period prepayments to residual grouping - Prop. Reg. sec. 1.951A-2(c)(6)

Treasury and the IRS state that the rules found in the final sec. 951A regulations - which generally disregard any deduction or loss attributable to disqualified basis in specified property resulting from the transfer of the property to a related party during the disqualified period and require deductions attributable to disqualified basis to be allocated and apportioned to residual income - should be extended to cover other transactions for which similar timing differences can arise. Accordingly, Prop. Reg. sec. 1.951A-2(c)(6) requires that all deductions attributable to payments to a related CFC during the disqualified period should be allocated and apportioned to residual income consistent with the asset transfer rules under the final sec. 951A regulations.

The takeaway

The final regulations provide guidance related to the anti-hybrid provisions of Sections 245A(e) and 267A. They retain the overall architecture of the proposed regulations but make a number of changes that either clarify, expand, or narrow the reach of the proposed regulations and thus may impact how taxpayers are affected by these rules. In addition, the new proposed regulations will expand the reach of the anti-conduit regulations to impact financing arrangements that currently may not be in the scope of the regulations. Taxpayers should evaluate the impact of the final and proposed regulations on their businesses.

The above-mentioned highlights are not an exhaustive list of the provisions in the new final and proposed regulations. We expect to publish an in-depth Insight in the coming days.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

International Tax Services

Marty Hunter
(647) 449-8532
martin.p.hunter@pwc.com

Oren Penn
(202) 413-4459
oren.penn@pwc.com

Steve Nauheim
(202) 415-0625
stephen.a.nauheim@pwc.com

Transfer Pricing

Marco Fiaccadori
(202) 374-4981
marco.fiaccadori@pwc.com

David Ernick
(202) 734-9685
david.ernick@pwc.com

Joe Murphy
(301) 873-3646
w.joe.murphy@pwc.com

Mergers & Acquisitions

Karen Lohnes
(202) 236-2572
karen.lohnes@pwc.com

Julie Allen
(703) 965-9353
julie.allen@pwc.com